Supporting Papers December 2018

EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho

5 September 2016

External Reporting Board Policy for dealing with audit reports received under the Companies Act 1993 and the Financial Markets Conduct Act 2013

Purpose of the Policy

1. The Companies Act 1993 and the Financial Markets Conduct Act 2013 both require an auditor to send a copy of the audit report, and a copy of the financial statements or group financial statements, to the External Reporting Board (XRB), and other specified parties, if the financial reporting requirements of the respective Acts have not been complied with. However, the two Acts are silent on the purpose of the provisions and on the actions, if any, that the XRB (and the other specified parties) must take when it receives the audit reports.

2. This Policy sets out the processes that the Board of the XRB and its sub-Boards, the New Zealand Accounting Standards Board (NZASB) and the New Zealand Auditing and Assurance Board (NZAuASB), will follow when audit reports are sent to the XRB by auditors in accordance with the Companies Act 1993 and the Financial Markets Conduct Act 2013. The Policy also applies when audit reports are referred to the XRB by any other party.

Policy[1]

3. Audit reports received by the XRB will be reviewed by both the NZASB and the NZAuASB.

4. The NZASB's review will be focused on modified audit opinions in relation to material misstatements in the financial statements.

5. The NZAuASB's review will be focused on modified audit opinions in relation to when the auditor has been unable to obtain sufficient audit evidence.

6. Where the reviews raise issues or trends that relate to XRB strategy, these will be referred to the XRB Board for consideration.

7. Reviews by the NZASB and the NZAuASB will consider implications for the relevant standards by ensuring that the modified audit opinions do not raise any issue about the appropriateness, applicability, clarity and/or completeness of the relevant standards.

8. No action needs to be taken by the XRB, the NZASB or the NZAuASB if the modification of the audit opinion results from non-compliance by an entity of an otherwise appropriate standard (that is, a standard that is applicable, clear, complete and has

[1] The Background and Basis for the Policy is set out in Appendix 1.

appropriate accompanying guidance). Such non-compliance is a matter for the appropriate regulator to deal with.

9. Where the modification of the audit opinion has implications for standards, the NZASB and the NZAuASB will consider their respective standards' convergence and/or harmonisation policies. Matters raised may need to be addressed through, or in cooperation, relevant international standards Boards rather than unilaterally, or, where appropriate, through the provision of additional New Zealand guidance.

10. The actions that may be taken by the NZASB and/or the NZAuASB where the modified audit opinions have implications for any XRB standards include, for example:

    a. amend a domestic standard;
    b. raise an issue with the relevant international standards board;
    c. issue guidance; and/or
    d. re-examine the initial cost-benefit analysis undertaken when the relevant standard was developed.

11. Reviews by the XRB Board (when necessary) will consider the implications for the XRB strategy to ensure that the multi-standards, multi-tier system remains appropriate. The actions that the XRB Board may take where the modified audit opinions have implications for XRB strategy and/or the standards frameworks include, for example:

    a. Review the XRB strategy and/or standards frameworks;

    b. Refer a matter an appropriate party for their further action (for example, the regulators and/or policy makers);

    c. Refer a matter to the appropriate professional body after consultation with the regulators (for example in the rare and unusual circumstances where an audit qualification was considered to be incorrect);

    d. Engage with or liaise with policy makers and/or regulators;

    e. Engage with relevant organisations or industries directly and after consultation with the regulators, to determine the cause of the non-compliance, before taking any further action (for example, where the modified audit opinions indicate a trend of persistent non-compliance by a particular industry or with a particular standard); and/or

    f. Engage with auditors on their duties under the Companies Act 1993 and the Financial Markets Conduct Act 2013 to send audit reports with modified audit opinions to the XRB.

12. In each instance before the XRB Board takes any action, it would, where necessary, liaise with the regulators and/or policy makers.

Review of this Policy

13. This Policy will be reviewed every three years to ensure that it is still appropriate.

Appendix 1: Background and Basis for the Policy

Legislative provisions

1. The Companies Act 1993 and the Financial Markets Conduct Act 2013 both require an auditor to send a copy of the audit report, and a copy of the financial statements or group financial statements, to the XRB (and other specified parties) if the financial reporting requirements of the respective Acts have not been complied with. However, the two Acts are silent on the purpose of the provisions and on the actions, if any, that the XRB (and the other specified parties) must take when it receives the audit reports.

Companies Act 1993

2. Part 11 of the Companies Act 1993 specifies, among other matters, the requirements for a company's financial reporting and audit of its financial statements. It specifies the companies that must prepare financial statements, and that those financial statements must comply with generally accepted accounting practice (GAAP)[2]. Part 11 also specifies whose financial statements must be subject to audit and that the audit must be carried out in accordance with applicable auditing and assurance standards[3]. GAAP, applicable financial reporting standards and applicable auditing and assurance standards are defined in the Companies Act 1993 by reference to the Financial Reporting Act 2013. GAAP, applicable financial reporting standards and applicable auditing and assurance standards in the Financial Reporting Act 2013 refer to standards issued by the XRB[4].

3. Within Part 11, section 207C of the Companies Act 1993 provides that the auditor's report of a company must be sent to the Registrar of Companies and the XRB if the requirements of the Companies Act 1993 have not been complied with:

> "*If the auditor's report indicates that the requirements of this Act have not been complied with, the auditor must, within 7 working days after signing the report, send a copy of the report and a copy of the financial statements or group financial statements to which it relates to the Registrar and the External Reporting Board*".

4. In the context of the requirements of Part 11 of the Companies Act 1993 about audits of a company's financial statements, the reference to non-compliance with "*the requirements of this Act*" in section 207C is read to mean non-compliance with applicable financial reporting standards and applicable auditing and assurance standards.

Financial Markets Conduct Act 2013

5. Part 7 of the Financial Markets Conduct Act 2013 sets out the financial reporting requirements of an "FMC reporting entity"[5], including the requirements for the

[2] Sections 200 – 202 of the Companies Act 1993.
[3] Sections 206 – 207A of the Companies Act 1993.
[4] Section 5 of the Financial Reporting Act 2013.
[5] The meaning of an "FMC reporting entity" is set out in section 451 of the Financial Markets Conduct Act 2013.

preparation[6] and audit of the financial statements[7]. Financial statements of an FMC reporting entity must comply with GAAP[8] and the audit of those financial statements must comply with applicable auditing and assurance standards[9].

6. Similar to the Companies Act 1993, GAAP, applicable financial reporting standards and applicable auditing and assurance standards are defined in the Act by reference to the Financial Reporting Act 2013 (and hence refer to standards issued by the XRB).

7. Within Subpart 3 *Preparation, audit, and lodgement of financial statements* of Part 7 *Financial reporting* of the Financial Markets Conduct Act 2013, section 461G on the auditor's report states:

> *"(1) The auditor's report on the financial statements or group financial statements that are required to be audited under this subpart must comply with the requirements of all applicable auditing and assurance standards.*
>
> *(2) If the auditor's report indicates that the requirements of this Part have not been complied with, the auditor must, within 7 working days after signing the report, send a copy of the report, and a copy of the financial statements or group financial statements to which it relates, to—*
>
> *(a) the FMA; and*
>
> *(b) the External Reporting Board; and*
>
> *(c) in the case of an issuer of debt securities or a manager of a registered scheme, the supervisor."*

8. In the context of the requirements of Subpart 3 of Part 7 of the Financial Markets Conduct Act 2013 about financial statements and audit of an FMC reporting entity's financial statements, the reference to non-compliance with "*the requirements of this Part*" in section 461G is read to mean non-compliance with the applicable financial reporting standards and applicable auditing and assurance standards.

Functions of the XRB

9. The functions of the XRB are set out in the Financial Reporting Act 2013. Section 12 of the Financial Reporting Act 2013 provides:

> *"The Board has the following functions:*
>
> *(a) to prepare and, if it thinks fit, issue financial reporting standards for the purposes of any enactment that requires—*
>
> *(i) financial statements or group financial statements to comply, or be prepared in accordance, with generally accepted accounting practice or non-GAAP standards; or*
>
> *(ii) a statement, report, or other information to comply, or be prepared in accordance, with financial reporting standards:*
>
> *(b) to prepare and, if it thinks fit, issue auditing and assurance standards for—*

[6] Sections 460 – 461 of the Financial Markets Conduct Act 2013.

[7] Section 461D of the Financial Markets Conduct Act 2013.

[8] Sections 460 – 461 of the Financial Markets Conduct Act 2013.

[9] Sections 461F – 461G of the Financial Markets Conduct Act 2013.

(i) *the purposes of the Auditor Regulation Act 2011 or any other enactment that requires a person to comply with those standards; or*

(ii) *the purposes of any rules or codes of ethics of an association of accountants where those rules or codes require the association's members to comply with those standards; or*

(iii) *any other purpose approved by the Minister by notice in writing to the Board:*

(c) *to prepare and, if it thinks fit, issue authoritative notices for the purposes of the definition of generally accepted accounting practice:*

(d) *to develop and implement strategies for the issue of standards in order to provide a framework for the Board's overall direction in the setting of standards (including implementing a strategy for tiers of financial reporting in accordance with sections 29 to 33):*

(e) *to liaise with international or national organisations that perform functions that correspond with, or are similar to, those conferred on the Board:*

(f) *to perform and exercise the functions, duties, and powers conferred or imposed on it by or under this Act and any other enactments."*

Interpretation of the legislative intent of the provisions of the Companies Act and the Financial Markets Conduct Act for the XRB

10. In determining the intent of legislation in providing for the XRB to receive the audit reports under section 207C of the Companies Act 1993 and Section 461G of the Financial Markets Conduct Act 2013, regard needs to be had to the functions (and role) of the XRB under the Financial Reporting Act 2013.

11. Under the Financial Reporting Act 2013, the key function of the XRB is the setting of accounting and auditing & assurance standards, and the development and implementation of a strategy for an accounting standards framework (XRB strategy). The standard-setting and strategic functions of the XRB are in contrast to the functions of the other specified parties. Those parties have, among other functions, regulatory powers to take enforcement action (where necessary). The functions of the XRB do not extend to the ability to take enforcement action against an entity's non-compliance with the respective Acts. Therefore, unlike the other specified parties, the XRB does not have a legislative responsibility to take any direct regulatory action or make contact with the preparers or auditors of the financial statements about any aspect of the non-compliance.

12. Any action the XRB takes in relation to receiving the audit reports should be consistent with the XRB's role and functions: the actions taken should be for the primary objective of assessing, based on the nature of the non-compliance, whether the non-compliance set out in the audit reports indicates a need to clarify and/or modify accounting standards, auditing & assurance standards and/or the XRB strategy.

What type of audit opinions are we concerned with?

13. Audit reports may contain unmodified audit opinions (unqualified opinions) or modified audit opinions (qualified opinions, adverse opinions or disclaimers of opinion).

14. In the context of the requirements of section 207C of the Companies Act 1993 and section 461G of the Financial Markets Conduct Act 2013, audit reports that are sent to the XRB would be all audit reports that contain modified audit opinions. These would be audit reports that contain audit opinions that indicate non-compliance with the financial reporting and/or audit requirements of the Companies Act 1993 or the Financial Markets Conduct Act 2013.

15. Accounting standards require financial statements to present fairly the financial position, financial performance and cash flows of an entity. There is a presumption in accounting standards that application of applicable financial reporting standards, with additional disclosures when necessary, results in financial statements that achieve such a fair presentation[10]. In auditing standards[11], the recognition of this presumption requires the financial reporting framework that is used to be a "fair presentation framework". Auditing standards acknowledge that in complying with a fair presentation framework, additional disclosures may sometimes be necessary and, in extremely rare circumstances, departures may also be necessary.

16. Auditing standards[12] set out the types of modified audit opinions and the circumstances when a modification of an audit opinion is required. An auditor is required to modify the opinion in the auditor's report when:

    a. The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

    b. The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

17. A material misstatement of the financial statements, based on the audit evidence obtained, may arise in relation to:

    a. The appropriateness of the selected accounting policies;

    b. The application of the selected accounting policies; or

    c. The appropriateness or adequacy of disclosures in the financial statements.

18. A material misstatement of the financial statements, based on auditor's inability to obtain sufficient appropriate audit evidence (also referred to as "a limitation on the scope of the audit"), may arise in relation to:

    a. Circumstances beyond the control of the entity;

    b. Circumstances relating to the nature or timing of the auditor's work; or

    c. Limitations imposed by management.

19. The XRB's interest (and ability to take some action) is more likely to be in those modified audit opinions that indicate material misstatements in the financial statements that arise from audit evidence obtained by the auditor. As these modified

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[10] NZ IAS 1 *Presentation of financial statements* and PBE IPSAS 1 *Presentation of financial statements*.

[11] ISA(NZ) 700 *Forming an opinion and reporting on financial statements.*

[12] See ISA(NZ) 700 *Forming an opinion and reporting on financial statements*.

opinions focus on material misstatements in financial statements, the issues that arise are more likely to be related to accounting standards (than to auditing & assurance standards or the XRB strategy).

20. The XRB interest (and ability to take action) is less likely in relation to the audit reports received that cover modified opinions that arise from "a limitation on the scope of an audit". This is because these are often more likely to arise from "practical" issues and are often less likely to arise as a direct result of applying, or not applying, XRB standards or the XRB strategy. Therefore, the XRB is less likely to need to modify accounting standards, auditing & assurance standards or the XRB strategy or take other action (for example, issuing further guidance) in response to this type of modified audit report.

21. Nevertheless, limitations imposed by management may be related to, for example, the governing body considering that an accounting standard requirement is not practicable. Similarly, while auditors not complying with auditing & assurance standards falls, prima facie, within the role of the regulator to take action (rather than within the role of the XRB), such non-compliance may indicate that further guidance is required.

22. As such, for the purpose of this policy, all modified audit opinions will be reviewed to determine if any XRB action is required.

What entities and standards are involved?

23. The Companies Act 1993 covers all companies incorporated under that Act. These may be for-profit companies or public benefit entities (PBEs).

24. The Financial Markets Conduct Act 2013 covers FMC reporting entities. These may be entities under any organisational structure (companies, credit unions, building society etc).

25. Entities under both Acts may be in:

    a. For-profit Tier 1 and Tier 2[13]; or
    b. PBE Tier 1, Tier 2 or Tier 3[14].

26. Therefore, the modified audit opinions could potentially affect all the accounting standards (except the Tier 4 standards) and all auditing & assurance standards issued by the XRB.

[13] A Tier 2 for-profit entity that is not an FMC reporting entity may opt out of the audit requirements.

[14] A Tier 4 PBE is not required to have an audit. A Tier 3 PBE with expenses of less than $1 million is also not required to have an audit.

EXPOSURE DRAFT

PUBLIC BENEFIT ENTITY INTERNATIONAL FINANCIAL REPORTING STANDARD 17 INSURANCE CONTRACTS (PBE IFRS 17)

Issued [Date]

This [draft][1] Standard was issued on [Date] by the New Zealand Accounting Standards Board of the External Reporting Board pursuant to section 12(a) of the Financial Reporting Act 2013.

This [draft] Standard is a disallowable instrument for the purposes of the Legislation Act 2012, and pursuant to section 27(1) of the Financial Reporting Act 2013 takes effect on [Date].

Reporting entities that are subject to this [draft] Standard are required to apply it in accordance with the effective date, which is set out in paragraphs 132.1 to 132.2.

In finalising this [draft] Standard, the New Zealand Accounting Standards Board has carried out appropriate consultation in accordance with section 22(1) of the Financial Reporting Act 2013.

This New Zealand Tier 1 and Tier 2 Public Benefit Entity Accounting Standard has been issued to align the requirements for insurance contracts for Tier 1 and Tier 2 public benefit entities with the requirements for Tier 1 and Tier 2 for-profit entities applying New Zealand Equivalent to International Financial Reporting Standard 17 *Insurance Contracts* (NZ IFRS 17).

This Standard, when applied, supersedes PBE IFRS 4 *Insurance Contracts*.

[1] References to "this Standard" throughout this Exposure Draft should be read as referring to "this draft Standard".

PBE IFRS 17 INSURANCE CONTRACTS

ISBN

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PBE IFRS 17 INSURANCE CONTRACTS

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The following is available within New Zealand on the XRB website as additional material

IASB Basis for Conclusions

IASB Illustrative Examples

Public Benefit Entity International Financial Reporting Standard 17 *Insurance Contracts* (PBE IFRS 17) is set out in paragraphs 1–166~~32~~ and Appendices A–D. PBE IFRS 17 is based on International Financial Reporting Standard 17 *Insurance Contracts* issued by the International Accounting Standards Board and NZ IFRS 17 *Insurance Contracts*. All the paragraphs have equal authority. PBE IFRS 17 should be read in the context of its objective, the NZASB's Basis for Conclusions on PBE IFRS 17, the IASB's Basis for Conclusions on IFRS 17, the *Public Benefit Entities' Conceptual Framework* and Standard XRB A1 *Application of the Accounting Standards Framework.* PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. **PBE IFRS 17 *Insurance Contracts* establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the Standard. The objective of PBE IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.**

2. An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying PBE IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (i.e., no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).

Scope

2.1 **This Standard applies to Tier 1 and Tier 2 public benefit entities.**

3. An entity shall apply PBE IFRS 17 to:

   (a) Insurance contracts, including reinsurance contracts, it issues;

   (b) Reinsurance contracts it holds; ~~and~~

   (c) Investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts~~.~~; and

   (d) Schemes where:

      (i) The scheme is intended to be fully funded from contributions and levies (paragraphs AG1.1–AG1.4 provide additional guidance); and

      (ii) There is evidence that the entity manages the scheme in the same way as an issuer of insurance contracts, including assessing the financial performance and financial position of the scheme on a regular basis (paragraphs AG1.5–AG1.6 provide additional guidance).

4. All references in PBE IFRS 17 to insurance contracts also apply to:

   (a) Reinsurance contracts held, except:

      (i) For references to insurance contracts issued; and

      (ii) As described in paragraphs 60–70.

   (b) Investment contracts with discretionary participation features as set out in paragraph 3(c), except for the reference to insurance contracts in paragraph 3(c) and as described in paragraph 71.

5. All references in PBE IFRS 17 to insurance contracts issued also apply to insurance contracts acquired by the entity in a transfer of insurance contracts or a business combination other than reinsurance contracts held.

6. ~~Appendix A~~Paragraph 13.1 defines an insurance contract and paragraphs AG~~B~~2–AG~~B~~30 ~~of Appendix B~~ provide guidance on the definition of an insurance contract.

7. An entity shall not apply PBE IFRS 17 to:

   (a) Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see~~ IFRS 15 *Revenue from Contracts with Customers*~~ PBE IPSAS 9 *Revenue from Exchange Transactions* and PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*).

(b) Employers' assets and liabilities from employee benefit plans (see PBE IPSAS ~~1~~39 *Employee Benefits* ~~and IFRS 2 *Share-based Payment*~~) and retirement benefit obligations reported by defined benefit retirement plans (see the relevant international or national standard dealing with reporting by retirement benefit plans~~IAS 26 *Accounting and Reporting by Retirement Benefit Plans*~~).

(c) Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item (for example, some licence fees, royalties, ~~variable and other~~ contingent lease payments and similar items: see ~~IFRS 15~~PBE IPSAS 9, PBE IPSAS 13 *Leases* and PBE IPSAS 31 ~~IAS 38~~ *Intangible Assets* ~~and IFRS 16 *Leases*~~).

(d) Residual value guarantees provided by a manufacturer, dealer or retailer and a lessee's residual value guarantees when they are embedded in a lease (see ~~IFRS 15 and IFRS 16~~PBE IPSAS 13).

(e) Financial guarantee contracts, unless the issuer has previously ~~asserted explicitly that it regards such contracts as insurance contracts and has used~~applied accounting applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts. The issuer shall choose to apply either PBE IFRS 17 or PBE IPSAS ~~3~~28 *Financial Instruments: Presentation*, ~~IFRS 7~~PBE IPSAS 30 *Financial Instruments: Disclosures* and PBE IPSAS 41 ~~IFRS 9~~ *Financial Instruments* to such financial guarantee contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.

(f) Contingent consideration payable or receivable in a business combination (see PBE IFRS 3 *Business Combinations*).[2]

(g) Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held (see paragraph 3(b)).

8. Some contracts meet the definition of an insurance contract but have as their primary purpose the provision of services for a fixed fee. An entity may choose to apply ~~IFRS 15~~PBE IPSAS 9 instead of PBE IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:

(a) The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;

(b) The contract compensates the customer by providing services, rather than by making cash payments to the customer; and

(c) The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

Combination of Insurance Contracts

9. A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.

Separating Components from an Insurance Contract (paragraphs AG~~B~~31–~~B~~AG35)

10. An insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both). An entity shall apply paragraphs 11–13 to identify and account for the components of the contract.

11. An entity shall:

(a) Apply PBE IPSAS 41~~IFRS 9~~ to determine whether there is an embedded derivative to be separated and, if there is, how to account for that derivative.

[2] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 7(f) would refer to PBE IPSAS 40 *PBE Combinations* rather than to PBE IFRS 3.

(b) Separate from a host insurance contract an investment component if, and only if, that investment component is distinct (see paragraphs ~~B~~AG31–~~B~~AG32). The entity shall apply ~~IFRS 9~~ PBE IPSAS 41 to account for the separated investment component.

12. After applying paragraph 11 to separate any cash flows related to embedded derivatives and distinct investment components, an entity shall separate from the host insurance contract any promise to transfer distinct goods or non-insurance services to a policyholder. ~~, applying paragraph 7 of IFRS 15. The entity shall account for such promises applying IFRS 15. In applying paragraph 7 of IFRS 15 t~~To separate the promise, the entity shall apply paragraphs ~~B~~AG33–~~B~~AG35 of PBE IFRS 17 and, on initial recognition, shall:

(a) ~~Apply IFRS 15 to a~~Attribute the cash inflows between the insurance component and any promises to provide distinct goods or non-insurance services; and

(b) Attribute the cash outflows between the insurance component and any promised goods or non-insurance services accounted for ~~applying IFRS 15~~ so that:

(i) Cash outflows that relate directly to each component are attributed to that component; and

(ii) Any remaining cash outflows are attributed on a systematic and rational basis, reflecting the cash outflows the entity would expect to arise if that component were a separate contract.

13. After applying paragraphs 11–12, an entity shall apply PBE IFRS 17 to all remaining components of the host insurance contract. Hereafter, all references in PBE IFRS 17 to embedded derivatives refer to derivatives that have not been separated from the host insurance contract and all references to investment components refer to investment components that have not been separated from the host insurance contract (except those references in paragraphs ~~B~~AG31–~~B~~AG32).

Definitions

13.1 **The following terms are used in this Standard with the meanings specified:**

The contractual service margin is a component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned ~~profit~~ surplus the entity will recognise as it provides services under the insurance contracts in the group.

For insurance contracts without direct participation features, ~~T~~the coverage period is the period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract. For insurance contracts with direct participation features, the period during which the entity provides coverage for insured events or investment-related services. This period includes the coverage for insured events or investment-related services that relates to all premiums within the boundary of the insurance contract.

Experience adjustment: A difference between:

(a) For premium receipts (and any related cash flows such as insurance acquisition cash flows and insurance premium taxes)—the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or

(b) For insurance service expenses (excluding insurance acquisition expenses)—the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.

Financial risk is the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Fulfilment cash flows is an explicit, unbiased and probability-weighted estimate (~~ie~~i.e., expected value) of the present value of the future cash outflows minus the present value of the future cash inflows that will arise as the entity fulfils insurance contracts, including a risk adjustment for non-financial risk.

A group of insurance contracts is a set of insurance contracts resulting from the division of a portfolio of insurance contracts into, at a minimum, contracts written within a period of no longer than one year and that, at initial recognition:

(a) Are onerous, if any;

(b) Have no significant possibility of becoming onerous subsequently, if any; or

(c) Do not fall into either (a) or (b), if any.

Insurance acquisition cash flows are cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

An insurance contract is a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

An insurance contract with direct participation features is an insurance contract for which, at inception:

(a) The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and

(c) The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

An insurance contract without direct participation features is an insurance contract that is not an insurance contract with direct participation features.

Insurance risk is risk, other than financial risk, transferred from the holder of a contract to the issuer.

An insured event is an uncertain future event covered by an insurance contract that creates insurance risk.

Investment component: The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

An investment contract with discretionary participation features is a financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

(a) That are expected to be a significant portion of the total contractual benefits;

(b) The timing or amount of which are contractually at the discretion of the issuer; and

(c) That are contractually based on:

- **(i) The returns on a specified pool of contracts or a specified type of contract;**
- **(ii) Realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or**
- **(iii) The ~~profit or loss~~surplus or deficit of the entity or fund that issues the contract.**

Liability for incurred claims: An entity’s obligation to investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses.

Liability for remaining coverage: An entity’s obligation to investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred (i.e., the obligation that relates to the unexpired portion of the coverage period).

Non-performance risk is the risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.

A policyholder is a party that has a right to compensation under an insurance contract if an insured event occurs.

Portfolio of insurance contracts: Insurance contracts subject to similar risks and managed together.

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

Risk adjustment for non-financial risk: is the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

Underlying items are items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.

Terms defined in other PBE Standards are used in this Standard with the same meaning as in those standards, and are reproduced in the *Glossary of Defined Terms* published separately.

Level of Aggregation of Insurance Contracts

14. **An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.**

15. **Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.**

16. **An entity shall divide a portfolio of insurance contracts issued into a minimum of:**

    (a) **A group of contracts that are onerous at initial recognition, if any;**

    (b) **A group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and**

    (c) **A group of the remaining contracts in the portfolio, if any.**

17. If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

18. For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

19. For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

    (a) Based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.

(b) Using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(i) An entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but

(ii) An entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

20. If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

21. An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:

(a) More groups that are not onerous at initial recognition—if the entity's internal reporting provides information that distinguishes:

(i) Different levels of profitability; or

(ii) Different possibilities of contracts becoming onerous after initial recognition; and

(b) More than one group of contracts that are onerous at initial recognition—if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.

22. **An entity shall not include contracts issued more than one year apart in the same group. To achieve this the entity shall, if necessary, further divide the groups described in paragraphs 16–21.**

23. A group of insurance contracts shall comprise a single contract if that is the result of applying paragraphs 14–22.

24. An entity shall apply the recognition and measurement requirements of PBE IFRS 17 to the groups of contracts ~~issued~~ determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently, except as set out in paragraph 28. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

Recognition

25. **An entity shall recognise a group of insurance contracts it issues from the earliest of the following:**

(a) **The beginning of the coverage period of the group of contracts;**

(b) **The date when the first payment from a policyholder in the group becomes due; and**

(c) **For a group of onerous contracts, when the group becomes onerous.**

26. If there is no contractual due date, the first payment from the policyholder is deemed to be due when it is received. An entity is required to determine whether any contracts form a group of onerous contracts applying paragraph 16 before the earlier of the dates set out in paragraphs 25(a) and 25(b) if facts and circumstances indicate there is such a group.

27. An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of ~~issued~~ insurance contracts issued or expected to be issued that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or ~~income~~ revenue applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).

28. In recognising a group of insurance contracts in a reporting period, an entity shall include only contracts that meet the criteria set out in paragraph 26(a)–(c) applied to each contract ~~issued by the end of the reporting period~~ and shall make estimates for the discount rates at the date of initial recognition (see paragraph AG~~B~~73) and the coverage units provided in the reporting period (see paragraph ~~B~~AG119). An entity may ~~issue~~ include more contracts in the group after the end of a reporting period, subject to paragraphs 14–22. An entity shall add the contracts to the group in the reporting period in which the contracts meet the criteria set out in paragraph 26(a)–(c) applied to each contract~~are issued~~. This may result in a change to the determination of the discount rates at the date of initial recognition applying paragraph ~~B~~AG73. An entity shall apply the revised rates from the start of the reporting period in which the new contracts are added to the group.

Measurement (paragraphs ~~B~~AG36–~~B~~AG119)

29. An entity shall apply paragraphs 30–52 to all groups of insurance contracts within the scope of PBE IFRS 17, with the following exceptions:

    (a) For groups of insurance contracts meeting either of the criteria specified in paragraph 53, an entity may simplify the measurement of the group using the premium allocation approach in paragraphs 55–59.

    (b) For groups of reinsurance contracts held, an entity shall apply paragraphs 32–46 as required by paragraphs 63–70. Paragraphs 45 (on insurance contracts with direct participation features) and 47–52 (on onerous contracts) do not apply to groups of reinsurance contracts held.

    (c) For groups of investment contracts with discretionary participation features, an entity shall apply paragraphs 32–52 as modified by paragraph 71.

30. When applying PBE IPSAS 4~~21~~ *The Effects of Changes in Foreign Exchange Rates* to a group of insurance contracts that generate cash flows in a foreign currency, an entity shall treat the group of contracts, including the contractual service margin, as a monetary item.

31. In the financial statements of an entity that issues insurance contracts, the fulfilment cash flows shall not reflect the non-performance risk of that entity~~ (non-performance risk is defined in IFRS 13 *Fair Value Measurement*)~~.

Measurement on Initial Recognition (paragraphs ~~B~~AG36–~~B~~AG95)

32. **On initial recognition, an entity shall measure a group of insurance contracts at the total of:**

    (a) **The fulfilment cash flows, which comprise:**

        (i) **Estimates of future cash flows (paragraphs 33–35);**

        (ii) **An adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and**

        (iii) **A risk adjustment for non-financial risk (paragraph 37).**

    (b) **The contractual service margin, measured applying paragraphs 38–39.**

Estimates of Future Cash Flows (paragraphs ~~B~~AG36–~~B~~AG71)

33. **An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:**

    (a) **Incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs ~~B~~AG37–~~B~~AG41). To do this, an entity shall estimate the expected value (i.e., the probability-weighted mean) of the full range of possible outcomes.**

(b) **Reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see paragraphs ~~B~~AG42–~~B~~AG53).**

(c) **Be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future (see paragraphs ~~B~~AG54–~~B~~AG60).**

(d) **Be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates (see paragraph ~~B~~AG90). The entity also shall estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see paragraph ~~B~~AG46).**

34. Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs ~~B~~AG61–~~B~~AG71). A substantive obligation to provide services ends when:

(a) The entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) Both of the following criteria are satisfied:

(i) The entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) The pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

35. An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

Discount Rates (paragraphs ~~B~~AG72–~~B~~AG85)

36. **An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:**

(a) **Reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;**

(b) **Be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and**

(c) **Exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.**

Risk Adjustment for Non-Financial Risk (paragraphs ~~B~~AG86–~~B~~AG92)

37. **An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.**

Contractual Service Margin

38. **The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned ~~profit~~ surplus the entity will recognise as it provides services in the future. An entity shall measure the contractual service margin on initial recognition of a**

group of insurance contracts at an amount that, unless paragraph 47 (on onerous contracts) applies, results in no ~~income~~ revenue or expenses arising from:

(a) **The initial recognition of an amount for the fulfilment cash flows, measured by applying paragraphs 32–37;**

(b) **The derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows applying paragraph 27; and**

(c) **Any cash flows arising from the contracts in the group at that date.**

39. For insurance contracts acquired in a transfer of insurance contracts or a business combination within the scope of PBE IFRS 3, an entity shall apply paragraph 38 in accordance with paragraphs ~~B~~AG93–~~B~~AG95.[3]

Subsequent Measurement

40. **The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:**

(a) **The liability for remaining coverage comprising:**

(i) **The fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92;**

(ii) **The contractual service margin of the group at that date, measured applying paragraphs 43–46; and**

(b) **The liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92.**

41. **An entity shall recognise ~~income~~ revenue and expenses for the following changes in the carrying amount of the liability for remaining coverage:**

(a) **Insurance revenue—for the reduction in the liability for remaining coverage because of services provided in the period, measured applying paragraphs ~~B~~AG120–~~B~~AG124;**

(b) **Insurance service expenses—for losses on groups of onerous contracts, and reversals of such losses (see paragraphs 47–52); and**

(c) **Insurance finance ~~income~~ revenue or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.**

42. **An entity shall recognise ~~income~~ revenue and expenses for the following changes in the carrying amount of the liability for incurred claims:**

(a) **Insurance service expenses—for the increase in the liability because of claims and expenses incurred in the period, excluding any investment components;**

(b) **Insurance service expenses—for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses; and**

(c) **Insurance finance ~~income~~ revenue or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.**

Contractual Service Margin (paragraphs ~~B~~AG96—~~B~~AG119)

43. **The contractual service margin at the end of the reporting period represents the ~~profit~~ surplus in the group of insurance contracts that has not yet been recognised in ~~profit or loss~~surplus or deficit because it relates to the future service to be provided under the contracts in the group.**

[3] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 39 would refer to PBE IPSAS 40 rather than to PBE IFRS 3.

44. For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

(a) The effect of any new contracts added to the group (see paragraph 28);

(b) Interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph ~~B~~AG72(b);

(c) The changes in fulfilment cash flows relating to future service as specified in paragraphs ~~B~~AG96–~~B~~AG100, except to the extent that:

(i) Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or

(ii) Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) The effect of any currency exchange differences on the contractual service margin; and

(e) The amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph ~~B~~AG119.

45. For insurance contracts with direct participation features (see paragraphs ~~B~~AG101–~~B~~AG118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:

(a) The effect of any new contracts added to the group (see paragraph 28);

(b) The entity's share of the change in the fair value of the underlying items (see paragraph AG~~B~~104(b)(i)), except to the extent that:

(i) Paragraph ~~B~~AG115 (on risk mitigation) applies;

(ii) The entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) The entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).

(c) The changes in fulfilment cash flows relating to future service, as specified in paragraphs ~~B~~AG101–~~B~~AG118, except to the extent that:

(i) Paragraph ~~B~~AG115 (on risk mitigation) applies;

(ii) Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) The effect of any currency exchange differences arising on the contractual service margin; and

(e) The amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying paragraph ~~B~~AG119.

46. Some changes in the contractual service margin offset changes in the fulfilment cash flows for the liability for remaining coverage, resulting in no change in the total carrying amount of the liability for remaining coverage. To the extent that changes in the contractual service margin do not offset changes

in the fulfilment cash flows for the liability for remaining coverage, an entity shall recognise ~~income~~ revenue and expenses for the changes, applying paragraph 41.

Onerous Contracts

47. An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in ~~profit or loss~~surplus or deficit for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

48. A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:

(a) Unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and

(b) For a group of insurance contracts with direct participation features, the entity's share of a decrease in the fair value of the underlying items.

Applying paragraphs 44(c)(i), 45(b)(ii) and 45(c)(ii), an entity shall recognise a loss in ~~profit or loss~~surplus or deficit to the extent of that excess.

49. An entity shall establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised applying paragraphs 47–48. The loss component determines the amounts that are presented in ~~profit or loss~~surplus or deficit as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue.

50. After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:

(a) The subsequent changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:

(i) The loss component of the liability for remaining coverage; and

(ii) The liability for remaining coverage, excluding the loss component.

(b) Any subsequent decrease in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service and any subsequent increases in the entity's share in the fair value of the underlying items solely to the loss component until that component is reduced to zero. Applying paragraphs 44(c)(ii), 45(b)(iii) and 45(c)(iii), an entity shall adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

51. The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated applying paragraph 50(a) are:

(a) Estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses;

(b) Changes in the risk adjustment for non-financial risk recognised in ~~profit or loss~~surplus or deficit because of the release from risk; and

(c) Insurance finance ~~income~~revenue or expenses.

52. The systematic allocation required by paragraph 50(a) shall result in the total amounts allocated to the loss component in accordance with paragraphs 48–50 being equal to zero by the end of the coverage period of a group of contracts.

Premium Allocation Approach

53. An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:

(a) The entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or

(b) The coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

54. The criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) The extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) The length of the coverage period of the group of contracts.

55. Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:

(a) On initial recognition, the carrying amount of the liability is:

(i) The premiums, if any, received at initial recognition;

(ii) Minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and

(iii) Plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.

(b) At the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:

(i) Plus the premiums received in the period;

(ii) Minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

(iii) Plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);

(iv) Plus any adjustment to a financing component, applying paragraph 56;

(v) Minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph ~~B~~AG126); and

(vi) Minus any investment component paid or transferred to the liability for incurred claims.

56. If insurance contracts in the group have a significant financing component, an entity shall adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk using the discount rates specified in paragraph 36, as determined on initial recognition. The entity is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the coverage and the related premium due date is no more than a year.

57. If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between:

(a) The carrying amount of the liability for remaining coverage determined applying paragraph 55; and

(b) The fulfilment cash flows that relate to remaining coverage of the group, applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92. However, if, in applying paragraph 59(b), the entity does not adjust the liability for incurred claims for the time value of money and the effect of financial risk, it shall not include in the fulfilment cash flows any such adjustment.

58. To the extent that the fulfilment cash flows described in paragraph 57(b) exceed the carrying amount described in paragraph 57(a), the entity shall recognise a loss in ~~profit or loss~~surplus or deficit and increase the liability for remaining coverage.

59. In applying the premium allocation approach, an entity:

(a) May choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.

(b) Shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92. However, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.

Reinsurance Contracts Held

60. The requirements in PBE IFRS 17 are modified for reinsurance contracts held, as set out in paragraphs 61–70.

61. An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.

Recognition

62. Instead of applying paragraph 25, an entity shall recognise a group of reinsurance contracts held:

(a) If the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) In all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

Measurement

63. In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

64. Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

65. The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned ~~profit~~ surplus but instead a net cost or net gain on purchasing the reinsurance. Hence, on initial recognition:

(a) The entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) The net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph ~~B~~AG5, the entity shall recognise such a cost immediately in ~~profit or loss~~surplus or deficit as an expense.

66. Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) The effect of any new contracts added to the group (see paragraph 28);

(b) Interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph ~~B~~AG72(b);

(c) Changes in the fulfilment cash flows to the extent that the change:

(i) Relates to future service; unless

(ii) The change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) The effect of any currency exchange differences arising on the contractual service margin; and

(e) The amount recognised in ~~profit or loss~~surplus or deficit because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph ~~B~~AG119.

67. Changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

68. Reinsurance contracts held cannot be onerous. Accordingly, the requirements of paragraphs 47–52 do not apply.

Premium Allocation Approach for Reinsurance Contracts Held

69. An entity may use the premium allocation approach set out in paragraphs 55–56 and 59 (adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued, for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held, if at the inception of the group:

(a) The entity reasonably expects the resulting measurement would not differ materially from the result of applying the requirements in paragraphs 63–68; or

(b) The coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

70. An entity cannot meet the condition in paragraph 69(a) if, at the inception of the group, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the asset for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) The extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) The length of the coverage period of the group of reinsurance contracts held.

Investment Contracts with Discretionary Participation Features

71. An investment contract with discretionary participation features does not include a transfer of significant insurance risk. Consequently, the requirements in PBE IFRS 17 for insurance contracts are modified for investment contracts with discretionary participation features as follows:

(a) The date of initial recognition (see paragraph 25) is the date the entity becomes party to the contract.

(b) The contract boundary (see paragraph 34) is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks.

(c) The allocation of the contractual service margin (see paragraphs 44(e) and 45(e)) is modified so that the entity shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract.

Modification and Derecognition

Modification of an Insurance Contract

72. If the terms of an insurance contract are modified, for example by agreement between the parties to the contract or by a change in regulation, an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying PBE IFRS 17 or other applicable Standards if, and only if, any of the conditions in (a)–(c) are satisfied. The exercise of a right included in the terms of a contract is not a modification. The conditions are that:

(a) If the modified terms had been included at contract inception:

(i) The modified contract would have been excluded from the scope of PBE IFRS 17, applying paragraphs 3–8;

(ii) An entity would have separated different components from the host insurance contract applying paragraphs 10–13, resulting in a different insurance contract to which PBE IFRS 17 would have applied;

(iii) The modified contract would have had a substantially different contract boundary applying paragraph 34; or

(iv) The modified contract would have been included in a different group of contracts applying paragraphs 14–24.

(b) The original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition, or vice versa; or

(c) The entity applied the premium allocation approach in paragraphs 53–59 or paragraphs 69–70 to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach in paragraph 53 or paragraph 69.

73. If a contract modification meets none of the conditions in paragraph 72, the entity shall treat changes in cash flows caused by the modification as changes in estimates of fulfilment cash flows by applying paragraphs 40–52.

Derecognition

74. **An entity shall derecognise an insurance contract when, and only when:**

(a) **It is extinguished, i.e., when the obligation specified in the insurance contract expires or is discharged or cancelled; or**

(b) **Any of the conditions in paragraph 72 are met.**

75. When an insurance contract is extinguished, the entity is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance contract. For example, when an entity buys reinsurance, it shall derecognise the underlying insurance contract(s) when, and only when, the underlying insurance contract(s) is or are extinguished.

76. An entity derecognises an insurance contract from within a group of contracts by applying the following requirements in PBE IFRS 17:

(a) The fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group, applying paragraphs 40(a)(i) and 40(b);

(b) The contractual service margin of the group is adjusted for the change in fulfilment cash flows described in (a), to the extent required by paragraphs 44(c) and 45(c), unless paragraph 77 applies; and

(c) The number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit in the period is based on that adjusted number, applying paragraph ~~B~~AG119.

77. When an entity derecognises an insurance contract because it transfers the contract to a third party or derecognises an insurance contract and recognises a new contract applying paragraph 72, the entity shall instead of applying paragraph 76(b):

(a) Adjust the contractual service margin of the group from which the contract has been derecognised, to the extent required by paragraphs 44(c) and 45(c), for the difference between (i) and either (ii) for contracts transferred to a third party or (iii) for contracts derecognised applying paragraph 72:

(i) The change in the carrying amount of the group of insurance contracts resulting from the derecognition of the contract, applying paragraph 76(a).

(ii) The premium charged by the third party.

(iii) The premium the entity would have charged had it entered into a contract with equivalent terms as the new contract at the date of the contract modification, less any additional premium charged for the modification.

(b) Measure the new contract recognised applying paragraph 72 assuming that the entity received the premium described in (a)(iii) at the date of the modification.

Presentation in the Statement of Financial Position

78. **An entity shall present separately in the statement of financial position the carrying amount of groups of:**

(a) **Insurance contracts issued that are assets;**

(b) **Insurance contracts issued that are liabilities;**

(c) **Reinsurance contracts held that are assets; and**

(d) **Reinsurance contracts held that are liabilities.**

79. An entity shall include any assets or liabilities for insurance acquisition cash flows recognised applying paragraph 27 in the carrying amount of the related groups of insurance contracts issued, and any assets or liabilities for cash flows related to groups of reinsurance contracts held (see paragraph 65(a)) in the carrying amount of the groups of reinsurance contracts held.

Recognition and Presentation in the Statement~~(s) of Financial Performance~~ of Comprehensive Revenue and Expense (paragraphs ~~B~~AG120–~~B~~AG136)

80. **Applying paragraphs 41 and 42, an entity shall disaggregate the amounts recognised in the statement~~(s)~~ of ~~profit or loss and other~~ comprehensive ~~income~~ revenue and expense~~(hereafter referred to as the statement(s) of financial performance)~~ into:**

(a) **An insurance service result (paragraphs 83–86), comprising insurance revenue and insurance service expenses; and**

(b) **Insurance finance ~~income~~revenue or expenses (paragraphs 87–92).**

81. An entity is not required to disaggregate the change in the risk adjustment for non-financial risk between the insurance service result and insurance finance ~~income~~revenue or expenses. If an entity does not make such a disaggregation, it shall include the entire change in the risk adjustment for non-financial risk as part of the insurance service result.

82. **An entity shall present ~~income~~revenue or expenses from reinsurance contracts held separately from the expenses or ~~income~~revenue from insurance contracts issued.**

Insurance Service Result

83. **An entity shall present in ~~profit or loss~~surplus or deficit insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Paragraphs ~~B~~AG120–~~B~~AG127 specify how an entity measures insurance revenue.**

84. **An entity shall present in ~~profit or loss~~surplus or deficit insurance service expenses arising from a group of insurance contracts issued, comprising incurred claims (excluding repayments of investment components), other incurred insurance service expenses and other amounts as described in paragraph 103(b).**

85. **Insurance revenue and insurance service expenses presented in ~~profit or loss~~surplus or deficit shall exclude any investment components. An entity shall not present premium information in ~~profit or loss~~surplus or deficit if that information is inconsistent with paragraph 83.**

86. An entity may present the ~~income~~revenue or expenses from a group of reinsurance contracts held (see paragraphs 60–70), other than insurance finance ~~income~~revenue or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

(a) Treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;

(b) Treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; and

(c) Not present the allocation of premiums paid as a reduction in revenue.

Insurance Finance ~~Income~~Revenue or Expenses (see paragraphs ~~B~~AG128–~~B~~AG136)

87. **Insurance finance ~~income~~revenue or expenses comprises the change in the carrying amount of the group of insurance contracts arising from:**

(a) **The effect of the time value of money and changes in the time value of money; and**

(b) **The effect of financial risk and changes in financial risk; but**

(c) **Excluding any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin but do not do so when applying paragraphs 45(b)(ii), 45(b)(iii), 45(c)(ii) or 45(c)(iii). These are included in insurance service expenses.**

88. **Unless paragraph 89 applies, an entity shall make an accounting policy choice between:**

(a) **Including insurance finance ~~income~~revenue or expenses for the period in ~~profit or loss~~surplus or deficit; or**

(b) **Disaggregating insurance finance ~~income~~revenue or expenses for the period to include in ~~profit or loss~~surplus or deficit an amount determined by a systematic allocation of the expected total insurance finance ~~income~~revenue or expenses over the duration of the group of contracts, applying paragraphs ~~B~~AG130–~~B~~AG133.**

89. **For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity shall make an accounting policy choice between:**

(a) **Including insurance finance ~~income~~revenue or expenses for the period in ~~profit or loss~~surplus or deficit; or**

(b) **Disaggregating insurance finance ~~income~~revenue or expenses for the period to include in ~~profit or loss~~surplus or deficit an amount that eliminates accounting mismatches with ~~income~~revenue or expenses included in ~~profit or loss~~surplus or deficit on the underlying items held, applying paragraphs ~~B~~AG134–~~B~~AG136.**

90. **If an entity chooses the accounting policy set out in paragraph 88(b) or in paragraph 89(b), it shall include in other comprehensive ~~income~~ revenue and expense the difference between the insurance finance ~~income~~revenue or expenses measured on the basis set out in those paragraphs and the total insurance finance ~~income~~revenue or expenses for the period.**

91. **If an entity transfers a group of insurance contracts or derecognises an insurance contract applying paragraph 77:**

    (a) **It shall reclassify to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1 *Presentation of Financial ~~Statements~~Reports*) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive ~~income~~ revenue and expense because the entity chose the accounting policy set out in paragraph 88(b).**

    (b) **It shall not reclassify to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive ~~income~~ revenue and expense because the entity chose the accounting policy set out in paragraph 89(b).**

92. Paragraph 30 requires an entity to treat an insurance contract as a monetary item under PBE IPSAS 4~~21~~ for the purpose of translating foreign exchange items into the entity's functional currency. An entity includes exchange differences on changes in the carrying amount of groups of insurance contracts in the statement of ~~profit or loss~~surplus or deficit, unless they relate to changes in the carrying amount of groups of insurance contracts included in other comprehensive ~~income~~ revenue and expense applying paragraph 90, in which case they shall be included in other comprehensive ~~income~~revenue and expense.

Disclosure

93. **The objective of the disclosure requirements is for an entity to disclose information in the notes that, together with the information provided in the statement of financial position, statement~~(s)~~ of ~~financial performance~~comprehensive revenue and expense and ~~statement of~~ cash flow statement, gives a basis for users of financial statements to assess the effect that contracts within the scope of PBE IFRS 17 have on the entity's financial position, financial performance and cash flows. To achieve that objective, an entity shall disclose qualitative and quantitative information about:**

    (a) **The amounts recognised in its financial statements for contracts within the scope of PBE IFRS 17 (see paragraphs 97–116);**

    (b) **The significant judgements, and changes in those judgements, made when applying PBE IFRS 17 (see paragraphs 117–120); and**

    (c) **The nature and extent of the risks from contracts within the scope of PBE IFRS 17 (see paragraphs 121–132).**

94. An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. If the disclosures provided, applying paragraphs 97–132, are not enough to meet the objective in paragraph 93, an entity shall disclose additional information necessary to meet that objective.

95. An entity shall aggregate or disaggregate information so that useful information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics.

96. Paragraphs ~~29~~45–47~~31~~ of PBE IPSAS 1 set out requirements relating to materiality and aggregation of information. Examples of aggregation bases that might be appropriate for information disclosed about insurance contracts are:

    (a) Type of contract (for example, major product lines); or

    (b) Geographical area (for example, country or region).~~; or~~

    (c) [Not used]~~reportable segment, as defined in IFRS 8 *Operating Segments*.~~

Explanation of Recognised Amounts

97. Of the disclosures required by paragraphs 98–109, only those in paragraphs 98–100 and 102–105 apply to contracts to which the premium allocation approach has been applied. If an entity uses the premium allocation approach, it shall also disclose:

(a) Which of the criteria in paragraphs 53 and 69 it has satisfied;

(b) Whether it makes an adjustment for the time value of money and the effect of financial risk applying paragraphs 56 and 57(b); and

(c) The method it has chosen to recognise insurance acquisition cash flows applying paragraph 59(a).

98. An entity shall disclose reconciliations that show how the net carrying amounts of contracts within the scope of PBE IFRS 17 changed during the period because of cash flows and ~~income~~revenue and expenses recognised in the statement~~(s)~~ of ~~financial performance~~comprehensive revenue and expense. Separate reconciliations shall be disclosed for insurance contracts issued and reinsurance contracts held. An entity shall adapt the requirements of paragraphs 100–109 to reflect the features of reinsurance contracts held that differ from insurance contracts issued; for example, the generation of expenses or reduction in expenses rather than revenue.

99. An entity shall provide enough information in the reconciliations to enable users of financial statements to identify changes from cash flows and amounts that are recognised in the statement~~(s)~~ of comprehensive revenue and expense~~financial performance~~. To comply with this requirement, an entity shall:

(a) Disclose, in a table, the reconciliations set out in paragraphs 100–105; and

(b) For each reconciliation, present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for groups of contracts that are assets and a total for groups of contracts that are liabilities, that equal the amounts presented in the statement of financial position applying paragraph 78.

100. An entity shall disclose reconciliations from the opening to the closing balances separately for each of:

(a) The net liabilities (or assets) for the remaining coverage component, excluding any loss component.

(b) Any loss component (see paragraphs 47–52 and 57–58).

(c) The liabilities for incurred claims. For insurance contracts to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose separate reconciliations for:

(i) The estimates of the present value of the future cash flows; and

(ii) The risk adjustment for non-financial risk.

101. For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall also disclose reconciliations from the opening to the closing balances separately for each of:

(a) The estimates of the present value of the future cash flows;

(b) The risk adjustment for non-financial risk; and

(c) The contractual service margin.

102. The objective of the reconciliations in paragraphs 100–101 is to provide different types of information about the insurance service result.

103. An entity shall separately disclose in the reconciliations required in paragraph 100 each of the following amounts related to insurance services, if applicable:

(a) Insurance revenue.

(b) Insurance service expenses, showing separately:

(i) Incurred claims (excluding investment components) and other incurred insurance service expenses;

(ii) Amortisation of insurance acquisition cash flows;

(iii) Changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims; and

(iv) Changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses.

(c) Investment components excluded from insurance revenue and insurance service expenses.

104. An entity shall separately disclose in the reconciliations required in paragraph 101 each of the following amounts related to insurance services, if applicable:

(a) Changes that relate to future service, applying paragraphs ~~B~~AG96–~~B~~AG118, showing separately:

(i) Changes in estimates that adjust the contractual service margin;

(ii) Changes in estimates that do not adjust the contractual service margin, i.e., losses on groups of onerous contracts and reversals of such losses; and

(iii) The effects of contracts initially recognised in the period.

(b) Changes that relate to current service, i.e.,:

(i) The amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit to reflect the transfer of services;

(ii) The change in the risk adjustment for non-financial risk that does not relate to future service or past service; and

(iii) Experience adjustments (see paragraphs ~~B96(a), B~~AG97(c) and ~~B~~AG113(a)), excluding amounts relating to the risk adjustment included in (ii).

(c) Changes that relate to past service, i.e., changes in fulfilment cash flows relating to incurred claims (see paragraphs ~~B~~AG97(b) and ~~B~~AG113(a)).

105. To complete the reconciliations in paragraphs 100–101, an entity shall also disclose separately each of the following amounts not related to insurance services provided in the period, if applicable:

(a) Cash flows in the period, including:

(i) Premiums received for insurance contracts issued (or paid for reinsurance contracts held);

(ii) Insurance acquisition cash flows; and

(iii) Incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows.

(b) The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held;

(c) Insurance finance ~~income~~revenue or expenses; and

(d) Any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts.

106. For insurance contracts issued other than those to which the premium allocation approach described in paragraphs 53–59 has been applied, an entity shall disclose an analysis of the insurance revenue recognised in the period comprising:

(a) The amounts relating to the changes in the liability for remaining coverage as specified in paragraph ~~B~~AG124, separately disclosing:

(i) The insurance service expenses incurred during the period as specified in paragraph ~~B~~AG124(a);

(ii) The change in the risk adjustment for non-financial risk, as specified in paragraph ~~B~~AG124(b); and

(iii) The amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit because of the transfer of services in the period, as specified in paragraph ~~B~~AG124(c).

(b) The allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flows.

107. For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose the effect on the statement of financial position separately for insurance contracts issued and reinsurance contracts held that are initially recognised in the period, showing their effect at initial recognition on:

(a) The estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows;

(b) The estimates of the present value of future cash inflows;

(c) The risk adjustment for non-financial risk; and

(d) The contractual service margin.

108. In the disclosures required by paragraph 107, an entity shall separately disclose amounts resulting from:

(a) Contracts acquired from other entities in transfers of insurance contracts or business combinations; and

(b) Groups of contracts that are onerous.

109. For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose an explanation of when it expects to recognise the contractual service margin remaining at the end of the reporting period in ~~profit or loss~~surplus or deficit, either quantitatively, in appropriate time bands, or by providing qualitative information. Such information shall be provided separately for insurance contracts issued and reinsurance contracts held.

Insurance Finance ~~Income~~Revenue or Expenses

110. An entity shall disclose and explain the total amount of insurance finance ~~income~~revenue or expenses in the reporting period. In particular, an entity shall explain the relationship between insurance finance ~~income~~revenue or expenses and the investment return on its assets, to enable users of its financial statements to evaluate the sources of finance ~~income~~revenue or expenses recognised in ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense.

111. For contracts with direct participation features, the entity shall describe the composition of the underlying items and disclose their fair value.

112. For contracts with direct participation features, if an entity chooses not to adjust the contractual service margin for some changes in the fulfilment cash flows, applying paragraph ~~B~~AG115, it shall disclose the effect of that choice on the adjustment to the contractual service margin in the current period.

113. For contracts with direct participation features, if an entity changes the basis of disaggregation of insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense, applying paragraph ~~B~~AG135, it shall disclose, in the period when the change in approach occurred:

(a) The reason why the entity was required to change the basis of disaggregation;

(b) The amount of any adjustment for each financial statement line item affected; and

(c) The carrying amount of the group of insurance contracts to which the change applied at the date of the change.

Transition Amounts

114. An entity shall provide disclosures that enable users of financial statements to identify the effect of groups of insurance contracts measured at the transition date applying the modified retrospective approach (see paragraphs ~~C~~132.6~~–C~~132.19) or the fair value approach (see paragraphs ~~C~~132.20~~–C~~132.24) on the contractual service margin and insurance revenue in subsequent periods. Hence an entity shall disclose

the reconciliation of the contractual service margin applying paragraph 101(c), and the amount of insurance revenue applying paragraph 103(a), separately for:

(a) Insurance contracts that existed at the transition date to which the entity has applied the modified retrospective approach;

(b) Insurance contracts that existed at the transition date to which the entity has applied the fair value approach; and

(c) All other insurance contracts.

115. For all periods in which disclosures are made applying paragraphs 114(a) or 114(b), to enable users of financial statements to understand the nature and significance of the methods used and judgements applied in determining the transition amounts, an entity shall explain how it determined the measurement of insurance contracts at the transition date.

116. An entity that chooses to disaggregate insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~ revenue and expense applies paragraphs ~~C~~132.18(b), ~~C~~132.19(b), ~~C~~132.24(b) and ~~C~~132.24(c) to determine the cumulative difference between the insurance finance ~~income~~revenue or expenses that would have been recognised in ~~profit or loss~~surplus or deficit and the total insurance finance ~~income~~revenue or expenses at the transition date for the groups of insurance contracts to which the disaggregation applies. For all periods in which amounts determined applying these paragraphs exist, the entity shall disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive ~~income~~ revenue and expense for financial assets measured at fair value through other comprehensive revenue and expense~~income~~ related to the groups of insurance contracts. The reconciliation shall include, for example, gains or losses recognised in other comprehensive ~~income~~ revenue and expense in the period and gains or losses previously recognised in other comprehensive ~~income~~ revenue and expense in previous periods reclassified in the period to ~~profit or loss~~surplus or deficit.

Significant Judgements in Applying PBE IFRS 17

117. An entity shall disclose the significant judgements and changes in judgements made in applying PBE IFRS 17. Specifically, an entity shall disclose the inputs, assumptions and estimation techniques used, including:

(a) The methods used to measure insurance contracts within the scope of PBE IFRS 17 and the processes for estimating the inputs to those methods. Unless impracticable, an entity shall also provide quantitative information about those inputs.

(b) Any changes in the methods and processes for estimating inputs used to measure contracts, the reason for each change, and the type of contracts affected.

(c) To the extent not covered in (a), the approach used:

(i) To distinguish changes in estimates of future cash flows arising from the exercise of discretion from other changes in estimates of future cash flows for contracts without direct participation features (see paragraph ~~B~~AG98);

(ii) To determine the risk adjustment for non-financial risk, including whether changes in the risk adjustment for non-financial risk are disaggregated into an insurance service component and an insurance finance component or are presented in full in the insurance service result;

(iii) To determine discount rates; and

(iv) To determine investment components.

118. If, applying paragraph 88(b) or paragraph 89(b), an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses into amounts presented in ~~profit or loss~~surplus or deficit and amounts presented in other comprehensive ~~income~~revenue and expense, the entity shall disclose an explanation of the methods used to determine the insurance finance ~~income~~revenue or expenses recognised in ~~profit or loss~~surplus or deficit.

119. An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, it shall disclose the technique used and the confidence level corresponding to the results of that technique.

120. An entity shall disclose the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items, applying paragraph 36. When an entity provides this disclosure in aggregate for a number of groups of insurance contracts, it shall provide such disclosures in the form of weighted averages, or relatively narrow ranges.

Nature and Extent of Risks that arise from Contracts within the Scope of PBE IFRS 17

121. An entity shall disclose information that enables users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows that arise from contracts within the scope of PBE IFRS 17. Paragraphs 122–132 contain requirements for disclosures that would normally be necessary to meet this requirement.

122. These disclosures focus on the insurance and financial risks that arise from insurance contracts and how they have been managed. Financial risks typically include, but are not limited to, credit risk, liquidity risk and market risk.

123. If the information disclosed about an entity's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, the entity shall disclose that fact, the reason why the period-end exposure is not representative, and further information that is representative of its risk exposure during the period.

124. For each type of risk arising from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) The exposures to risks and how they arise;

(b) The entity's objectives, policies and processes for managing the risks and the methods used to measure the risks; and

(c) Any changes in (a) or (b) from the previous period.

125. For each type of risk arising from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) Summary quantitative information about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to the entity's key management personnel.

(b) The disclosures required by paragraphs 127–132, to the extent not provided applying (a) of this paragraph.

126. An entity shall disclose information about the effect of the regulatory frameworks in which it operates; for example, minimum capital requirements or required interest-rate guarantees. If an entity applies paragraph 20 in determining the groups of insurance contracts to which it applies the recognition and measurement requirements of PBE IFRS 17, it shall disclose that fact.

All Types of Risk—Concentrations of Risk

127. An entity shall disclose information about concentrations of risk arising from contracts within the scope of PBE IFRS 17, including a description of how the entity determines the concentrations, and a description of the shared characteristic that identifies each concentration (for example, the type of insured event, industry, geographical area, or currency). Concentrations of financial risk might arise, for example, from interest-rate guarantees that come into effect at the same level for a large number of contracts. Concentrations of financial risk might also arise from concentrations of non-financial risk; for example, if an entity provides product liability protection to pharmaceutical companies and also holds investments in those companies.

Insurance and Market Risks—Sensitivity Analysis

128. An entity shall disclose information about sensitivities to changes in risk ~~exposures~~ variables arising from contracts within the scope of PBE IFRS 17. To comply with this requirement, an entity shall disclose:

(a) A sensitivity analysis that shows how ~~profit or loss~~surplus or deficit and equity would have been affected by changes in risk ~~exposures~~ variables that were reasonably possible at the end of the reporting period:

(i) For insurance risk—showing the effect for insurance contracts issued, before and after risk mitigation by reinsurance contracts held; and

(ii) For each type of market risk—in a way that explains the relationship between the sensitivities to changes in risk ~~exposures~~ variables arising from insurance contracts and those arising from financial assets held by the entity.

(b) The methods and assumptions used in preparing the sensitivity analysis; and

(c) Changes from the previous period in the methods and assumptions used in preparing the sensitivity analysis, and the reasons for such changes.

129. If an entity prepares a sensitivity analysis that shows how amounts different from those specified in paragraph 128(a) are affected by changes in risk ~~exposures~~ variables and uses that sensitivity analysis to manage risks arising from contracts within the scope of PBE IFRS 17, it may use that sensitivity analysis in place of the analysis specified in paragraph 128(a). The entity shall also disclose:

(a) An explanation of the method used in preparing such a sensitivity analysis and of the main parameters and assumptions underlying the information provided; and

(b) An explanation of the objective of the method used and of any limitations that may result in the information provided.

Insurance Risk—Claims Development

130. An entity shall disclose actual claims compared with previous estimates of the undiscounted amount of the claims (i.e., claims development). The disclosure about claims development shall start with the period when the earliest material claim(s) arose and for which there is still uncertainty about the amount and timing of the claims payments at the end of the reporting period; but the disclosure is not required to start more than 10 years before the end of the reporting period. The entity is not required to disclose information about the development of claims for which uncertainty about the amount and timing of the claims payments is typically resolved within one year. An entity shall reconcile the disclosure about claims development with the aggregate carrying amount of the groups of insurance contracts, which the entity discloses applying paragraph 100(c).

Credit Risk—Other Information

131. For credit risk that arises from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) The amount that best represents its maximum exposure to credit risk at the end of the reporting period, separately for insurance contracts issued and reinsurance contracts held; and

(b) Information about the credit quality of reinsurance contracts held that are assets.

Liquidity Risk—Other Information

132. For liquidity risk arising from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) A description of how it manages the liquidity risk.

(b) Separate maturity analyses for groups of insurance contracts issued that are liabilities and groups of reinsurance contracts held that are liabilities that show, as a minimum, net cash flows of the groups for each of the first five years after the reporting date and in aggregate beyond the first five years. An entity is not required to include in these analyses liabilities for remaining coverage measured applying paragraphs 55–59. The analyses may take the form of:

(i) An analysis, by estimated timing, of the remaining contractual undiscounted net cash flows; or

(ii) An analysis, by estimated timing, of the estimates of the present value of the future cash flows.

(c) The amounts that are payable on demand, explaining the relationship between such amounts and the carrying amount of the related groups of contracts, if not disclosed applying (b) of this paragraph.

Effective Date and Transition

Effective Date

~~C~~132.1 **An entity shall apply PBE IFRS 17 for annual ~~reporting~~ financial statements covering periods beginning on or after [Date]~~1 January 2021~~. If an entity applies PBE IFRS 17 earlier, it shall disclose that fact. Early application is permitted for entities that apply ~~IFRS 9~~PBE IPSAS 41 ~~*Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*~~ on or before the date of initial application of PBE IFRS 17.**

~~C~~132.2 For the purposes of the transition requirements in paragraphs ~~C~~132.1 and ~~C~~132.3–~~C~~132.33:

(a) The date of initial application is the beginning of the annual reporting period in which an entity first applies PBE IFRS 17; and

(b) The transition date is the beginning of the annual reporting period immediately preceding the date of initial application.

Transition

~~C~~132.3 An entity shall apply PBE IFRS 17 retrospectively unless impracticable, except that:

(a) An entity is not required to present the quantitative information required by paragraph ~~28~~33(f) of PBE IPSAS ~~38~~ *Accounting Policies, Changes in Accounting Estimates and Errors*; and

(b) An entity shall not apply the option in paragraph ~~B~~AG115 for periods before the date of initial application of PBE IFRS 17.

~~C~~132.4 To apply PBE IFRS 17 retrospectively, an entity shall at the transition date:

(a) Identify, recognise and measure each group of insurance contracts as if PBE IFRS 17 had always applied;

(b) Derecognise any existing balances that would not exist had PBE IFRS 17 always applied; and

(c) Recognise any resulting net difference in equity.

~~C~~132.5 If, and only if, it is impracticable for an entity to apply paragraph ~~C~~132.3 for a group of insurance contracts, an entity shall apply the following approaches instead of applying paragraph ~~C~~132.4(a):

(a) The modified retrospective approach in paragraphs ~~C~~132.6–~~C~~132.19, subject to paragraph ~~C~~132.6(a); or

(b) The fair value approach in paragraphs ~~C~~132.20–~~C~~132.24.

Modified Retrospective Approach

~~C~~132.6 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. Accordingly, in applying this approach, an entity shall:

(a) Use reasonable and supportable information. If the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach, it shall apply the fair value approach.

(b) Maximise the use of information that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort.

~~C~~132.7 Paragraphs ~~C~~132.9–~~C~~132.19 set out permitted modifications to retrospective application in the following areas:

(a) Assessments of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition;

(b) Amounts related to the contractual service margin or loss component for insurance contracts without direct participation features;

(c) Amounts related to the contractual service margin or loss component for insurance contracts with direct participation features; and

(d) Insurance finance ~~income~~revenue or expenses.

~~C~~132.8 To achieve the objective of the modified retrospective approach, an entity is permitted to use each modification in paragraphs ~~C~~132.9–~~C~~132.19 only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach.

Assessments at Inception or Initial Recognition

~~C~~132.9 To the extent permitted by paragraph ~~C~~132.8, an entity shall determine the following matters using information available at the transition date:

(a) How to identify groups of insurance contracts, applying paragraphs 14–24;

(b) Whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs ~~B~~AG101–~~B~~AG109; and

(c) How to identify discretionary cash flows for insurance contracts without direct participation features, applying paragraphs ~~B~~AG98–~~B~~AG100.

~~C~~132.10 To the extent permitted by paragraph ~~C~~132.8, an entity shall not apply paragraph 22 to divide groups into those that do not include contracts issued more than one year apart.

Determining the Contractual Service Margin or Loss Component for Groups of Insurance Contracts without Direct Participation Features

~~C~~132.11 To the extent permitted by paragraph ~~C~~132.8, for contracts without direct participation features, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage (see paragraphs 49–52) at the transition date by applying paragraphs ~~C~~132.12–~~C~~132.16.

~~C~~132.12 To the extent permitted by paragraph ~~C~~132.8, an entity shall estimate the future cash flows at the date of initial recognition of a group of insurance contracts as the amount of the future cash flows at the transition date (or earlier date, if the future cash flows at that earlier date can be determined retrospectively, applying paragraph ~~C~~132.4(a)), adjusted by the cash flows that are known to have occurred between the date of initial recognition of a group of insurance contracts and the transition date (or earlier date). The cash flows that are known to have occurred include cash flows resulting from contracts that ceased to exist before the transition date.

~~C~~132.13 To the extent permitted by paragraph ~~C~~132.8, an entity shall determine the discount rates that applied at the date of initial recognition of a group of insurance contracts (or subsequently):

(a) Using an observable yield curve that, for at least three years immediately before the transition date, approximates the yield curve estimated applying paragraphs 36 and ~~B~~AG72–~~B~~AG85, if such an observable yield curve exists.

(b) If the observable yield curve in paragraph (a) does not exist, estimate the discount rates that applied at the date of initial recognition (or subsequently) by determining an average spread between an observable yield curve and the yield curve estimated applying paragraphs 36 and ~~B~~AG72–~~B~~AG85, and applying that spread to that observable yield curve. That spread shall be an average over at least three years immediately before the transition date.

~~C~~132.14 To the extent permitted by paragraph ~~C~~132.8, an entity shall determine the risk adjustment for non-financial risk at the date of initial recognition of a group of insurance contracts (or subsequently) by adjusting the risk adjustment for non-financial risk at the transition date by the expected release of risk before the transition date. The expected release of risk shall be determined by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.

~~C~~132.15 If applying paragraphs ~~C~~132.12–~~C~~13214 results in a contractual service margin at the date of initial recognition, to determine the contractual service margin at the date of transition an entity shall:

(a) If the entity applies paragraph ~~C~~132.13 to estimate the discount rates that apply on initial recognition, use those rates to accrete interest on the contractual service margin; and

(b) To the extent permitted by paragraph ~~C~~132.8, determine the amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit because of the transfer of services before the transition date, by comparing the remaining coverage units at that date with the coverage units provided under the group of contracts before the transition date (see paragraph ~~B~~AG119).

~~C~~132.16 If applying paragraphs ~~C~~132.12–~~C~~132.14 results in a loss component of the liability for remaining coverage at the date of initial recognition, an entity shall determine any amounts allocated to the loss component before the transition date applying paragraphs ~~C~~132.12–~~C~~132.14 and using a systematic basis of allocation.

Determining the Contractual Service Margin or Loss Component for Groups of Insurance Contracts with Direct Participation Features

~~C~~132.17 To the extent permitted by paragraph ~~C~~132.8, for contracts with direct participation features an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as:

(a) The total fair value of the underlying items at that date; minus

(b) The fulfilment cash flows at that date; plus or minus

(c) An adjustment for:

(i) Amounts charged by the entity to the policyholders (including amounts deducted from the underlying items) before that date.

(ii) Amounts paid before that date that would not have varied based on the underlying items.

(iii) The change in the risk adjustment for non-financial risk caused by the release from risk before that date. The entity shall estimate this amount by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.

(d) If (a)–(c) result in a contractual service margin—minus the amount of the contractual service margin that relates to services provided before that date. The total of (a)–(c) is a proxy for the total contractual service margin for all services to be provided under the group of contracts, i.e., before any amounts that would have been recognised in ~~profit or loss~~surplus or deficit for services provided. The entity shall estimate the amounts that would have been recognised in ~~profit or loss~~surplus or deficit for services provided by comparing the remaining coverage units at the transition date with the coverage units provided under the group of contracts before the transition date; or

(e) If (a)–(c) result in a loss component—adjust the loss component to nil and increase the liability for remaining coverage excluding the loss component by the same amount.

Insurance Finance ~~Income~~Revenue or Expenses

~~C~~132.18 For groups of insurance contracts that, applying paragraph ~~C~~132.10, include contracts issued more than one year apart:

(a) An entity is permitted to determine the discount rates at the date of initial recognition of a group specified in paragraphs ~~B~~AG72(b)–~~B~~AG72(e)(ii) and the discount rates at the date of the incurred claim specified in paragraph ~~B~~AG72(e)(iii) at the transition date instead of at the date of initial recognition or incurred claim.

(b) If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between amounts included in ~~profit or loss~~surplus or deficit and amounts included in other comprehensive ~~income~~ revenue and expense applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance ~~income~~revenue or expenses recognised in other comprehensive ~~income~~ revenue and expense at the transition date to apply paragraph 91(a) in future periods. The entity is permitted to determine that cumulative ~~difference~~ amount either by applying paragraph ~~C~~132.19(b) or:

(i) As nil, unless (ii) applies; and

(ii) For insurance contracts with direct participation features to which paragraph ~~B~~AG134 applies, as equal to the cumulative amount recognised in other comprehensive ~~income~~ revenue and expense on the underlying items.

~~C~~132.19 For groups of insurance contracts that do not include contracts issued more than one year apart:

(a) If an entity applies paragraph ~~C~~132.13 to estimate the discount rates that applied at initial recognition (or subsequently), it shall also determine the discount rates specified in paragraphs ~~B~~AG72(b)–~~B~~AG72(e) applying paragraph ~~C~~132.13; and

(b) If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between amounts included in ~~profit or loss~~surplus or deficit and amounts included in other comprehensive ~~income~~revenue and expense, applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance ~~income~~revenue or expenses recognised in other comprehensive ~~income~~ revenue and expense at the transition date to apply paragraph 91(a) in future periods. The entity shall determine that cumulative ~~difference~~amount:

(i) For insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph ~~B~~AG131—if the entity applies paragraph ~~C~~132.13 to estimate the discount rates at initial recognition—using the discount rates that applied at the date of initial recognition, also applying paragraph ~~C~~132.13;

(ii) For insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph ~~B~~AG132—on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, i.e., as nil;

(iii) For insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph ~~B~~AG133—if the entity applies paragraph ~~C~~132.13 to estimate the discount rates at initial recognition (or subsequently)—using the discount rates that applied at the date of the incurred claim, also applying paragraph ~~C~~132.13; and

(iv) For insurance contracts with direct participation features to which paragraph ~~B~~AG134 applies—as equal to the cumulative amount recognised in other comprehensive ~~income~~ revenue and expense on the underlying items.

Fair Value Approach

~~C~~132.20 To apply the fair value approach, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. ~~In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 *Fair Value Measurement* (relating to demand features).~~

~~C~~132.21 In applying the fair value approach, an entity may apply paragraph ~~C~~132.22 to determine:

(a) How to identify groups of insurance contracts, applying paragraphs 14–24;

(b) Whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs ~~B~~AG101–~~B~~AG109; and

(c) How to identify discretionary cash flows for insurance contracts without direct participation features, applying paragraphs ~~B~~AG98–~~B~~AG100.

~~C~~132.22 An entity may choose to determine the matters in paragraph ~~C~~132.21 using:

(a) Reasonable and supportable information for what the entity would have determined given the terms of the contract and the market conditions at the date of inception or initial recognition, as appropriate; or

(b) Reasonable and supportable information available at the transition date.

~~C~~132.23 In applying the fair value approach, an entity is not required to apply paragraph 22, and may include in a group contracts issued more than one year apart. An entity shall only divide groups into those including only contracts issued within a year (or less) if it has reasonable and supportable information to make the division. Whether or not an entity applies paragraph 22, it is permitted to determine the discount rates at the date of initial recognition of a group specified in paragraphs ~~B~~AG72(b)~~–B~~AG72(e)(ii) and the discount rates at the date of the incurred claim specified in paragraph ~~B~~AG72(e)(iii) at the transition date instead of at the date of initial recognition or incurred claim.

~~C~~132.24 In applying the fair value approach, if an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense, it is permitted to determine the cumulative amount of insurance finance ~~income~~revenue or expenses recognised in other comprehensive ~~income~~ revenue and expense at the transition date:

(a) Retrospectively—but only if it has reasonable and supportable information to do so; or

(b) As nil—unless (c) applies; and

(c) For insurance contracts with direct participation features to which paragraph ~~B~~AG134 applies—as equal to the cumulative amount recognised in other comprehensive ~~income~~ revenue and expense from the underlying items.

Comparative Information

~~C~~132.25 Notwithstanding the reference to the annual reporting period immediately preceding the date of initial application in paragraph ~~C~~132.2(b), an entity may also present adjusted comparative information applying PBE IFRS 17 for any earlier periods presented, but is not required to do so. If an entity does present adjusted comparative information for any earlier periods, the reference to 'the beginning of the annual reporting period immediately preceding the date of initial application' in paragraph ~~C~~132.2(b) shall be read as 'the beginning of the earliest adjusted comparative period presented'.

~~C~~132.26 An entity is not required to provide the disclosures specified in paragraphs 93–132 for any period presented before the beginning of the annual reporting period immediately preceding the date of initial application.

~~C~~132.27 If an entity presents unadjusted comparative information and disclosures for any earlier periods, it shall clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis.

~~C~~132.28 An entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies PBE IFRS 17. However, if an entity does not disclose that information, it shall disclose that fact.

Redesignation of Financial Assets

~~C~~132.29 At the date of initial application of PBE IFRS 17, an entity that had applied ~~IFRS 9~~ PBE IPSAS 41 to annual reporting periods before the initial application of PBE IFRS 17:

(a) May reassess whether an eligible financial asset meets the condition in paragraph 40~~.1.2(a)~~ or paragraph 41~~.1.2A(a)~~ of PBE IPSAS 41~~IFRS 9~~. A financial asset is eligible only if the financial asset is not held in respect of an activity that is unconnected with contracts within the scope of PBE IFRS 17. Examples of financial assets that would not be eligible for reassessment are financial assets held in respect of banking activities or financial assets held in funds relating to investment contracts that are outside the scope of PBE IFRS 17.

(b) Shall revoke its previous designation of a financial asset as measured at fair value through ~~profit or loss~~surplus or deficit if the condition in paragraph 44~~.1.5~~ of PBE IPSAS 41~~IFRS 9~~ is no longer met because of the application of PBE IFRS 17.

(c) May designate a financial asset as measured at fair value through ~~profit or loss~~surplus or deficit if the condition in paragraph 44~~.1.5~~ of PBE IPSAS 41~~IFRS 9~~ is met.

(d) May designate an investment in an equity instrument as at fair value through other comprehensive ~~income~~ revenue and expense applying paragraph 106~~5.7.5~~ of PBE IPSAS 41~~IFRS 9~~.

(e) May revoke its previous designation of an investment in an equity instrument as at fair value through other comprehensive revenue and expense~~income~~ applying paragraph 106~~5.7.5~~ of PBE IPSAS 41~~IFRS 9~~.

~~C~~132.30 An entity shall apply paragraph ~~C~~132.29 on the basis of the facts and circumstances that exist at the date of initial application of PBE IFRS 17. An entity shall apply those designations and classifications retrospectively. In doing so, the entity shall apply the relevant transition requirements in ~~IFRS 9~~PBE IPSAS 41. The date of initial application for that purpose shall be deemed to be the date of initial application of PBE IFRS 17.

~~C~~132.31 An entity that applies paragraph ~~C~~132.29 is not required to restate prior periods to reflect such changes in designations or classifications. The entity may restate prior periods only if it is possible without the use of hindsight. If an entity restates prior periods, the restated financial statements must reflect all the requirements of ~~IFRS 9~~ PBE IPSAS 41 for those affected financial assets. If an entity does not restate prior periods, the entity shall recognise, in the opening ~~retained earnings~~accumulated comprehensive revenue and expense (or other component of equity, as appropriate) at the date of initial application, any difference between:

(a) The previous carrying amount of those financial assets; and

(b) The carrying amount of those financial assets at the date of initial application.

~~C~~132.32 When an entity applies paragraph ~~C~~132.29, it shall disclose in that annual reporting period for those financial assets by class:

(a) If paragraph ~~C~~132.29(a) applies—its basis for determining eligible financial assets;

(b) If any of paragraphs ~~C~~132.29(a)–~~C~~132.29(e) apply:

(i) The measurement category and carrying amount of the affected financial assets determined immediately before the date of initial application of PBE IFRS 17; and

(ii) The new measurement category and carrying amount of the affected financial assets determined after applying paragraph ~~C~~132.29.

(c) If paragraph ~~C~~132.29(b) applies—the carrying amount of financial assets in the statement of financial position that were previously designated as measured at fair value through ~~profit or loss~~surplus or deficit applying paragraph 44~~.1.5~~ of PBE IPSAS 41~~IFRS 9~~ that are no longer so designated.

~~C~~132.33 When an entity applies paragraph ~~C~~132.29, the entity shall disclose in that annual reporting period qualitative information that would enable users of financial statements to understand:

(a) How it applied paragraph ~~C~~132.29 to financial assets the classification of which has changed on initially applying PBE IFRS 17;

(b) The reasons for any designation or de-designation of financial assets as measured at fair value through ~~profit or loss~~surplus or deficit applying paragraph 44~~.1.5~~ of PBE IPSAS 41~~IFRS 9~~; and

(c) Why the entity came to any different conclusions in the new assessment applying paragraphs 40~~.1.2~~(a) or 41~~.1.2A~~(a) of PBE IPSAS 41~~IFRS 9~~.

Withdrawal and Replacement of PBE IFRS 4

~~C~~132.34 PBE IFRS 17 supersedes PBE IFRS 4 *Insurance Contracts*.

Appendix A

Defined terms

[Not used]

Appendix B

Application Guidance

This Appendix is an integral part of PBE IFRS 17 Insurance Contracts

~~B~~AG1. This appendix provides guidance on the following:

(a) Determining whether a scheme is intended to be fully funded from contributions and levies (see paragraphs AG1.1–AG1.4);

(b) Determining whether an entity is managing a scheme in the same way as an insurer (see paragraphs AG1.5–AG1.6);

(c) Definition of an insurance contract (see paragraphs ~~B~~AG2–~~B~~AG30);

(~~b~~d) Separation of components from an insurance contract (see paragraphs ~~B~~AG31–~~B~~AG35);

(~~c~~e) Measurement (see paragraphs ~~B~~AG36–~~B~~AG119);

(~~d~~f) Insurance revenue (see paragraphs ~~B~~AG120–~~B~~AG127);

(~~e~~g) Insurance finance ~~income~~revenue or expenses (see paragraphs ~~B~~AG128–~~B~~AG136); and

(~~f~~g) Interim financial statements (see paragraph ~~B~~AG137).

Determining Whether a Scheme is Intended to be Fully Funded from Contributions and Levies (paragraph 3(d)(i))

AG1.1 A ~~social benefit~~ scheme is intended to be fully funded from contributions and levies when:

(a) The legislation or other arrangement governing the ~~social benefit~~ scheme provides for the scheme to be funded by contributions or levies paid by or on behalf of either the potential beneficiaries or those whose activities create or exacerbate the ~~social~~ risks which are mitigated by the ~~social benefit~~ scheme, together with investment returns arising from the contributions or levies; and

(b) One or more of the following indicators (individually or in combination) is satisfied:

(i) Contribution rates or levy rates are reviewed (and, where appropriate, adjusted in line with the scheme's funding policy), either on a regular basis or when specified criteria are met, with the aim of ensuring that the revenue from contributions and levies will be sufficient to fully fund the ~~social benefit~~ scheme; and/or

(ii) ~~Social b~~Benefit levels are reviewed (and, where appropriate, adjusted in line with the scheme's funding policy), either on a regular basis or when specified criteria are met, with the aim of ensuring that the levels of ~~social~~ benefits provided will not exceed the level of funding available from contributions or levies.

In subparagraphs (i) and (ii) above, reviews are undertaken on a regular basis when they are performed at a frequency appropriate for the specific scheme. While annual reviews are common, less frequent—or more frequent—reviews will be appropriate for some schemes.

AG1.2 In some circumstances, a public sector entity may be required to make contributions to a ~~social benefit~~ scheme on behalf of those individuals and/or households who could not afford to do so. Such contributions may be made by the entity administering the scheme or some other entity. For example, a public sector entity may be required to make contributions to a ~~retirement pension~~ scheme for those individuals who are unemployed. Where the contributions relate to specified individuals and/or households ~~(which in some cases will require the contributions to be credited against the individuals' contribution accounts)~~, the contributions made by the public sector entity are to be considered as contributions for the purposes of determining whether a ~~social benefit~~ scheme is intended to be fully funded in accordance with paragraph 3~~2~~(~~a~~d)(i). Where a public sector entity makes contributions to fund the deficit on a ~~social benefit~~ scheme, the contributions are not related to specified individuals and/or households, and are not considered as contributions for the purposes of determining whether a ~~social benefit~~ scheme is intended to be fully funded in accordance with paragraph 3~~2~~(~~a~~d)(i).

AG1.3. In assessing whether a ~~social benefit~~ scheme is intended to be fully funded from contributions and levies, an entity considers substance over form. For example, where a ~~social benefit~~ scheme is in deficit for a period but the scheme has an ability to ~~and receives a loan from government to offset that deficit, the scheme is still intended to be fully funded from contributions and levies where the public sector entity operating the social benefits scheme reviews, and where necessary~~ adjusts~~,~~ the future contribution rates and/or benefits payable such that the deficit is addressed. ~~and the loan is repaid. The requirement to consider substance over form applies equally to assessing whether the other criteria for applying the insurance approach have been satisfied.~~

AG1.4 The reference in paragraph AG1.1~~2~~(a) to "those whose activities create or exacerbate the ~~social~~ risks which are mitigated by the ~~social benefit~~ scheme" is intended to cover those ~~social benefit~~ schemes such as accident insurance schemes that:

(a) Are funded by levies on, for example, motorists or employers in particular industries; and

(b) Provide coverage against ~~social~~ risks to the wider population.

Determining Whether an Entity is Managing a Scheme in the Same Way as an Insurer (paragraph 3(d)(ii))

AG1.5 An entity is managing a scheme in the same way as an insurer would manage an insurance portfolio when the ~~social benefit~~ scheme has commercial substance, and has, with the exception of its legislative rather than contractual origins, the look and feel of an insurance contract. The ~~social benefit~~ scheme should confer the rights and obligations on parties similar to that of an insurance contract.

AG1.6 In determining whether it is managing a scheme in the same way as an insurer would manage an insurance portfolio, an entity considers the following indicators:

(a) Does the entity consider itself bound by the scheme in a similar manner to an insurer being bound by an insurance contract? For example, there may be evidence that the entity considers that it can amend the terms of the scheme for existing participants in a manner that an insurer could not (such as where the entity can make retrospective changes to the scheme). In such cases, the entity will not be bound in a similar manner to an insurer, and the ~~social benefit~~ scheme will not have commercial substance or look and feel like an insurance contract. An entity will be bound by the scheme in a similar manner to an insurer where its ability to amend the scheme for existing participants is limited to:

(i) Circumstances prescribed by the legislation that establishes the scheme (equivalent to a contractual term permitting changes in specific circumstances); or

(ii) When a government is setting new contribution or levy rates (where a trade-off between the contributions and prospective benefits is part of the process of determining an appropriate rate).

(b) Are assets relating to the ~~social benefit~~ scheme held in a separate fund, or otherwise earmarked, and restricted to being used to provide ~~social~~ benefits to participants? If an entity does not separately identify amounts relating to ~~social~~ benefits, this will provide evidence that the entity considers the contributions as a form of taxation. The ~~social benefit~~ scheme will not have commercial substance or look and feel like an insurance contract. There will also be practical difficulties with applying the measurement requirements of PBE IFRS 17 ~~the relevant international or national accounting standard dealing with insurance contracts~~ if the assets associated with a ~~social benefit~~ scheme are not separately identified.

(c) Does the legislation that establishes the ~~social~~ benefit give enforceable rights to participants in the event that the ~~social~~ risk occurs? Insurance contracts give such rights to policyholders. If the ~~social benefit~~ scheme does not also include such rights, then any ~~social~~ benefits provided by the entity will have a discretionary nature. The ~~social benefit~~ scheme will not have commercial substance or look and feel like an insurance contract. For rights to be enforceable, a participant would need to have the right to challenge–in a court of law, via an arbitration or dispute resolution process or similar mechanism–decisions by the entity. The decisions that may be challenged include, but are not limited to, those regarding whether an event is covered by a scheme, the level of ~~social~~ benefits payable by a scheme, and the duration of any ~~social~~ benefits payable by a scheme.

(d) An entity assesses the financial performance and financial position of a ~~social benefit~~ scheme on a regular basis where it is required to report internally on the financial performance of the scheme, and, where necessary, to take action to address any under-performance by the scheme. The assessment is expected to involve the use of actuarial reviews, mathematical modelling, or similar techniques to provide information for internal decision-making on the different possible outcomes that might occur.

(e) Is there a separate entity established by the government, which is expected to act like an insurer in relation to a ~~social benefit~~ scheme? The existence of such an entity provides evidence that the entity is managing a scheme in the same way as an insurer would manage an insurance portfolio. However, it is not a requirement for applying PBE IFRS 17 ~~the insurance approach~~ that a separate entity has been established. PBE IFRS 17 ~~Relevant international and national accounting standards dealing with insurance contracts~~ appliesy to insurance contracts, not just to insurance companies.

Definition of an Insurance Contract (~~Appendix a~~paragraph 13.1)

~~B~~AG2. This section provides guidance on the definition of an insurance contract as specified in ~~Appendix A~~paragraph 13.1. It addresses the following:

(a) Uncertain future event (see paragraphs ~~B~~AG3–~~B~~AG5);

(b) Payments in kind (see paragraph ~~B~~AG6);

(c) The distinction between insurance risk and other risks (see paragraphs ~~B~~AG7–~~B~~AG16);

(d) Significant insurance risk (see paragraphs ~~B~~AG17–~~B~~AG23);

(e) Changes in the level of insurance risk (see paragraphs ~~B~~AG24–~~B~~AG25); and

(f) Examples of insurance contracts (see paragraphs ~~B~~AG26–~~B~~AG30).

Uncertain Future Event

~~B~~AG3. Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:

(a) The probability of an insured event occurring;

(b) When the insured event will occur; or

(c) How much the entity will need to pay if the insured event occurs.

~~B~~AG4. In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if that loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

~~B~~AG5. Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

Payments in Kind

~~B~~AG6. Some insurance contracts require or permit payments to be made in kind. In such cases, the entity provides goods or services to the policyholder to settle the entity's obligation to compensate the policyholder for insured events. An example is when the entity replaces a stolen article instead of reimbursing the policyholder for the amount of its loss. Another example is when an entity uses its own hospitals and medical staff to provide medical services covered by the insurance contract. Such contracts are insurance contracts, even though the claims are settled in kind. Fixed-fee service contracts that meet the conditions specified in paragraph 8 are also insurance contracts, but applying paragraph 8, an entity may choose to account for them applying either PBE IFRS 17 or PBE IPSAS 9~~IFRS 15~~ *Revenue from Exchange Transactions~~Contracts with Customers~~*.

The Distinction between Insurance Risk and Other Risks

~~B~~AG7. The definition of an insurance contract requires that one party accepts significant insurance risk from another party. PBE IFRS 17 defines insurance risk as 'risk, other than financial risk, transferred from the holder of a contract to the issuer'. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

~~B~~AG8. The definition of financial risk in ~~Appendix A~~paragraph 13.1 refers to financial and non-financial variables. Examples of non-financial variables not specific to a party to the contract include an index of earthquake losses in a particular region or temperatures in a particular city. Financial risk excludes risk from non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects changes in the market prices for such assets (i.e., a financial variable) and the condition of a specific non-financial asset held by a party to a contract (i.e., a non-financial variable). For example, if a guarantee of the residual value of a specific car in which the policyholder has an insurable interest exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

~~B~~AG9. Some contracts expose the issuer to financial risk in addition to significant insurance risk. For example, many life insurance contracts guarantee a minimum rate of return to policyholders, creating financial risk, and at the same time promise death benefits that may significantly exceed the policyholder's account balance, creating insurance risk in the form of mortality risk. Such contracts are insurance contracts.

~~B~~AG10. Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided that the payment contingent on the insured event could be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because the payment is triggered by an uncertain future event—the survival of the person who receives the annuity. The link to the price index is a derivative, but it also transfers insurance risk because the number of payments to which the index applies depends on the survival of the annuitant. If the resulting transfer of insurance risk is significant, the derivative meets the definition of an insurance contract, in which case it shall not be separated from the host contract (see paragraph 11(a)).

~~B~~AG11. Insurance risk is the risk the entity accepts from the policyholder. This means the entity must accept, from the policyholder, a risk to which the policyholder was already exposed. Any new risk created by the contract for the entity or the policyholder is not insurance risk.

~~B~~AG12. The definition of an insurance contract refers to an adverse effect on the policyholder. This definition does not limit the payment by the entity to an amount equal to the financial effect of the adverse event. For example, the definition includes 'new for old' coverage that pays the policyholder an amount that permits the replacement of a used and damaged asset with a new one. Similarly, the definition does not limit the payment under a life insurance contract to the financial loss suffered by the deceased's dependants, nor does it exclude contracts that specify the payment of predetermined amounts to quantify the loss caused by death or an accident.

~~B~~AG13. Some contracts require a payment if a specified uncertain future event occurs, but do not require an adverse effect on the policyholder as a precondition for the payment. This type of contract is not an insurance contract even if the holder uses it to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying financial or non-financial variable correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because the payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. The definition of an insurance contract refers to an uncertain future event for which an adverse effect on the policyholder is a contractual precondition for payment. A contractual precondition does not require the entity to investigate whether the event actually caused an adverse effect, but it does permit the entity to deny the payment if it is not satisfied that the event did cause an adverse effect.

~~B~~AG14. Lapse or persistency risk (the risk that the policyholder will cancel the contract earlier or later than the issuer had expected when pricing the contract) is not insurance risk because the resulting variability in the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder. Similarly, expense risk (i.e., the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in the costs associated with insured events) is not insurance risk because an unexpected increase in such expenses does not adversely affect the policyholder.

~~B~~AG15. Consequently, a contract that exposes the entity to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the entity to significant insurance risk. However, if the entity mitigates its risk by using a second contract to transfer part of the non-insurance risk to another party, the second contract exposes the other party to insurance risk.

~~B~~AG16. An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.

Significant Insurance Risk

~~B~~AG17. A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs ~~B~~AG7–~~B~~AG16 discuss insurance risk. Paragraphs ~~B~~AG18–~~B~~AG23 discuss the assessment of whether the insurance risk is significant.

~~B~~AG18. Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (i.e., probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.

~~B~~AG19. In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.

~~B~~AG20. The additional amounts described in paragraph ~~B~~AG18 are determined on a present-value basis. If an insurance contract requires payment when an event with uncertain timing occurs and if the payment is not adjusted for the time value of money, there may be scenarios in which the present value of the payment increases, even if its nominal value is fixed. An example is insurance that provides a fixed death benefit when the policyholder dies, with no expiry date for the cover (often referred to as whole-life insurance for a fixed amount). It is certain that the policyholder will die, but the date of death is uncertain. Payments may be made when an individual policyholder dies earlier than expected. Because those payments are not adjusted for the time value of money, significant insurance risk could exist even if there is no overall loss on the portfolio of contracts. Similarly, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. An entity shall use the discount rates required in paragraph 36 to determine the present value of the additional amounts.

~~B~~AG21. The additional amounts described in paragraph ~~B~~AG18 refer to the present value of amounts that exceed those that would be payable if no insured event had occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and assessment costs, but exclude:

(a) The loss of the ability to charge the policyholder for future service. For example, in an investment-linked life insurance contract, the death of the policyholder means that the entity can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the entity does not result from insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of a client. Consequently, the potential loss of future investment management fees is not relevant when assessing how much insurance risk is transferred by a contract.

(b) A waiver, on death, of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, their waiver does not compensate the policyholder for a pre-existing risk. Consequently, they are not relevant when assessing how much insurance risk is transferred by a contract.

(c) A payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay CU1 million[4] if an asset suffers physical damage that causes an insignificant economic loss of CU1 to the holder. In this contract, the holder transfers the insignificant risk of losing CU1 to the issuer. At the same time, the contract creates a non-insurance risk that the issuer will need to pay CU999,999 if the specified event occurs. Because there is no scenario in which an insured event causes a significant loss to the holder of the contract, the issuer does not accept significant insurance risk from the holder and this contract is not an insurance contract.

(d) Possible reinsurance recoveries. The entity accounts for these separately.

~~B~~AG22. An entity shall assess the significance of insurance risk contract by contract. Consequently, the insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts.

~~B~~AG23. It follows from paragraphs ~~B~~AG18–~~B~~AG22 that, if a contract pays a death benefit that exceeds the amount payable on survival, the contract is an insurance contract unless the additional death benefit is not significant (judged by reference to the contract itself rather than to an entire portfolio of contracts). As noted in paragraph ~~B~~AG21(b), the waiver on death of cancellation or surrender charges is not included in this assessment if that waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

Changes in the Level of Insurance Risk

~~B~~AG24. For some contracts, the transfer of insurance risk to the issuer occurs after a period of time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rates the entity charges other new annuitants at the time the policyholder exercises that option. Such a contract transfers insurance risk to the issuer only after the option is exercised, because the entity remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to the entity at that time. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract, and before exercise there are no insurance cash flows within the boundary of the contract. However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to the issuer because the issuer is exposed to the risk that the annuity rates will be unfavourable to the issuer when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract.

~~B~~AG25. A contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (i.e., discharged, cancelled or expired), unless the contract is derecognised applying paragraphs 74–77, because of a contract modification.

Examples of Insurance Contracts

~~B~~AG26. The following are examples of contracts that are insurance contracts if the transfer of insurance risk is significant:

(a) Insurance against theft or damage.

(b) Insurance against product liability, professional liability, civil liability or legal expenses.

(c) Life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).

(d) Life-contingent annuities and pensions, i.e., contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to provide the annuitant or pensioner with a level of income that would otherwise be adversely affected by his or her survival. (Employers' liabilities that arise from employee benefit plans and retirement benefit obligations

[4] CU denotes currency unit.

reported by defined benefit retirement plans are outside the scope of PBE IFRS 17, applying paragraph 7(b)).

(e) Insurance against disability and medical costs.

(f) Surety bonds, fidelity bonds, performance bonds and bid bonds, i.e., contracts that compensate the holder if another party fails to perform a contractual obligation; for example, an obligation to construct a building.

(g) Product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of PBE IFRS 17. However, product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of PBE IFRS 17 applying paragraph 7(a), and are instead within the scope of ~~IFRS 15 or IAS 37~~ PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*.

(h) Title insurance (insurance against the discovery of defects in the title to land or buildings that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(i) Travel insurance (compensation in cash or in kind to policyholders for losses suffered in advance of, or during, travel).

(j) Catastrophe bonds that provide for reduced payments of principal, interest or both, if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk; for example, if the event is a change in an interest rate or a foreign exchange rate).

(k) Insurance swaps and other contracts that require a payment depending on changes in climatic, geological or other physical variables that are specific to a party to the contract.

~~B~~AG27. The following are examples of items that are not insurance contracts:

(a) Investment contracts that have the legal form of an insurance contract but do not transfer significant insurance risk to the issuer. For example, life insurance contracts in which the entity bears no significant mortality or morbidity risk are not insurance contracts; such contracts are financial instruments or service contracts—see paragraph ~~B~~AG28. Investment contracts with discretionary participation features do not meet the definition of an insurance contract; however, they are within the scope of PBE IFRS 17 provided they are issued by an entity that also issues insurance contracts, applying paragraph 3(c).

(b) Contracts that have the legal form of insurance, but return all significant insurance risk to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses. For example, some financial reinsurance contracts or some group contracts return all significant insurance risk to the policyholders; such contracts are normally financial instruments or service contracts (see paragraph ~~B~~AG28).

(c) Self-insurance (i.e., retaining a risk that could have been covered by insurance). In such situations, there is no insurance contract because there is no agreement with another party. Thus, if an entity issues an insurance contract to its parent, subsidiary or fellow subsidiary, there is no insurance contract in the consolidated financial statements because there is no contract with another party. However, for the individual or separate financial statements of the issuer or holder, there is an insurance contract.

(d) Contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, the event to adversely affect the policyholder. However, this does not exclude from the definition of an insurance contract contracts that specify a predetermined payout to quantify the loss caused by a specified event such as a death or an accident (see paragraph ~~B~~AG12).

(e) Derivatives that expose a party to financial risk but not insurance risk, because the derivatives require that party to make (or give them the right to receive) payment solely based on the changes in one or more of a specified interest rate, a financial instrument price, a commodity price, a foreign exchange rate, an index of prices or rates, a credit rating or a credit index or any other variable, provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract.

(f) Credit-related guarantees that require payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due; such contracts are accounted for applying ~~IFRS 9~~PBE IPSAS 41 *Financial Instruments* (see paragraph ~~B~~AG29).

(g) Contracts that require a payment that depends on a climatic, geological or any other physical variable not specific to a party to the contract (commonly described as weather derivatives).

(h) Contracts that provide for reduced payments of principal, interest or both, that depend on a climatic, geological or any other physical variable, the effect of which is not specific to a party to the contract (commonly referred to as catastrophe bonds).

~~B~~AG28. An entity shall apply other applicable Standards, such as ~~IFRS 9~~PBE IPSAS 41 and ~~IFRS 15~~PBE IPSAS 9, to the contracts described in paragraph ~~B~~AG27.

~~B~~AG29. The credit-related guarantees and credit insurance contracts discussed in paragraph ~~B~~AG27(f) can have various legal forms, such as that of a guarantee, some types of letters of credit, a credit default contract or an insurance contract. Those contracts are insurance contracts if they require the issuer to make specified payments to reimburse the holder for a loss that the holder incurs because a specified debtor fails to make payment when due to the policyholder applying the original or modified terms of a debt instrument. However, such insurance contracts are excluded from the scope of PBE IFRS 17 unless the issuer has previously asserted explicitly that it regards the contracts as insurance contracts and has used accounting applicable to insurance contracts (see paragraph 7(e)).

~~B~~AG30. Credit-related guarantees and credit insurance contracts that require payment, even if the policyholder has not incurred a loss on the failure of the debtor to make payments when due, are outside the scope of PBE IFRS 17 because they do not transfer significant insurance risk. Such contracts include those that require payment:

(a) Regardless of whether the counterparty holds the underlying debt instrument; or

(b) On a change in the credit rating or the credit index, rather than on the failure of a specified debtor to make payments when due.

Separating Components from an Insurance Contract (paragraphs 10–13)

Investment Components (paragraph 11(b))

~~B~~AG31. Paragraph 11(b) requires an entity to separate a distinct investment component from the host insurance contract. An investment component is distinct if, and only if, both the following conditions are met:

(a) The investment component and the insurance component are not highly interrelated.

(b) A contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information reasonably available in making this determination. The entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately.

~~B~~AG32. An investment component and an insurance component are highly interrelated if, and only if:

(a) The entity is unable to measure one component without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply PBE IFRS 17 to account for the combined investment and insurance component; or

(b) The policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity shall apply PBE IFRS 17 to account for the combined investment component and insurance component.

Promises to Transfer Distinct Goods or Non-Insurance Services (paragraph 12)

~~B~~AG33. Paragraph 12 requires an entity to separate from an insurance contract a promise to transfer distinct goods or non-insurance services to a policyholder. For the purpose of separation, an entity shall not consider activities that an entity must undertake to fulfil a contract unless the entity transfers a good or service to the policyholder as those activities occur. For example, an entity may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the tasks are performed.

~~B~~AG34. A good or non-insurance service promised to a policyholder is distinct if the policyholder can benefit from the good or service either on its own or together with other resources readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the entity or by another entity), or resources that the policyholder has already got (from the entity or from other transactions or events).

~~B~~AG35. A good or non-insurance service that is promised to the policyholder is not distinct if:

(a) The cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract; and

(b) The entity provides a significant service in integrating the good or non-insurance service with the insurance components.

Measurement (paragraphs 29–71)

Estimates of Future Cash Flows (paragraphs 33–35)

~~B~~AG36. This section addresses:

(a) Unbiased use of all reasonable and supportable information available without undue cost or effort (see paragraphs ~~B~~AG37–~~B~~AG41);

(b) Market variables and non-market variables (see paragraphs ~~B~~AG42–~~B~~AG53);

(c) Using current estimates (see paragraphs ~~B~~AG54–~~B~~AG60); and

(d) Cash flows within the contract boundary (see paragraphs ~~B~~AG61–~~B~~AG71).

Unbiased Use of all Reasonable and Supportable Information Available Without Undue Cost or Effort (paragraph 33(a))

~~B~~AG37. The objective of estimating future cash flows is to determine the expected value, or probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort. Reasonable and supportable information available at the reporting date without undue cost or effort includes information about past events and current conditions, and forecasts of future conditions (see paragraph ~~B~~AG41). Information available from an entity's own information systems is considered to be available without undue cost or effort.

~~B~~AG38. The starting point for an estimate of the cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows.

~~B~~AG39. When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. In practice, developing explicit scenarios is unnecessary if the resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available without undue cost or effort when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be necessary to satisfy the measurement objective.

~~B~~AG40. The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. Those scenarios exclude possible claims under possible future contracts.

~~B~~AG41. An entity shall estimate the probabilities and amounts of future payments under existing contracts on the basis of information obtained including:

(a) Information about claims already reported by policyholders.

(b) Other information about the known or estimated characteristics of the insurance contracts.

(c) Historical data about the entity's own experience, supplemented when necessary with historical data from other sources. Historical data is adjusted to reflect current conditions, for example, if:

 (i) The characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data;

 (ii) There are indications that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts; or

 (iii) There have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the insurance contracts.

(d) Current price information, if available, for reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts. This information shall be adjusted to reflect the differences between the cash flows that arise from those reinsurance contracts or other financial instruments, and the cash flows that would arise as the entity fulfils the underlying contracts with the policyholder.

Market Variables and Non-Market Variables

~~B~~AG42. PBE IFRS 17 identifies two types of variables:

(a) Market variables—variables that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates); and

(b) Non-market variables—all other variables (for example, the frequency and severity of insurance claims and mortality).

~~B~~AG43. Market variables will generally give rise to financial risk (for example, observable interest rates) and non-market variables will generally give rise to non-financial risk (for example, mortality rates). However, this will not always be the case. For example, there may be assumptions that relate to financial risks for which variables cannot be observed in, or derived directly from, markets (for example, interest rates that cannot be observed in, or derived directly from, markets).

Market Variables (paragraph 33(b))

~~B~~AG44. Estimates of market variables shall be consistent with observable market prices at the measurement date. An entity shall maximise the use of observable inputs and shall not substitute its own estimates for observable market data.~~ except as described in paragraph 79 of IFRS 13 *Fair Value Measurement*. Consistent with IFRS 13, i~~If variables need to be derived (for example, because no observable market variables exist) they shall be as consistent as possible with observable market variables.

~~B~~AG45. Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Consequently, they are not a single-point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'.

~~B~~AG46. An important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows *exactly* match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows that arise from a group of insurance contracts. The fair value of that asset reflects both the expected present value of the cash flows from the asset and the risk associated with those cash flows. If a replicating portfolio of assets exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate.

~~B~~AG47. PBE IFRS 17 does not require an entity to use a replicating portfolio technique. However, if a replicating asset or portfolio does exist for some of the cash flows that arise from insurance contracts and an entity chooses to use a different technique, the entity shall satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different measurement of those cash flows.

~~B~~AG48. Techniques other than a replicating portfolio technique, such as stochastic modelling techniques, may be more robust or easier to implement if there are significant interdependencies between cash flows that vary based on returns on assets and other cash flows. Judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances. In particular, the technique used must result in the measurement of any options and guarantees included in the insurance contracts being consistent with observable market prices (if any) for such options and guarantees.

Non-Market Variables

~~B~~AG49. Estimates of non-market variables shall reflect all reasonable and supportable evidence available without undue cost or effort, both external and internal.

~~B~~AG50. Non-market external data (for example, national mortality statistics) may have more or less relevance than internal data (for example, internally developed mortality statistics), depending on the circumstances. For example, an entity that issues life insurance contracts shall not rely solely on national mortality statistics, but shall consider all other reasonable and supportable internal and external sources of information available without undue cost or effort when developing unbiased estimates of probabilities for mortality scenarios for its insurance contracts. In developing those probabilities, an entity shall give more weight to the more persuasive information. For example:

(a) Internal mortality statistics may be more persuasive than national mortality data if national data is derived from a large population that is not representative of the insured population. This might be because, for example, the demographic characteristics of the insured population could significantly differ from those of the national population, meaning that an entity would need to place more weight on the internal data and less weight on the national statistics.

(b) Conversely, if the internal statistics are derived from a small population with characteristics that are believed to be close to those of the national population, and the national statistics are current, an entity shall place more weight on the national statistics.

~~B~~AG51. Estimated probabilities for non-market variables shall not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios shall be as consistent as possible with probabilities implied by market interest rates.

~~B~~AG52. In some cases, an entity may conclude that market variables vary independently of non-market variables. If so, the entity shall consider scenarios that reflect the range of outcomes for the non-market variables, with each scenario using the same observed value of the market variable.

~~B~~AG53. In other cases, market variables and non-market variables may be correlated. For example, there may be evidence that lapse rates (a non-market variable) are correlated with interest rates (a market variable). Similarly, there may be evidence that claim levels for house or car insurance are correlated with economic cycles and therefore with interest rates and expense amounts. The entity shall ensure that the probabilities for the scenarios and the risk adjustments for the non-financial risk that relates to the market variables are consistent with the observed market prices that depend on those market variables.

Using Current Estimates (paragraph 33(c))

~~B~~AG54. In estimating each cash flow scenario and its probability, an entity shall use all reasonable and supportable information available without undue cost or effort. An entity shall review the estimates that it made at the end of the previous reporting period and update them. In doing so, an entity shall consider whether:

(a) The updated estimates faithfully represent the conditions at the end of the reporting period.

(b) The changes in estimates faithfully represent the changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the period. If the conditions have not changed, shifting the estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period. If an entity's most recent estimates are different from its previous estimates, but conditions have not changed, it shall assess whether the new probabilities assigned to each scenario are justified. In updating its estimates of those probabilities, the entity shall consider both the evidence that supported its previous estimates and all newly available evidence, giving more weight to the more persuasive evidence.

~~B~~AG55. The probability assigned to each scenario shall reflect the conditions at the end of the reporting period. Consequently, applying PBE IPSAS 14~~0~~ *Events after the Reporting ~~Period~~Date*, an event occurring after the end of the reporting period that resolves an uncertainty that existed at the end of the reporting period does not provide evidence of the conditions that existed at that date. For example, there may be a 20 per cent probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period but before the financial statements are authorised for issue, a major storm strikes. The fulfilment cash flows under that contract shall not reflect the storm that, with hindsight, is known to have occurred. Instead, the cash flows included in the measurement include the 20 per cent probability apparent at the end of the reporting period (with disclosure applying PBE IPSAS 14~~0~~ that a non-adjusting event occurred after the end of the reporting period).

~~B~~AG56. Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience in the reporting period was 20 per cent worse than the previous mortality experience and previous expectations of mortality experience. Several factors could have caused the sudden change in experience, including:

(a) Lasting changes in mortality;

(b) Changes in the characteristics of the insured population (for example, changes in underwriting or distribution, or selective lapses by policyholders in unusually good health);

(c) Random fluctuations; or

(d) Identifiable non-recurring causes.

~~B~~AG57. An entity shall investigate the reasons for the change in experience and develop new estimates of cash flows and probabilities in the light of the most recent experience, the earlier experience and other information. The result for the example in paragraph ~~B~~AG56 would typically be that the expected present value of death benefits changes, but not by as much as 20 per cent. In the example in paragraph ~~B~~AG56, if mortality rates continue to be significantly higher than the previous estimates for reasons that are expected to continue, the estimated probability assigned to the high-mortality scenarios will increase.

~~B~~AG58. Estimates of non-market variables shall include information about the current level of insured events and information about trends. For example, mortality rates have consistently declined over long periods in many countries. The determination of the fulfilment cash flows reflects the probabilities that would be assigned to each possible trend scenario, taking account of all reasonable and supportable information available without undue cost or effort.

~~B~~AG59. Similarly, if cash flows allocated to a group of insurance contracts are sensitive to inflation, the determination of the fulfilment cash flows shall reflect current estimates of possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, the measurement of fulfilment cash flows shall reflect the probabilities for each inflation scenario in a way that is consistent with the probabilities implied by the market interest rates used in estimating the discount rate (see paragraph ~~B~~AG51).

~~B~~AG60. When estimating the cash flows, an entity shall take into account current expectations of future events that might affect those cash flows. The entity shall develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability of each scenario. However, an entity shall not take into account current expectations of future changes in legislation that would change or discharge the present obligation or create new obligations under the existing insurance contract until the change in legislation is substantively enacted.

Cash Flows within the Contract Boundary (paragraph 34)

~~B~~AG61. Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract and no other cash flows. An entity shall apply paragraph 2 in determining the boundary of an existing contract.

~~B~~AG62. Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts shall reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk shall reflect the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour. This requirement to determine the expected value applies regardless of the number of contracts in a group; for example it applies even if the group comprises a single contract. Thus, the measurement of a group of insurance contracts shall not assume a 100 per cent probability that policyholders will:

(a) Surrender their contracts, if there is some probability that some of the policyholders will not; or

(b) Continue their contracts, if there is some probability that some of the policyholders will not.

~~B~~AG63. When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it shall apply paragraph 34 to assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.

~~B~~AG64. Paragraph 34 refers to an entity's practical ability to set a price at a future date (a renewal date) that fully reflects the risks in the contract from that date. An entity has that practical ability in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has that practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage. In determining the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations.

~~B~~AG65. Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(a) Premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.

(b) Payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (i.e., reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

(c) Payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.

(d) Payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

(e) An allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) Claim handling costs (i.e., the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).

(g) Costs the entity will incur in providing contractual benefits paid in kind.

(h) Policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

(i) Transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) Payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.

(k) Potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

(l) An allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.

(m) Any other costs specifically chargeable to the policyholder under the terms of the contract.

~~B~~AG66. The following cash flows shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract:

(a) Investment returns. Investments are recognised, measured and presented separately.

(b) Cash flows (payments or receipts) that arise under reinsurance contracts held. Reinsurance contracts held are recognised, measured and presented separately.

(c) Cash flows that may arise from future insurance contracts, i.e., cash flows outside the boundary of existing contracts (see paragraphs 34–35).

(d) Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in ~~profit or loss~~surplus or deficit when incurred.

(e) Cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in ~~profit or loss~~surplus or deficit when incurred.

(f) Income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity. Such payments and receipts are recognised, measured and presented separately applying PBE IAS 12 *Income Taxes*.

(g) Cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders.

(h) Cash flows arising from components separated from the insurance contract and accounted for using other applicable PBE Standards (see paragraphs 10–13).

Contracts with Cash Flows that Affect or are Affected by Cash Flows to Policyholders of Other Contracts

~~B~~AG67. Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:

(a) The policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and

(b) Either:

(i) The policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts; or

(ii) Policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder.

~~B~~AG68. Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence the fulfilment cash flows for a group:

(a) Include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) Exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

~~B~~AG69. For example, to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (i.e., would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.

~~B~~AG70. Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

~~B~~AG71. After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.

Discount Rates (paragraph 36)

~~B~~AG72. An entity shall use the following discount rates in applying PBE IFRS 17:

(a) To measure the fulfilment cash flows—current discount rates applying paragraph 36;

(b) To determine the interest to accrete on the contractual service margin applying paragraph 44(b) for insurance contracts without direct participation features—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;

(c) To measure the changes to the contractual service margin applying paragraph ~~B~~AG96(a)–~~B~~AG96(c) for insurance contracts without direct participation features—discount rates applying paragraph 36 determined on initial recognition;

(d) For groups of contracts applying the premium allocation approach that have a significant financing component, to adjust the carrying amount of the liability for remaining coverage applying paragraph 56—discount rates applying paragraph 36 determined on initial recognition;

(e) If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~ revenue and expense (see paragraph 88), to determine the amount of the insurance finance ~~income~~revenue or expenses included in ~~profit or loss~~surplus or deficit:

(i) For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders, applying paragraph ~~B~~AG131—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;

(ii) For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders, applying paragraph ~~B~~AG132(a)(i)—discount rates that allocate the remaining revised expected finance ~~income~~revenue or expenses over the remaining duration of the group of contracts at a constant rate; and

(iii) For groups of contracts applying the premium allocation approach applying paragraphs 59(b) and ~~B~~AG133—discount rates determined at the date of the incurred claim, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items.

~~B~~AG73. To determine the discount rates at the date of initial recognition of a group of contracts described in paragraphs ~~B~~AG72(b)–~~B~~AG72(e), an entity may use weighted-average discount rates over the period that contracts in the group are issued, which applying paragraph 22 cannot exceed one year.

~~B~~AG74. Estimates of discount rates shall be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions; for example:

(a) Cash flows that do not vary based on the returns on any underlying items shall be discounted at rates that do not reflect any such variability;

(b) Cash flows that vary based on the returns on any financial underlying items shall be:

(i) Discounted using rates that reflect that variability; or

(ii) Adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made.

(c) Nominal cash flows (i.e., those that include the effect of inflation) shall be discounted at rates that include the effect of inflation; and

(d) Real cash flows (i.e., those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

~~B~~AG75. Paragraph ~~B~~AG74(b) requires cash flows that vary based on the returns on underlying items to be discounted using rates that reflect that variability, or to be adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made. The variability is a relevant factor regardless of whether it arises because of contractual terms or because the entity exercises discretion, and regardless of whether the entity holds the underlying items.

~~B~~AG76. Cash flows that vary with returns on underlying items with variable returns, but that are subject to a guarantee of a minimum return, do not vary solely based on the returns on the underlying items, even when the guaranteed amount is lower than the expected return on the underlying items. Hence, an entity shall adjust the rate that reflects the variability of the returns on the underlying items for the effect of the guarantee, even when the guaranteed amount is lower than the expected return on the underlying items.

~~B~~AG77. PBE IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. If an entity does not divide the estimated cash flows in this way, the entity shall apply discount rates appropriate for the estimated cash flows as a whole; for example, using stochastic modelling techniques or risk-neutral measurement techniques.

~~B~~AG78. Discount rates shall include only relevant factors, i.e., factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Such discount rates may not be directly observable in the market. Hence, when observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the insurance contracts, an entity shall estimate the appropriate rates. PBE IFRS 17 does not require a particular estimation technique for determining discount rates. In applying an estimation technique, an entity shall:

(a) Maximise the use of observable inputs (see paragraph ~~B~~AG44) and reflect all reasonable and supportable information on non-market variables available without undue cost or effort, both external and internal (see paragraph ~~B~~AG49). In particular, the discount rates used shall not contradict any available and relevant market data, and any non-market variables used shall not contradict observable market variables.

(b) Reflect current market conditions from the perspective of a market participant.

(c) Exercise judgement to assess the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

~~B~~AG79. For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment shall reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts.

~~B~~AG80. Hence, for cash flows of insurance contracts that do not vary based on the returns on underlying items, an entity may determine discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts (a bottom-up approach).

~~B~~AG81. Alternatively, an entity may determine the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets (a top-down approach). An entity shall adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio.

~~B~~AG82. In estimating the yield curve described in paragraph ~~B~~AG81:

(a) If there are observable market prices in active markets for assets in the reference portfolio, an entity shall use those prices~~ (consistent with paragraph 69 of IFRS 13)~~.

(b) If a market is not active, an entity shall adjust observable market prices for similar assets to make them comparable to market prices for the assets being measured~~ (consistent with paragraph 83 of IFRS 13)~~.

(c) If there is no market for assets in the reference portfolio, an entity shall apply an estimation technique. For such assets ~~(consistent with paragraph 89 of IFRS 13) ~~an entity shall:

(i) Develop unobservable inputs using the best information available in the circumstances. Such inputs might include the entity's own data and, in the context of PBE IFRS 17, the entity might place more weight on long-term estimates than on short-term fluctuations; and

(ii) Adjust those data to reflect all information about market participant assumptions that is reasonably available.

~~B~~AG83. In adjusting the yield curve, an entity shall adjust market rates observed in recent transactions in instruments with similar characteristics for movements in market factors since the transaction date, and shall adjust observed market rates to reflect the degree of dissimilarity between the instrument being measured and the instrument for which transaction prices are observable. For cash flows of insurance contracts that do not vary based on the returns on the assets in the reference portfolio, such adjustments include:

(a) Adjusting for differences between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts; and

(b) Excluding market risk premiums for credit risk, which are relevant only to the assets included in the reference portfolio.

~~B~~AG84. In principle, for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio, there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, in practice the top-down approach and the bottom-up approach may result in different yield curves, even in the same currency. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach. An entity is not required to reconcile the discount rate determined under its chosen approach with the discount rate that would have been determined under the other approach.

~~B~~AG85. PBE IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying paragraph ~~B~~AG81. However, fewer adjustments would be required to eliminate factors that are not relevant to the insurance contracts when the reference portfolio of assets has similar characteristics. For example, if the cash flows from the insurance contracts do not vary based on the returns on underlying items, fewer adjustments would be required if an entity used debt instruments as a starting point rather than equity instruments. For debt instruments, the objective would be to eliminate from the total bond yield the effect of credit risk and other factors that are not relevant to the insurance contracts. One way to estimate the effect of credit risk is to use the market price of a credit derivative as a reference point.

Risk Adjustment for Non-Financial Risk (paragraph 37)

~~B~~AG86. The risk adjustment for non-financial risk relates to risk arising from insurance contracts other than financial risk. Financial risk is included in the estimates of the future cash flows or the discount rate used to adjust the cash flows. The risks covered by the risk adjustment for non-financial risk are insurance risk and other non-financial risks such as lapse risk and expense risk (see paragraph ~~B~~AG14).

~~B~~AG87. The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:

(a) Fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and

(b) Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts.

For example, the risk adjustment for non-financial risk would measure the compensation the entity would require to make it indifferent between fulfilling a liability that—because of non-financial risk—has a 50 per cent probability of being CU90 and a 50 per cent probability of being CU110, and fulfilling a liability that is fixed at CU100. As a result, the risk adjustment for non-financial risk conveys information to users of financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows.

~~B~~AG88. Because the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount and timing of the cash flows, the risk adjustment for non-financial risk also reflects:

(a) The degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk; and

(b) Both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion.

~~B~~AG89. The purpose of the risk adjustment for non-financial risk is to measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk. Consequently, the risk adjustment for non-financial risk shall reflect all non-financial risks associated with the insurance contracts. It shall not reflect the risks that do not arise from the insurance contracts, such as general operational risk.

~~B~~AG90. The risk adjustment for non-financial risk shall be included in the measurement in an explicit way. The risk adjustment for non-financial risk is conceptually separate from the estimates of future cash flows and the discount rates that adjust those cash flows. The entity shall not double-count the risk adjustment for non-financial risk by, for example, also including the risk adjustment for non-financial risk implicitly when determining the estimates of future cash flows or the discount rates. The discount rates that are disclosed to comply with paragraph 120 shall not include any implicit adjustments for non-financial risk.

~~B~~AG91. PBE IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. However, to reflect the compensation the entity would require for bearing the non-financial risk, the risk adjustment for non-financial risk shall have the following characteristics:

(a) Risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity;

(b) For similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration;

(c) Risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution;

(d) The less that is known about the current estimate and its trend, the higher will be the risk adjustment for non-financial risk; and

(e) To the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa.

~~B~~AG92. An entity shall apply judgement when determining an appropriate estimation technique for the risk adjustment for non-financial risk. When applying that judgement, an entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities. Paragraph 119 requires an entity that uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk to disclose the technique used and the confidence level corresponding to the results of that technique.

Initial Recognition of Transfers of Insurance Contracts and Business Combinations within the Scope of PBE IFRS 3 (paragraph 39)[5]

~~B~~AG93. When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination within the scope of PBE IFRS 3, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.

~~B~~AG94. An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination within the scope of PBE IFRS 3, the consideration received or paid is the fair value of the contracts at that date. ~~In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 (relating to demand features).~~

~~B~~AG95. Unless the premium allocation approach for the liability for remaining coverage in paragraphs 55–59 applies, on initial recognition the contractual service margin is calculated applying paragraph 38 for acquired insurance contracts issued and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition. If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination within the scope of PBE IFRS 3 or as a loss in ~~profit or loss~~surplus or deficit for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess, and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component.

Changes in the Carrying Amount of the Contractual Service Margin for Insurance Contracts without Direct Participation Features (paragraph 44)

~~B~~AG96. For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:

(a) Experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph ~~B~~AG72(c);

(b) Changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph ~~B~~AG97(a), measured at the discount rates specified in paragraph ~~B~~AG72(c);

[5] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, this heading and paragraphs AG93–AG95 would refer to PBE IPSAS 40 rather than to PBE IFRS 3.

(c) Differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph ~~B~~AG72(c); and

(d) Changes in the risk adjustment for non-financial risk that relate to future service.

~~B~~AG97. An entity shall not adjust the contractual service margin for a group of insurance contracts without direct participation features for the following changes in fulfilment cash flows because they do not relate to future service:

(a) The effect of the time value of money and changes in the time value of money and the effect of financial risk and changes in financial risk (being the effect, if any, on estimated future cash flows and the effect of a change in discount rate);

(b) Changes in estimates of fulfilment cash flows in the liability for incurred claims; and

(c) Experience adjustments, except those described in paragraph ~~B~~AG96(a).

~~B~~AG98. The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity shall specify at inception of the contract the basis on which it expects to determine its commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns.

~~B~~AG99. An entity shall use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin).

~~B~~AG100. If an entity cannot specify at inception of the contract what it regards as its commitment under the contract and what it regards as discretionary, it shall regard its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions that relate to financial risk.

Changes in the Carrying Amount of the Contractual Service Margin for Insurance Contracts with Direct Participation Features (paragraph 45)

~~B~~AG101. Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. Hence, they are defined as insurance contracts for which:

(a) The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs ~~B~~AG105–~~B~~AG106);

(b) The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items (see paragraph ~~B~~AG107); and

(c) The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items (see paragraph ~~B~~AG107).

~~B~~AG102. An entity shall assess whether the conditions in paragraph ~~B~~AG101 are met using its expectations at inception of the contract and shall not reassess the conditions afterwards, unless the contract is modified, applying paragraph 72.

~~B~~AG103. To the extent that insurance contracts in a group affect the cash flows to policyholders of contracts in other groups (see paragraphs ~~B~~AG67–~~B~~AG71), an entity shall assess whether the conditions in paragraph ~~B~~AG101 are met by considering the cash flows that the entity expects to pay the policyholders determined applying paragraphs ~~B~~AG68–~~B~~AG70.

~~B~~AG104. The conditions in paragraph ~~B~~AG101 ensure that insurance contracts with direct participation features are contracts under which the entity's obligation to the policyholder is the net of:

(a) The obligation to pay the policyholder an amount equal to the fair value of the underlying items; and

(b) A variable fee (see paragraphs ~~B~~AG110–~~B~~AG118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:

  (i) The entity's share of the fair value of the underlying items; less

  (ii) Fulfilment cash flows that do not vary based on the returns on underlying items.

~~B~~AG105. A share referred to in paragraph ~~B~~AG101(a) does not preclude the existence of the entity's discretion to vary the amounts paid to the policyholder. However, the link to the underlying items must be enforceable (see paragraph 2).

~~B~~AG106. The pool of underlying items referred to in paragraph ~~B~~AG101(a) can comprise any items, for example a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items. However, a clearly identified pool of underlying items does not exist when:

(a) An entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect; or

(b) There are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified underlying items.

~~B~~AG107. Paragraph ~~B~~AG101(b) requires that the entity expects a substantial share of the fair value returns on the underlying items will be paid to the policyholder and paragraph ~~B~~AG101(c) requires that the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items. An entity shall:

(a) Interpret the term 'substantial' in both paragraphs in the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items; and

(b) Assess the variability in the amounts in paragraphs ~~B~~AG101(b) and ~~B~~AG101(c):

  (i) Over the duration of the group of insurance contracts; and

  (ii) On a present value probability-weighted average basis, not a best or worst outcome basis (see paragraphs ~~B~~AG37–~~B~~AG38).

~~B~~AG108. For example, if the entity expects to pay a substantial share of the fair value returns on underlying items, subject to a guarantee of a minimum return, there will be scenarios in which:

(a) The cash flows that the entity expects to pay to the policyholder vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items do not exceed the fair value return on the underlying items; and

(b) The cash flows that the entity expects to pay to the policyholder do not vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items exceed the fair value return on the underlying items.

The entity's assessment of the variability in paragraph ~~B~~AG101(c) for this example will reflect a present value probability-weighted average of all these scenarios.

~~B~~AG109. Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of PBE IFRS 17.

~~B~~AG110. For insurance contracts with direct participation features, the contractual service margin is adjusted to reflect the variable nature of the fee. Hence, changes in the amounts set out in paragraph ~~B~~AG104 are treated as set out in paragraphs ~~B~~AG111–~~B~~AG114.

~~B~~AG111. Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items (paragraph ~~B~~AG104(a)) do not relate to future service and do not adjust the contractual service margin.

~~B~~AG112. Changes in the entity's share of the fair value of the underlying items (paragraph ~~B~~AG104(b)(i)) relate to future service and adjust the contractual service margin, applying paragraph 45(b).

~~B~~AG113. Changes in the fulfilment cash flows that do not vary based on the returns on underlying items (paragraph ~~B~~AG104(b)(ii)) comprise:

(a) Changes in ~~estimates of~~ the fulfilment cash flows other than those specified in (b). An entity shall apply paragraphs ~~B~~AG96~~–B~~AG97, consistent with insurance contracts without direct participation features, to determine to what extent they relate to future service and, applying paragraph 45(c), adjust the contractual service margin. All the adjustments are measured using current discount rates.

(b) The change in the effect of the time value of money and financial risks not arising from the underlying items; for example, the effect of financial guarantees. These relate to future service and, applying paragraph 45(c), adjust the contractual service margin, except to the extent that paragraph ~~B~~AG115 applies.

~~B~~AG114. An entity is not required to identify the adjustments to the contractual service margin required by paragraphs ~~B~~AG112 and ~~B~~AG113 separately. Instead, a combined amount may be determined for some or all of the adjustments.

Risk Mitigation

~~B~~AG115. To the extent that an entity meets the conditions in paragraph ~~B~~AG116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items (see paragraph ~~B~~AG112) or the fulfilment cash flows set out in paragraph ~~B~~AG113(b).

~~B~~AG116. To apply paragraph ~~B~~AG115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) The entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) An economic offset exists between the insurance contracts and the derivative, i.e., the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.

(c) Credit risk does not dominate the economic offset.

~~B~~AG117. The entity shall determine the fulfilment cash flows in a group to which paragraph ~~B~~AG115 applies in a consistent manner in each reporting period.

~~B~~AG118. If any of the conditions in paragraph ~~B~~AG116 ceases to be met, an entity shall:

(a) Cease to apply paragraph ~~B~~AG115 from that date; and

(b) Not make any adjustment for changes previously recognised in ~~profit or loss~~surplus or deficit.

Recognition of the Contractual Service Margin in ~~Profit or Loss~~Surplus or Deficit

~~B~~AG119. An amount of the contractual service margin for a group of insurance contracts is recognised in ~~profit or loss~~surplus or deficit in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) Identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage ~~duration~~period.

(b) Allocating the contractual service margin at the end of the period (before recognising any amounts in ~~profit or loss~~surplus or deficit to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.

(c) Recognising in ~~profit or loss~~surplus or deficit the amount allocated to coverage units provided in the period.

Insurance Revenue (paragraphs 83 and 85)

~~B~~AG120. The total insurance revenue for a group of insurance contracts is the consideration for the contracts, i.e., the amount of premiums paid to the entity:

(a) Adjusted for a financing effect; and

(b) Excluding any investment components.

~~B~~AG121. Paragraph 83 requires the amount of insurance revenue recognised in a period to depict the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following amounts:

(a) Amounts related to the provision of services, comprising:

(i) Insurance service expenses, excluding any amounts relating to the risk adjustment included in (ii) and allocated to the loss component of the liability for remaining coverage;

(ii) The risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage; and

(iii) The contractual service margin.

(b) Amounts related to insurance acquisition cash flows.

~~B~~AG122. Insurance revenue for a period relating to the amounts described in paragraph ~~B~~AG121(a) is determined as set out in paragraphs ~~B~~AG123–~~B~~AG124. Insurance revenue for a period relating to the amounts described in paragraph ~~B~~AG121(b) is determined as set out in paragraph ~~B~~AG125.

~~B~~AG123. ~~Applying IFRS 15, when an entity provides services, it derecognises the performance obligation for those services and recognises revenue. Consistently, applying IFRS 17, w~~When an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. Those changes are:

(a) Changes that do not relate to services provided in the period, for example:

(i) Changes resulting from cash inflows from premiums received;

(ii) Changes that relate to investment components in the period;

(iii) Changes that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph ~~B~~AG65(i));

(iv) Insurance finance ~~income~~revenue or expenses;

(v) Insurance acquisition cash flows (see paragraph ~~B~~AG125); and

(vi) Derecognition of liabilities transferred to a third party.

(b) Changes that relate to services, but for which the entity does not expect consideration, i.e., increases and decreases in the loss component of the liability for remaining coverage (see paragraphs 47–52).

~~B~~AG124. Consequently, insurance revenue for the period can also be analysed as the total of the changes in the liability for remaining coverage in the period that relates to services for which the entity expects to receive consideration. Those changes are:

(a) Insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:

(i) Amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(a);

(ii) Repayments of investment components;

(iii) Amounts that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph ~~B~~AG65(i)); ~~and~~

(iv) Insurance acquisition expenses (see paragraph ~~B~~AG125); and~~.~~

(v) The amount related to the risk adjustment (see (b)).

(b) The change in the risk adjustment for non-financial risk, excluding:

(i) Changes included in insurance finance ~~income~~revenue or expenses applying paragraph 87;

(ii) Changes that adjust the contractual service margin because they relate to future service applying paragraphs 44(c) and 45(c); and

(iii) Amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(b).

(c) The amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit in the period, applying paragraphs 44(e) and 45(e).

~~B~~AG125. An entity shall determine insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of the passage of time. An entity shall recognise the same amount as insurance service expenses.

~~B~~AG126. When an entity applies the premium allocation approach in paragraphs 55–58, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage:

(a) On the basis of the passage of time; but

(b) If the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

~~B~~AG127. An entity shall change the basis of allocation between paragraphs ~~B~~AG126(a) and ~~B~~AG126(b) as necessary if facts and circumstances change.

Insurance Finance ~~Income~~Revenue or Expenses (paragraphs 87–92)

~~B~~AG128. Paragraph 87 requires an entity to include in insurance finance ~~income~~revenue or expenses the effect of changes in assumptions that relate to financial risk. For the purposes of PBE IFRS 17:

(a) Assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk; and

(b) Assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk.

~~B~~AG129. Paragraphs 88–89 require an entity to make an accounting policy choice as to whether to disaggregate insurance finance ~~income~~revenue or expenses for the period between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense. An entity shall apply its choice of accounting policy to portfolios of insurance contracts. In assessing the appropriate accounting policy for a portfolio of insurance contracts, applying paragraph 16~~3~~ of ~~IAS 8~~ PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors*, the entity shall consider for each portfolio the assets that the entity holds and how it accounts for those assets.

~~B~~AG130. If paragraph 88(b) applies, an entity shall include in ~~profit or loss~~surplus or deficit an amount determined by a systematic allocation of the expected total finance ~~income~~revenue or expenses over the duration of the group of insurance contracts. In this context, a systematic allocation is an allocation of the total expected finance ~~income~~revenue or expenses of a group of insurance contracts over the duration of the group that:

(a) Is based on characteristics of the contracts, without reference to factors that do not affect the cash flows expected to arise under the contracts. For example, the allocation of the finance ~~income~~revenue or expenses shall not be based on expected recognised returns on assets if those expected recognised returns do not affect the cash flows of the contracts in the group.

(b) Results in the amounts recognised in other comprehensive ~~income~~ revenue and expense over the duration of the group of contracts totalling zero. The cumulative amount recognised in other comprehensive ~~income~~ revenue and expense at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation.

~~B~~AG131. For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rates specified in paragraph ~~B~~AG72(e)(i).

~~B~~AG132. For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders:

(a) A systematic allocation for the finance ~~income~~revenue or expenses arising from the estimates of future cash flows can be determined in one of the following ways:

(i) Using a rate that allocates the remaining revised expected finance ~~income~~revenue or expenses over the remaining duration of the group of contracts at a constant rate; or

(ii) For contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.

(b) A systematic allocation for the finance ~~income~~revenue or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk applying paragraph 81, is determined using an allocation consistent with that used for the allocation for the finance ~~income~~revenue or expenses arising from the future cash flows.

(c) A systematic allocation for the finance ~~income~~revenue or expenses arising from the contractual service margin is determined:

(i) For insurance contracts that do not have direct participation features, using the discount rates specified in paragraph ~~B~~AG72(b); and

(ii) For insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the finance ~~income~~revenue or expenses arising from the future cash flows.

~~B~~AG133. In applying the premium allocation approach to insurance contracts described in paragraphs 53–59, an entity may be required, or may choose, to discount the liability for incurred claims. In such cases, it may choose to disaggregate the insurance finance ~~income~~revenue or expenses applying paragraph 88(b). If the entity makes this choice, it shall determine the insurance finance ~~income~~revenue or expenses in ~~profit or loss~~surplus or deficit using the discount rate specified in paragraph ~~B~~AG72(e)(iii).

~~B~~AG134. Paragraph 89 applies if an entity, either by choice or because it is required to, holds the underlying items for insurance contracts with direct participation features. If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses applying paragraph 89(b), it shall include in ~~profit or loss~~surplus or deficit expenses or ~~income~~revenue that exactly match the ~~income~~revenue or expenses included in ~~profit or loss~~surplus or deficit for the underlying items, resulting in the net of the two separately presented items being nil.

~~B~~AG135. An entity may qualify for the accounting policy choice in paragraph 89 in some periods but not in others because of a change in whether it holds the underlying items. If such a change occurs, the accounting policy choice available to the entity changes from that set out in paragraph 88 to that set out in paragraph 89, or vice versa. Hence, an entity might change its accounting policy between that set out in paragraph 88(b) and that set out in paragraph 89(b). In making such a change an entity shall:

(a) Include the accumulated amount previously included in other comprehensive ~~income~~ revenue and expense by the date of the change as a reclassification adjustment in ~~profit or loss~~surplus or deficit in the period of change and in future periods, as follows:

(i) If the entity had previously applied paragraph 88(b)—the entity shall include in ~~profit or loss~~surplus or deficit the accumulated amount included in other comprehensive ~~income~~ revenue and expense before the change as if the entity were continuing the approach in paragraph 88(b) based on the assumptions that applied immediately before the change; and

(ii) If the entity had previously applied paragraph 89(b)—the entity shall include in ~~profit or loss~~surplus or deficit the accumulated amount included in other comprehensive ~~income~~ revenue and expense before the change as if the entity were continuing the approach in paragraph 89(b) based on the assumptions that applied immediately before the change.

(b) Not restate prior period comparative information.

~~B~~AG136. When applying paragraph ~~B~~AG135(a), an entity shall not recalculate the accumulated amount previously included in other comprehensive ~~income~~ revenue and expense as if the new disaggregation had always applied; and the assumptions used for the reclassification in future periods shall not be updated after the date of the change.

Interim Financial Statements

~~B~~AG137 Notwithstanding the requirement in PBE IAS 34 *Interim Financial Reporting* that the frequency of an entity's reporting shall not affect the measurement of its annual results, an entity shall not change the treatment of accounting estimates made in previous interim financial statements when applying PBE IFRS 17 in subsequent interim financial statements or in the annual reporting period.

Appendix C

Effective Date and Transition

[Not used]

Appendix D
Amendments to other Standards

The amendments in this Appendix reflect the text of the relevant standards, including amendments set out in:

(a) PBE FRS 48 *Service Performance Reporting*, issued November 2017 and effective from 1 January 2021; and

(b) *2018 Omnibus Amendments to PBE Standards,* issued October 2018 and, in most cases, effective from 1 January 2019~~. The relevant amendments reflected in this Appendix are effective from 1 January 2019~~; and

(c) ED 2018-5 PBE IPSAS 41 *Financial Instruments*, issued in November 2018 and open for comment until 28 February 2019.

The amendments do not reflect the proposals in ED 2018-4 PBE IPSAS 40 *PBE Combinations*, issued in September 2018 and open for comment until 31 January 2019. However, this Appendix identifies the amendments that would be required to PBE IPSAS 40, if PBE IPSAS 40 were to be issued before PBE IFRS 17.

Except where otherwise stated, an entity shall apply the amendments in this Appendix when it applies PBE IFRS 17 issued in [date].

PBE IPSAS 1 *Presentation of Financial Reports*

Paragraphs 7, 88 and 99.1 are amended and paragraph 154.13 is added. New text is underlined and deleted text is struck through.

Definitions

7. **The following terms are used in this Standard with the meanings specified:**

...

Other comprehensive revenue and expense comprises items of revenue and expense (including reclassification adjustments) that are not recognised in surplus or deficit as required or permitted by other PBE Standards.

The components of other comprehensive revenue and expense include:

(a) …

(h) …; ~~and~~

(i) … ~~.~~;

(j) Insurance finance revenue and expenses from contracts issued within the scope of PBE IFRS 17 *Insurance Contracts* excluded from surplus or deficit when total insurance finance revenue or expenses is disaggregated to include in surplus or deficit an amount determined by a systematic allocation applying paragraph 88(b) of PBE IFRS 17, or by an amount that eliminates accounting mismatches with the finance revenue or expenses arising on the underlying items, applying paragraph 89(b) of PBE IFRS 17; and

(k) Finance revenue and expenses from reinsurance contracts held excluded from surplus or deficit when total reinsurance finance revenue or expenses is disaggregated to include in surplus or deficit an amount determined by a systematic allocation applying paragraph 88(b) of PBE IFRS 17.

...

Information to be Presented on the Face of the Statement of Financial Position

88. **The face of the statement of financial position shall include line items that present the following amounts:**

(a) **...**

(da) **Groups of contracts within the scope of PBE IFRS 17 that are assets, disaggregated as required by paragraph 78 of PBE IFRS 17;**

(e) **…**

(ma) **Groups of contracts within the scope of PBE IFRS 17 that are liabilities, disaggregated as required by paragraph 78 of PBE IFRS 17;**

(n) **...**

Statement of Comprehensive Revenue and Expense

…

Surplus or Deficit for the Period

…

99.1 The surplus or deficit section or the statement of comprehensive revenue and expense shall include line items that present the following amounts for the period:

(a) Revenue, presenting separately:

(i) Interest revenue calculated using the effective interest method; and

(ii) Insurance revenue (see PBE IFRS 17);

(aa) ...

(ab) Insurance service expenses from contracts issued within the scope of PBE IFRS 17 (see PBE IFRS 17);

(ac) Revenue or expenses from reinsurance contracts held (see PBE IFRS 17);

(b) ...

(bb) Insurance finance revenue or expenses from contracts issued within the scope of PBE IFRS 17 (see PBE IFRS 17);

(bc) Finance revenue or expenses from reinsurance contracts held (see PBE IFRS 17);

(c) ...

Effective Date

…

154.13 **PBE IFRS 17, issued in [date], amended paragraphs 7, 88 and 99.1. An entity shall apply those amendments when it applies PBE IFRS 17.**

PBE IPSAS 2 *Cash Flow Statements*

Paragraph 22 is amended and paragraph 63.4 is added. New text is underlined and deleted text is struck through.

Operating Activities

...

22. Cash flows from operating activities are primarily derived from the principal cash-generating activities of the entity. Examples of cash flows from operating activities are:

(a) …

(k) [Deleted by NZASB] ~~Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;~~

(l) …

Effective Date

…

63.4 **PBE IFRS 17 *Insurance Contracts*, issued in [date], amended paragraph 22. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 9 *Revenue from Exchange Transactions*

Paragraph 10 is amended and paragraph 42.6 is added. New text is underlined and deleted text is struck through.

Scope

…

10. This Standard does not deal with revenues arising from:

(a) …

(d) Insurance contracts within the scope of ~~PBE IFRS 4~~PBE IFRS 17 *Insurance Contracts*. However, an entity may choose to apply this Standard to insurance contracts that have as their primary purpose the provision of services for a fixed fee in accordance with paragraph 8 of PBE IFRS 17;

(e) …

Effective Date

…

42.6 **PBE IFRS 17 *Insurance Contracts*, issued in [date], amended paragraph 10. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 13 *Leases*

Paragraph 86.6 is added. New text is underlined.

Effective Date

…

86.6 **PBE IFRS 17, issued in [date], amended paragraph B7. An entity shall apply that amendment when it applies PBE IFRS 17.**

In Appendix B, paragraph B7 is amended. New text is underlined and deleted text is struck through.

Consensus

…

B7. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, PBE IPSAS 41 *Financial Instruments* or PBE IFRS 17~~PBE IFRS 4~~ *Insurance Contracts*, depending on the terms.

PBE IPSAS 16 *Investment Property*

Paragraphs 41.1–41.3 and 102.8 are added. New text is underlined.

Accounting Policy

…

41.1 **An entity may:**

(a) **choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and**

(b) **choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).**

41.2 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue insurance contracts with direct participation features, for which the underlying items include investment property. For the purposes of paragraphs 41.1–41.2 only, insurance contracts include investment contracts with discretionary participation features. Paragraph 41.1 does not permit an entity to measure property held by the fund (or property that is an underlying item) partly at cost and partly at fair value. (See PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard.)

41.3 If an entity chooses different models for the two categories described in paragraph 41.1, sales of investment property between pools of assets measured using different models shall be recognised at fair value and the cumulative change in fair value shall be recognised in surplus or deficit. Accordingly, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the property's fair value at the date of the sale becomes its deemed cost.

...

Effective Date

…

102.8 **PBE IFRS 17, issued in [date], added paragraphs 41.1–41.3. An entity shall apply those amendments when it applies PBE IFRS 17.**

In the Basis for Conclusions, paragraphs BC10–BC11 and the related heading are added. New text is underlined.

PBE IFRS 17 *Insurance Contracts*

BC10. IFRS 4 *Insurance Contracts* added paragraphs 32A–32C to IAS 40. Paragraph 32B was subsequently amended as a consequential amendment of IFRS 17 *Insurance Contracts*. The equivalent paragraphs were not included in PBE IPSAS 16 when the NZASB issued the suite of PBE Standards.

BC11. When developing PBE IFRS 17 *Insurance Contracts* the NZASB considered these paragraphs and believed that adding these paragraphs to PBE IPSAS 16 would maintain the cohesion of the suite of PBE Standards and align the requirements with NZ IFRS for entities that issue insurance contracts. Therefore, PBE IFRS 17 issued in [date], added paragraphs 41.1–41.3 to PBE IPSAS 16. These paragraphs contain the same requirements as paragraphs 32A–32C of IAS 40.

PBE IPSAS 17 *Property, Plant and Equipment*

Paragraphs 42.1, 42.2 and 108.13 are added. New text is underlined.

Measurement after Recognition

…

42.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue groups of insurance contracts with direct participation features and hold the underlying items. Some such funds or underlying items include owner-occupied property. The entity applies PBE IPSAS 17 to owner-occupied properties that are included in such a fund or are underlying items. Despite paragraph 42, the entity may elect to measure such properties using the fair value model in accordance with PBE IPSAS 16. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard).

42.2 An entity shall treat owner-occupied property measured using the investment property fair value model applying paragraph 42.1 as a separate class of property, plant and equipment.

...

Effective Date

…

108.13 **PBE IFRS 17, issued in [date], added paragraphs 42.1 and 42.2. An entity shall apply those amendments when it applies PBE IFRS 17.**

PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*

Paragraph 1 is amended and paragraph 112.9 is added. New text is underlined and deleted text is struck through.

Scope

1. **An entity that prepares and presents financial statements shall apply this Standard in accounting for provisions, contingent liabilities, and contingent assets, except:**

   (a) ...

   (d) **Insurance contracts and other contracts within the scope of ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts*.**

   (e) ...

Effective Date

...

112.9 **PBE IFRS 17, issued in [date], amended paragraph 1. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 26 *Impairment of Cash-Generating Assets*

Paragraph 2 is amended and paragraph 127.10 is added. New text is underlined and deleted text is struck through.

Scope

2. **An entity that prepares and presents financial statements shall apply this Standard in accounting for the impairment of cash-generating assets, except for:**

   (a) **...**

   (k) **~~Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance~~ Contracts within the scope of ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts* that are assets; and**

   (l) **…**

Effective Date

…

127.10 **PBE IFRS 17, issued in [date], amended paragraph 2. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 28 *Financial Instruments: Presentation*

Paragraphs 3 and 9 are amended and paragraphs 38.1 and 62.7 are added. New text is underlined and deleted text is struck through.

Scope (see also paragraphs AG3–AG9)

3. **An entity that prepares and presents financial statements shall apply this Standard to all types of financial instruments except:**

…

(c) **~~Obligations arising from i~~Insurance contracts as defined in PBE IFRS 17 *Insurance Contracts* and investment contracts with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to:**

(i) **Derivatives that are embedded in ~~insurance~~ contracts within the scope of PBE IFRS 17 if PBE IPSAS 41 requires the entity to account for them separately; and**

(ii) **Investment components that are separated from contracts within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation. ~~Financial guarantee contracts, if the issuer applies PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising and measuring them.~~**

Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 17 if the issuer elects, in accordance with paragraph 7(e) of PBE IFRS 17, to apply PBE IFRS 17 in recognising and measuring them.

~~In addition to (i) and (ii) above, an entity may apply this Standard to insurance contracts which involve the transfer of financial risk.~~

(d) [Deleted by NZASB]**~~Financial instruments that are within the scope of PBE IFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15–32 and AG25–AG35 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see PBE IPSAS 41)~~.**

(e) …

Definitions (see also paragraphs AG10–AG48)

9. **The following terms are used in this Standard with the meanings specified:**

…

An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See ~~Appendix B of~~ the Application Guidance in PBE IFRS 17~~4~~ for guidance on this definition.)

…

Treasury Shares (see also paragraph AG61)

…

38.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's treasury shares. Despite paragraph 38, an entity may elect not to deduct from equity a treasury share that is included in such a fund or is an underlying item when, and only when, an entity reacquires its own equity instrument for such purposes. Instead, the entity may elect to continue to account for that treasury share as equity and to account for the reacquired instrument as if the instrument were a financial asset and measure it at fair value through surplus or deficit in accordance with PBE IPSAS 41. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See PBE IFRS 17 for terms used in this paragraph that are defined in that Standard.)

...

Effective Date

…

62.7 **PBE IFRS 17, issued in [date], amended paragraphs 3, 9, AG9, AG15 and AG61, and added paragraph 38.1. An entity shall apply those amendments when it applies PBE IFRS 17.**

In the Application Guidance, paragraphs AG9, AG15 and AG61 are amended. New text is underlined and deleted text is struck through.

Insurance Contracts

…

AG9. In accordance with paragraph 3(c), an entity treats financial guarantee contracts as financial instruments unless it elects to treat such contracts as insurance contracts in accordance with ~~PBE IFRS 4~~ PBE IFRS 17.

Definitions (paragraphs 9–12)

Financial Assets and Financial Liabilities

…

AG15. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be ~~insurance~~ contracts within the scope of PBE IFRS 17.

…

Treasury Shares (paragraphs38–39)

AG61. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired. Paragraph 38 requires an entity that reacquires its own equity instruments to deduct those equity instruments from net assets/equity (but see also paragraph 38.1). However, when an entity holds its own equity instruments on behalf of others, for example, a financial institution holding its own equity instruments on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position.

…

PBE IPSAS 30 *Financial Instruments: Disclosures*

Paragraphs 3, 11 and 35 are amended, paragraph 53.8 is added and paragraph 36 is deleted. New text is underlined and deleted text is struck through.

Scope

3. **This Standard shall be applied by all entities to all types of financial instruments, except:**

   (a) …

   (c) **~~Rights and obligations arising under i~~Insurance contracts. as defined in PBE IFRS 17 *Insurance Contracts* and investment contracts with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to:**

   (i) **Derivatives that are embedded in ~~insurance~~ contracts within the scope of PBE IFRS 17, if PBE IPSAS 41 requires the entity to account for them separately; and**

   (ii) **Investment components that are separated from contracts within the scope of PBE IFRS 17 if PBE IFRS 17 requires such separation. ~~An issuer of financial guarantee contracts if the issuer applies PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising and measuring them.~~**

   Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 17 if the issuer elects, in accordance with paragraph 7(e) of PBE IFRS 17, to apply PBE IFRS 17 in recognising and measuring them.

   ~~In addition to (i) and (ii) above, an entity may apply this Standard to insurance contracts which involve the transfer of financial risk.~~

   (d) …

Categories of Financial Assets and Financial Liabilities

11. The carrying amounts of each of the following categories, as specified in PBE IPSAS 41, shall be disclosed either in the statement of financial position or in the notes:

   *(a) Financial assets measured at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 152 of PBE IPSAS 41; (ii) those measured as such in accordance with the election in paragraph 38.1 of PBE IPSAS 41; (iii) those measured as such in accordance with the election in paragraph 38.1 of PBE IPSAS 28; and (~~ii~~iv) those mandatorily measured at fair value through surplus or deficit in accordance with PBE IPSAS 41.

   (b) …

Fair Value

...

35. Disclosures of fair value are not required:

   (a) …

   (c) [Deleted by NZASB]~~For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.~~

36. [Deleted by NZASB]~~In the case described in paragraph 35(c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including:~~

   ~~(a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;~~

~~(b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;~~

~~(c) information about the market for the instruments;~~

~~(d) information about whether and how the entity intends to dispose of the financial instruments; and~~

~~(e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.~~

...

Effective Date and Transition

…

53.8 **PBE IFRS 17, issued in [date], amended paragraphs 3, 11 and 35 and deleted paragraph 36. An entity shall apply those amendments when it applies PBE IFRS 17.**

PBE IPSAS 31 *Intangible Assets*

Paragraph 3 is amended and paragraph 133.10 is added. New text is underlined and deleted text is struck through.

Scope

3. **This Standard shall be applied in accounting for intangible assets, except:**

(a) …

(i) **~~Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance c~~Contracts within the scope of ~~PBE IFRS 4~~PBE IFRS 17 *Insurance Contracts* ~~PBE IFRS 4 sets out specific disclosure requirements for those deferred acquisition costs but not for those intangible assets. Therefore, the disclosure requirements in this Standard apply to those intangible assets~~; and**

(j) ...

Effective Date

…

133.10 **PBE IFRS 17, issued in [date], amended paragraph 3. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 32 *Service Concession Arrangements: Grantor*

Paragraph 37.6 is added. New text is underlined.

Effective Date

…

37.6 **PBE IFRS 17, issued in [date], amended paragraph AG52. An entity shall apply that amendment when it applies PBE IFRS 17.**

In the Application Guidance, paragraph AG52 is amended. New text is underlined and deleted text is struck through.

Other Liabilities, Commitments, Contingent Liabilities and Contingent Assets (see paragraph 29)

AG51. …

AG52. Certain guarantees made by a grantor may meet the definition of a financial guarantee contract. The grantor determines whether guarantees made by the grantor as part of a service concession arrangement meet the definition of a financial guarantee contract and applies PBE IPSAS 28, PBE IPSAS 30 and PBE IPSAS 41 in accounting for the guarantee. Where the guarantee is an insurance contract, the grantor can elect to apply PBE IFRS 17 ~~PBE IFRS 4~~ *Insurance Contracts*. See PBE IPSAS 28, paragraphs AG3-AG9, for further guidance.

PBE IPSAS 36 *Investments in Associates and Joint Ventures*

Paragraph 24 is amended and paragraph 51.6 is added.[6] New text is underlined and deleted text is struck through.

Exemptions from Applying the Equity Method

…

24. When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through profit or loss in accordance with PBE IPSAS 41. An example of an investment-linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture. (See PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard.) An investment entity will, by definition, have made this election for its investments.

...

Effective Date

…

51.6 **PBE IFRS 17, issued in [date], amended paragraph 24. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 39 *Employee Benefits*

The footnote to paragraph 8 (definition of a qualifying insurance policy) is amended and paragraph 177.2 is added. New text is underlined and deleted text is struck through.

A qualifying insurance policy is not necessarily an insurance contract, as defined in ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts*.

...

6 *2018 Omnibus Amendments to PBE Standards*, issued in November 2018, amended paragraph 24.

Effective Date

…

177.2 **PBE IFRS 17, issued in [date], amended the footnote to paragraph 8. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 41 *Financial Instruments*

Paragraph 2 is amended and paragraphs 38.1 and 156.1 are added. New text is underlined and deleted text is struck through.

Scope

2. **This Standard shall be applied by all entities to all types of financial instruments except:**

   (a) **...**

   (e) **Rights and obligations arising under~~:~~ (i) ~~A~~an insurance contract as defined in PBE IFRS 17 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, ~~in paragraph 9;~~ or (ii) an investment contract with discretionary participation features within the scope of PBE IFRS 17. ~~A contract that is within the scope of PBE IFRS 4 *Insurance Contracts* because it contains a discretionary participation feature.~~ However, ~~T~~this Standard applies to (i) a derivative that is embedded in ~~an insurance~~ contract within the scope of PBE IFRS 17, if the derivative is not itself ~~an insurance~~ contract within the scope of PBE IFRS 17; and (ii) an investment component that is separated from a contract within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation. Moreover, if an issuer of financial guarantee contracts has previously applied accounting that is applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, the issuer may elect to apply either this Standard or PBE IFRS 17 to such financial guarantee contracts (see paragraphs AG5–AG6). The issuer may make that election contract by contract, but the election for each contract is irrevocable. ~~(see paragraphs 47–53 and paragraphs AG99–AG106 of this Standard). An entity applies this Standard to financial guarantee contracts, but shall apply PBE IFRS 4 if the issuer elects to apply that standard in recognising and measuring them. Notwithstanding (i) above, an entity may apply this Standard to other insurance contracts which involve the transfer of financial risk.~~**

…

Derecognition of Financial Liabilities

…

38.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's financial liability (for example, a corporate bond issued). Despite the other requirements in this Standard for the derecognition of financial liabilities, an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item when, and only when, the entity repurchases its financial liability for such purposes. Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset, and measure it at fair value through surplus or deficit in accordance with this Standard. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See PBE IFRS 17 for terms used in this paragraph that are defined in that Standard.)

...

Effective Date and Transition

Effective Date

156 …

156.1 **PBE IFRS 17, issued in [date], amended paragraphs 2, AG1, AG4, AG5 and AG92 and added paragraph 38.1. An entity shall apply those amendments when it applies PBE IFRS 17.**

> Paragraphs AG1, AG4, AG5 and AG92 are amended. New text is underlined and deleted text is struck through.

Scope

AG1. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not within the scope of PBE IFRS 17 *Insurance Contracts*, ~~insurance contracts,~~ they are within the scope of this Standard.

…

AG4. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under ~~insurance~~ contracts within the scope of PBE IFRS 17. ~~An entity does however apply this Standard to:~~

~~(a) Financial guarantee contracts, except those where the issuer elects to treat such contracts as insurance contracts in accordance with PBE IPSAS 28 *Financial Instruments: Presentation*; and~~

~~(b) Embedded derivatives included in insurance contracts.~~

~~An entity may, but is not required to, apply this Standard to other insurance contracts that involve the transfer of financial risk.~~

AG5. Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in PBE IFRS 17 (see paragraph 7(e) of PBE IFRS 17) if the risk transferred is significant, the issuer applies this Standard. Nevertheless, ~~an entity may elect, under certain circumstances, to treat financial guarantee contracts as insurance contracts using PBE IPSAS 28~~ if the issuer has previously applied accounting that is applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, ~~and has used accounting that is applicable to insurance contracts;~~ the issuer may elect to apply either this Standard or ~~PBE IFRS 4~~ PBE IFRS 17 to such financial guarantee contracts. …

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in this Standard, and are not insurance contracts as defined in PBE IFRS 17. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) …

Designation Eliminates or Significantly Reduces an Accounting Mismatch

…

AG92. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through surplus or deficit only if it meets the principle in paragraph 44 or 46(a):

(a) An entity has ~~liabilities under insurance~~ contracts within the scope of PBE IFRS 17 (~~whose~~ the measurement of which incorporates current information ~~(as permitted by paragraph 24 of~~

~~PBE IFRS 4~~) and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive revenue and expense or amortised cost.

(b) …

PBE IFRS 3 *Business Combinations* (if PBE IPSAS 40 *PBE Combinations* is not issued and does not become effective before PBE IFRS 17)

Paragraphs 17, 20, 21 and 35 are amended, after paragraph 31, a heading and paragraph 31.1 are added and paragraph 64.9 is added. New text is underlined and deleted text is struck through.

Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination

…

17. This Standard provides ~~two~~<u>an</u> exception~~s~~ to the principle in paragraph 15:

(a) Classification of a lease contract as either an operating lease or a finance lease in accordance with PBE IPSAS 13 *Leases*<u>.</u>~~; and~~

(b) <u>[Deleted by NZASB]</u>~~classification of a contract as an insurance contract in accordance with PBE IFRS 4 *Insurance Contracts*.~~

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

…

Measurement Principle

…

20. Paragraphs B41–B45 provide guidance on measuring the fair value of particular identifiable assets and a non-controlling interest in an acquiree. Paragraphs 24~~–31~~<u>31.1</u> specify the types of identifiable assets and liabilities that include items for which this Standard provides limited exceptions to the measurement principle.

Exceptions to the Recognition or Measurement Principles

21. This Standard provides limited exceptions to its recognition and measurement principles. Paragraphs 22- ~~31~~<u>31.1</u> specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs 22~~–31~~<u>31.1</u>, which will result in some items being:

…

<u>*Insurance Contracts*</u>

<u>31.1. The acquirer shall measure a group of contracts within the scope of PBE IFRS 17 *Insurance Contracts* acquired in a business combination as a liability or asset in accordance with paragraphs 39 and AG93- AG95 of PBE IFRS 17, at the acquisition date.</u>

…

Bargain Purchases

…

35. A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 22~~–31~~<u>31.1</u> may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

...

Effective Date and Transition

Effective Date

…

64.9 **PBE IFRS 17, issued in [date], amended paragraphs 17, 20, 21, 35 and B63, and after paragraph 31 added a heading and paragraph 31.1. An entity shall apply ~~those~~ the amendments to paragraph 17 to business combinations with an acquisition date after the date of initial application of PBE IFRS 17. An entity shall apply the other amendments when it applies PBE IFRS 17.**

In Appendix B, paragraph B63 is amended. New text is underlined and deleted text is struck through.

Other PBE Standards that Provide Guidance on Subsequent Measurement and Accounting (application of paragraph 54)

B63. Examples of other PBE Standards that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination include:

(a) …

(b) [Deleted by NZASB]~~PBE IFRS 4 *Insurance Contracts* provides guidance on the subsequent accounting for an insurance contract acquired in a business combination.~~

(c) …

Forthcoming PBE IPSAS 40 *PBE Combinations*

Note: NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3 *Business Combinations*. The amendments that would be required to PBE IPSAS 40, if PBE IPSAS 40 were to be issued before PBE IFRS 17, are set out below.

Paragraphs 71, 74, 75 and 89 are amended, after paragraph 84.1, a heading and paragraph 84.2 are added and paragraph 126.2 is added. New text is underlined and deleted text is struck through.

Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in an Acquisition

…

71. This Standard provides ~~two~~an exception~~s~~ to the principle in paragraph 69:

(a) Classification of a lease arrangement as either an operating lease or a finance lease in accordance with PBE IPSAS 13 *Leases*; and

(b) [Deleted by NZASB]~~Classification of a contract as an insurance contract in accordance with PBE IFRS 4 *Insurance Contracts*.~~

The acquirer shall classify those binding arrangements on the basis of the terms and other factors at the inception of the binding arrangement (or, if the terms of the binding arrangement have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

…

Measurement Principle

…

74. Paragraphs 78–84.~~1~~2 specify the types of identifiable assets and liabilities that include items for which this Standard provides limited exceptions to the measurement principle.

Exceptions to the Recognition or Measurement Principles

75. This Standard provides limited exceptions to its recognition and measurement principles. Paragraphs 76-84.~~1~~2 specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs 76–84.~~1~~2, which will result in some items being:

…

Insurance Contracts

84.2. The acquirer shall measure a group of contracts within the scope of PBE IFRS 17 *Insurance Contracts* acquired in an acquired operation as a liability or asset in accordance with paragraphs 39 and AG93–AG95 of PBE IFRS 17, at the acquisition date.

…

Bargain Purchases

…

89. A bargain purchase might happen, for example, in an acquisition that is a forced sale in which the seller is acting under economic compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 76–84.~~1~~2 may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

…

Effective Date

…

126.2 **PBE IFRS 17, issued in [date], amended paragraphs 71, 74, 75, 89 and AG107, and after paragraph 84.1 added a heading and paragraph 84.2. An entity shall apply the amendments to paragraph 71 to business combinations with an acquisition date after the date of initial application of PBE IFRS 17. An entity shall apply the other amendments when it applies PBE IFRS 17.**

In Appendix A Application Guidance, paragraph AG107 is amended. New text is underlined and deleted text is struck through.

Subsequent Measurement and Accounting (see paragraph 112)

AG107. Examples of other PBE Standards that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in an acquisition include:

(f) …

(g) [Deleted by NZASB]~~PBE IFRS 4 provides guidance on the subsequent accounting for an insurance contract acquired in an acquisition.~~

(h) …

PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Paragraph 5 is amended and paragraph 44.10 is added. New text is underlined and deleted text is struck through.

Scope

…

5. The measurement provisions of this Standard [footnote omitted] do not apply to the following assets, which are covered by the Standards listed, either as individual assets or as part of a disposal group:

   (a) …

   (f) ~~Contractual rights under insurance contracts as defined in PBE IFRS 4~~Groups of contracts within the scope of PBE IFRS 17 *Insurance Contracts*.

   ...

Effective Date

…

44.10 **PBE IFRS 17, issued in [date], amended paragraph 5. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE FRS 47 *First-time Adoption of PBE Standards by Entities other than those Previously Applying NZ IFRS*

Paragraph 42.10 is added. New text is underlined.

Effective Date

…

42.10 **PBE IFRS 17 *Insurance Contracts*, issued in [date], amended paragraph A1 and after paragraph A9 added a heading and paragraph A10. An entity shall apply those amendments when it applies PBE IFRS 17.**

In Appendix A, paragraph A1 is amended. After paragraph A9, a heading and paragraph A10 are added. New text is underlined and deleted text is struck through.

A1. An entity shall apply the following exceptions:

   (a) …

   (f) Embedded derivatives (paragraph A9); and~~.~~

   (g) Insurance contracts (paragraph A10).

   …

Insurance Contracts

A10. An entity shall apply the transition provisions in paragraphs 132.1–132.24 and 132.28 of PBE IFRS 17 to contracts within the scope of PBE IFRS 17. The references in those paragraphs in PBE IFRS 17 to the transition date shall be read as the date of transition to PBE Standards.

XRB A1 *Application of the Accounting Standards Framework*

Appendix C is amended. New text is underlined.

APPENDIX C

TIER 1 PBE ACCOUNTING REQUIREMENTS AND TIER 2 PBE ACCOUNTING REQUIREMENTS TO BE APPLIED BY PUBLIC BENEFIT ENTITIES

This appendix forms an integral part of XRB A1 Application of the Accounting Standards Framework.

…

Accounting Standards

…

PBE IFRS 4	*Insurance Contracts* <u>(superseded on adoption of PBE IFRS 17)</u>
…	
PBE IFRS 9	*Financial Instruments* (superseded on adoption of PBE IPSAS 41)
<u>PBE IFRS 17</u>	<u>*Insurance Contracts*</u>
…	

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, PBE IFRS 17.

BC1. The IPSASB has not developed, and at the date of issuing PBE IFRS 17 *Insurance Contracts* has no plans of developing, an IPSAS for accounting for insurance contracts.

BC2. When the PBE Standards were developed, the New Zealand Accounting Standards Board (NZASB) included PBE IFRS 4 *Insurance Contracts*, which was based on NZ IFRS 4 *Insurance Contracts*. Although NZ IFRS 4 included the requirements of IFRS 4 *Insurance Contracts*, it also included appendices that carried forward the accounting for insurance contracts that was applicable in New Zealand before the adoption of IFRS® Standards.

BC3. In August 2017 the NZASB approved NZ IFRS 17 *Insurance Contracts*, which is identical to IFRS 17 *Insurance Contracts* except for a New Zealand-specific scope paragraph. On adoption, NZ IFRS 17 supersedes NZ IFRS 4.

BC4. The NZASB did not modify the requirements in NZ IFRS 17 for application by Tier 1 and Tier 2 public benefit entities except for the scope as outlined below. The NZASB considered that the requirements of NZ IFRS 17 were appropriate for application by public benefit entities. Where applicable, the language has been generalised for use by public benefit entities.

Scope

BC5. The NZASB is aware that the IPSASB is finalising proposals for an International Public Sector Accounting Standard (IPSAS) dealing with the accounting for social benefits.[7] IPSASB ED 63 *Social Benefits* proposed that entities with contributory social benefit schemes that met certain criteria could elect to apply the insurance approach to those schemes, and that the insurance approach should be based on IFRS 17 or national standards that have adopted substantially the same principles as IFRS 17. The IPSASB considered that for social benefits schemes that meet the criteria to apply the insurance approach, that approach was expected to provide information that best meets users' needs. [IPSASB BC125].

BC6. In its comment letter to the IPSASB on ED 63, the NZASB supported the criteria proposed by the IPSASB for a scheme to be able to apply the insurance approach.

BC7. The NZASB is, therefore, proposing to amend the scope of PBE IFRS 17 to capture schemes that are eligible to apply the insurance approach under the IPSASB's forthcoming IPSAS dealing with Social Benefits.

BC8. The types of schemes that are proposed to be included in the scope of PBE IFRS 17 are those:

(a) That are intended to be fully funded from contributions and levies; and

(b) Where there is evidence that the entity manages the scheme in the same way as an issuer of insurance contracts, including assessing the financial performance and financial position of the arrangement on a regular basis.

BC9. The NZASB is also proposing to add Application Guidance from ED 63 on determining:

(a) Whether a scheme is intended to be fully funded from contributions and levies; and

(b) Whether a scheme is being managed in the same way as an insurer would manage an insurance portfolio.

Other PBE-specific modifications considered

BC10. The NZASB considered the following issues in determining whether PBE-specific modifications are needed to the requirements of IFRS 17.

(a) Whether a risk adjustment for non-financial risk is appropriate for PBEs.

(b) Whether the contract boundary is clear for PBEs that are funded through levies, particularly when determining their eligibility to apply the premium allocation approach.

7 The IPSASB is currently considering respondents' comments on ED 63 and plans to issue a final IPSAS at the end of 2018/early 2019.

(c) Whether the requirements of IFRS 17 to divide portfolios of insurance contracts into more granular groups of contracts and assess onerous contracts at that granular level are appropriate for PBEs.

(d) Whether the discount rate described in IFRS 17 is appropriate for PBEs, in particular the need for the discount rate to factor in liquidity.

~~(d)~~(e) Whether the onerous contracts provisions of IFRS 17 would need to be applied to a scheme where the fulfilment cash flows would reflect a net outflow in cases where the contributions or levies charged in a current coverage period are determined on a different basis as to how the fulfilment cash flows of the insurance liability for that same coverage period is measured under IFRS 17 for broader policy reasons.

BC11. The NZASB has not proposed any PBE-specific modifications to the requirements of IFRS 17 in relation to the issues outlined above for the following reasons.

(a) The NZASB acknowledged that some people disagree with the inclusion of a risk adjustment when measuring long-term liabilities for public sector entities. The requirements in PBE IFRS 17 are explicit in that the risk adjustment is determined from the perspective of the entity issuing the insurance contract. The risk adjustment under PBE IFRS 17 for a PBE could be small, and even potentially immaterial, but it is unlikely to equal zero. Although PBEs with the ability to recover cost overruns by increasing premiums/levies in future periods might have a less risk averse approach to an equivalent entity which does not have such ability, such PBEs are still expected to have a risk adjustment for non-financial risk, albeit lower than that of an equivalent entity without such powers.

(b) Paragraph 34 of PBE IFRS 17 explains which cash flows are within the boundary of an insurance contract, and when a substantive obligation to provide services ends (that is, the contract boundary). Paragraph 34 requires the entity to have the practical ability to reassess:

(i) the risks of the particular policyholder and, as a result, set a level of benefits that fully reflects those risks; and

(ii) the risks of the portfolio of insurance contacts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio.

(c) The NZASB considered the requirements in IFRS 17 for determining the boundary of an insurance contract for a PBE that is funded through levies rather than premiums. The NZASB is of the view that the requirements are sufficiently clear for such a PBE to determine the contract boundary.

(d) The NZASB considered the applicability of the requirements in IFRS 17 to public sector PBEs and is unaware of any situations in which a PBE would not be eligible to apply the PAA, and the application of the general model would not be appropriate.

(e) The NZASB notes that similar concerns regarding the level of granularity have been expressed by for-profit insurers and that this issue is, therefore, not specific to PBEs.

(f) Although concerns have been raised regarding the appropriateness for PBEs of applying a discount rate that includes an adjustment for liquidity and inconsistencies concerning discount rates in PBE Standards, the NZASB is of the view that it would be more appropriate to wait for the IPSASB to consider discount rates generally at a future date.

~~(f)~~(g) In assessing whether a scheme is intended to be fully funded from contributions and levies, an entity considers substance over form. Although a single coverage period could reflect a net cash outflow, the entity may consider the overall scheme to be sufficiently funded or overfunded on a portfolio basis over the long term.

BC12. The Australian Accounting Standards Board (AASB) considered the suitability of the requirements of IFRS 17 for private not-for-profit entities when developing AASB 17 *Insurance Contracts*. AASB 17 was issued in July 2017 and is applicable to for-profit entities and not-for-profit private sector entities. No changes were made to the recognition and measurement requirements in IFRS 17 when AASB 17 was developed. The AASB sought feedback on the appropriateness of the requirements for public sector entities and is undertaking further work on some issues raised by respondents.

History of Amendments

PBE IFRS 17 *Insurance Contracts* was issued in [Date].

This table lists the pronouncements establishing and substantially amending PBE IFRS 17.

Pronouncements	**Date approved**	**Early operative date**	**Effective date (annual reporting periods… on or after …)**
PBE IFRS 17 *Insurance Contracts*	[Date]	Early application is permitted	[Date]

June 2018

IFRS® Standards
Discussion Paper DP/2018/1

Financial Instruments with Characteristics of Equity

Comments to be received by 7 January 2019

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Financial Instruments with Characteristics of Equity

Comments to be received by 7 January 2019

This Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity* is published by the International Accounting Standards Board (Board) for comment only. The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by 7 January 2019 and should be submitted in writing to the address below, by email to commentletters@ifrs.org or electronically using our 'Open for comment' page at: http://ifrs.org/projects/open-for-comment/.

All comments will be on the public record and posted on our website at www.ifrs.org unless the respondent requests confidentiality. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for details on this and on how we use your personal data.

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CONTENTS

Summary and invitation to comment

Why is the Board publishing this Discussion Paper?

IN1 The distinction between liabilities and equity plays a significant role in how entities provide information in their financial statements. Two important consequences of the distinction between liabilities and equity for the issuers of financial instruments are that:

(a) it provides structure to the statement of financial position by including carrying amounts of liabilities and equity in separate totals; and

(b) changes in the carrying amounts of liabilities meet the definition of income and expense and are therefore included in the statement of financial performance.

IN2 IAS 32 *Financial Instruments: Presentation* establishes principles for distinguishing financial liabilities from equity instruments. It applies to the classification of financial instruments as financial assets, financial liabilities or equity instruments. A financial instrument is a contract that gives rise to a financial asset of one entity (the holder) and a financial liability or an equity instrument of another entity (the issuer). The focus of the Financial Instruments with Characteristics of Equity research project (FICE project) is on the classification of financial liabilities and equity instruments from the perspective of the issuer (the entity). The requirements in IFRS 9 *Financial Instruments* for the accounting by the holder of financial assets are therefore outside the FICE project's scope.[1]

IN3 The requirements in IAS 32 have been applied to the classification of the majority of financial instruments without difficulty, and their application to these instruments has produced classification outcomes that provide useful information to users of financial statements. Furthermore, the International Accounting Standards Board (Board) is not aware of any evidence to suggest that there were fundamental problems with IAS 32 during the global financial crisis of 2007–8.

IN4 However, various challenges have arisen from the application of IAS 32 to a growing number of financial instruments that combine various features, including different features of both simple bonds and ordinary shares—financial instruments with characteristics of equity. Users of financial statements who wish to understand the consequences of these financial instruments on an entity's financial position and financial performance have raised questions about their classification. Users have also expressed concerns about the limited information provided through presentation and disclosure about various features of these instruments. Furthermore, entities have encountered challenges when applying IAS 32 to particular financial instruments with characteristics of equity. These challenges have been brought to the attention of the Board through responses to various consultations and through the IFRS Interpretations Committee (Committee). The Committee has been unable to

1 See paragraph IN17.

resolve some of these questions because it was unable to identify a clear and consistent classification principle in IAS 32.

IN5 In response to such feedback, the Board decided to add the FICE project to its research agenda to investigate the challenges with applying IAS 32 to financial instruments with characteristics of equity. To address the challenges it identified, the Board has developed preliminary views on the classification, presentation and disclosure of financial instruments with characteristics of equity.

IN6 The Board is seeking feedback on the topics explored in this Discussion Paper, in particular on:

(a) the financial reporting challenges the Board has identified;

(b) the possible approaches to addressing those challenges; and

(c) whether the Board's preferred approach should be developed into a standards-level solution.

What challenges has the Board identified?

IN7 Although many classification outcomes of IAS 32 are well understood, the Board observed that a number of challenges arise from the application of IAS 32 because it does not always provide a clear rationale for its requirements. For example:

(a) IAS 32 does not provide a clear rationale for the requirements in relation to obligations settled by delivering an entity's own equity instruments. The classification outcome of obligations to deliver an entity's own equity instruments is one of the differences that arises from applying the definition of a financial liability in IAS 32 compared to applying the definition of a liability in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). The lack of a clear and consistent rationale in IAS 32 and in the *Conceptual Framework*, makes it difficult for the Board to develop consistent classification requirements across IFRS Standards.

(b) Even when the application of IAS 32 is straightforward, the absence of a clear rationale has prompted questions from stakeholders about whether the financial reporting consequences provide useful information about particular types of financial instruments with characteristics of equity. For example, some stakeholders have questioned whether recognising, in profit or loss, income and expense arising from some financial instruments provides useful information—such as shares that are redeemable by the holder for their fair value.

(c) Furthermore, the absence of a clear rationale introduces challenges in applying IAS 32 to financial instruments for which IAS 32 does not contain specific guidance—such as some written put options on non-controlling interests (NCI puts) and some types of contingent convertible bonds—and has resulted in diversity in practice.

IN8 One of the challenges in distinguishing liabilities from equity is that claims[2] against entities can have a wide variety of features, and the classification of claims as liabilities or equity can only provide some of the information about those features. Consequently, instead of relying solely on classification to provide useful information about similarities and differences between claims, the Board has considered whether the provision of information about some aspects of claims through presentation and disclosure should be required in addition to classification.

Summary of the Board's preliminary views

IN9 To respond to the challenges it has identified, the Board developed an approach (the Board's preferred approach) that:

(a) articulates the principles for the classification of financial instruments as either financial liabilities or equity instruments with a clear rationale, but without fundamentally changing the existing classification outcomes of IAS 32 (paragraphs IN10–IN12);

(b) would improve the information provided through presentation and disclosure about features of financial liabilities and equity instruments not captured by classification alone (paragraphs IN13–IN14); and

(c) would improve the consistency, completeness and clarity of the requirements for classification, in particular for contractual rights and/or obligations to exchange financial instruments, in which at least one of the financial instruments to be exchanged is an entity's own equity instrument (derivatives on own equity) (paragraph IN15).

Classification principles

IN10 The Board's preferred approach would classify a financial instrument as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

2 This Discussion Paper refers to liabilities and equity collectively as 'claims'.

IN11 The table below shows how the Board's preferred approach would classify financial liabilities and equity instruments:

Distinction based on amount feature Distinction based on timing feature	Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)	No obligation for an amount independent of the entity's available economic resources (such as an amount indexed to the entity's own share price)
Obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as scheduled cash payments)	**Liability** (eg simple bonds)	**Liability** (eg shares redeemable at fair value)
No obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as settlement in an entity's own shares)	**Liability** (eg bonds with an obligation to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of cash)	**Equity** (eg ordinary shares)

IN12 The two key features described in paragraph IN10 are based on the information needs of users of financial statements. In particular, information provided through the classification of financial liabilities and equity instruments applying the Board's preferred approach would be relevant to the following assessments of an entity's financial position and financial performance:

(a) information about financial instruments that require a transfer of cash or another financial asset at a specified time other than at liquidation would help users of financial statements assess whether the entity will have the cash or another financial asset required to meet its obligations as and when they fall due.

(b) information about financial instruments that are obligations for a specified amount independent of the entity's available economic resources and information about how that amount changes over time would help users of financial statements to assess:

(i) whether the entity has sufficient economic resources to meet its obligations at a point in time; and

(ii) whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve.

Presentation and disclosure

IN13 The Board's preferred approach would provide additional information through separate presentation on the face of the financial statements, including:

(a) information about some financial liabilities (such as obligations to transfer cash equal to the fair value of ordinary shares) that would be provided through the separate presentation of income and expense recognised on those financial liabilities; and

(b) information about equity instruments that would be provided by attributing total income and expense to some equity instruments other than ordinary shares.[3]

IN14 The Board also identified additional information about both financial liabilities and equity instruments that would be provided through disclosure in the notes to the financial statements, including information about:

(a) the priority of claims on liquidation;

(b) potential dilution of ordinary shares; and

(c) terms and conditions.

Consistency, completeness and clarity

IN15 In addition, the Board considered how the application of the Board's preferred approach to financial instruments would address various application challenges of applying IAS 32 to derivatives on own equity. In order to increase the comparability and therefore the usefulness of financial statements, financial instruments with similar contractual rights and obligations should be classified consistently regardless of the structure of the financial arrangement. Therefore, the Board considered how the two features described in paragraph IN10 would apply to derivatives on own equity that could be either separate financial instruments or embedded derivatives, including:

(a) the classification of derivatives on own equity, including when there is some variability in the number of equity instruments to be delivered or in the amount of cash or another financial asset to be received by the entity in exchange;

(b) the accounting for compound instruments (such as convertible bonds and some types of contingent convertible bonds); and

(c) the accounting for obligations to redeem equity instruments (such as NCI puts).

Who would be affected if the preliminary views in this Discussion Paper were to be implemented?

IN16 The distinction between liabilities and equity plays an important role in how entities provide information through their financial statements. Therefore, the challenges of making the distinction affect a broad range of stakeholders,

3 The Board has not reached a view on the best approach to determine the amount of attribution for derivative equity instruments.

including users of financial statements, entities preparing financial statements, auditors, and prudential and securities regulators.

IN17 However, the application of IAS 32 to the majority of financial instruments does not present significant challenges. Therefore, the Board is seeking to limit unnecessary changes to classification outcomes that are already well understood and provide useful information. The Board's preliminary views, as discussed in this Discussion Paper, would also have limited consequences for holders of financial assets, whose accounting is set out in IFRS 9.

IN18 The Board expects most of the existing classification outcomes of IAS 32 to remain the same if the Board's preferred approach were to be implemented. For example:

(a) obligations to transfer cash and obligations to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of currency would continue to be classified as financial liabilities; and

(b) ordinary shares, many non-cumulative preference shares and simple derivatives on own equity—such as written call options to deliver a fixed number of an entity's own ordinary shares for a fixed amount of cash—would continue to be classified as equity instruments.

IN19 In addition, the Board's preliminary view is that particular requirements of IAS 32 should be carried forward largely unaltered. For example:

(a) non-derivative financial instruments that include both a liability and an equity component (compound instruments) would continue to be separated as required by paragraph 28 of IAS 32;

(b) the exception to account for some financial liabilities as if they are equity instruments would be retained if they meet the conditions as set out in paragraphs 16A–16B or 16C–16D of IAS 32 (puttable exception); and

(c) the conclusions in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* would also be carried forward.

IN20 Clarifying the rationale for distinguishing financial liabilities from equity instruments would help to explain many of the existing classification outcomes arising from applying IAS 32. The Board's preferred approach would also help address the challenges of applying IAS 32 that have led to diversity in practice. Improving the consistency in accounting for similar financial instruments and addressing other challenges that have been identified, such as the classification and presentation of foreign currency convertible bonds, would also improve the comparability of financial information.

IN21 Although application of the Board's preferred approach would not be expected to change classification outcomes for the majority of financial instruments, the Board is aware that entities would be likely to incur some costs on transition because they would need to assess the effect of the proposals, if finalised, on their existing financial instruments. The Board would consider how to alleviate these consequences if it develops an exposure draft to implement its preliminary views.

IN22 For some financial instruments, there would be some changes to the classification outcomes compared to applying IAS 32. For example:[4]

(a) financial instruments with obligations for fixed cumulative returns, such as cumulative perpetual preference shares, would be classified as financial liabilities. Applying IAS 32, some of these obligations for which an entity has an unconditional right to defer cash payment indefinitely are classified as equity instruments (see Section 3).

(b) derivatives to deliver a fixed number of an entity's own ordinary shares for a fixed amount of cash that are net-settled by delivering the entity's own equity instruments would be classified as equity instruments. Applying IAS 32, all net-share settled derivative financial instruments are classified as financial assets or financial liabilities (see Section 4).

(c) all derivatives to deliver a fixed number of an entity's own ordinary shares for a fixed amount of foreign currency would be classified as financial assets or financial liabilities. Applying IAS 32, some of these derivative financial instruments are classified as equity instruments if they meet the foreign currency rights issue exception (see Section 4).

IN23 If the Board's preliminary views on presentation and disclosure were to be implemented they 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 distinctions within liabilities and within equity would help users of financial statements to make better assessments of an entity's prospects for future cash flows.

What does this Discussion Paper cover?

Section	Title	Summary
1	Objective, scope and challenges	Discusses the objective and scope of the FICE project and the challenges the Board identified in applying IAS 32.
2	The Board's preferred approach	Discusses the Board's preferred approach to the classification of liabilities and equity based on its analysis of various features of claims, and their economic consequences to the entity's financial position and financial performance.
3	Classification of non-derivative financial instruments	Discusses the application to non-derivative financial instruments of the Board's preferred approach.

continued...

4 Refer to Appendix D for a more detailed comparison of the classification outcomes.

...continued

Section	Title	Summary
4	Classification of derivative financial instruments	Discusses the application to derivative financial instruments of the Board's preferred approach.
5	Compound instruments and redemption obligation arrangements	Discusses the application to compound instruments and redemption obligation arrangements of the Board's preferred approach.
6	Presentation	Discusses what information about financial liabilities and equity instruments could be provided through presentation on the face of the financial statements.
7	Disclosure	Discusses what information about financial liabilities and equity instruments could be provided through disclosure in the notes to the financial statements.
8	Contractual terms	Discusses some of the challenges in determining whether obligations arise from contractual terms or some other mechanism and hence, whether particular rights or obligations are within the scope of the Board's preferred approach, including: (a) economic compulsion and indirect obligations; and (b) the relationship between contracts and law.

What are the next steps?

IN24 The views expressed in this Discussion Paper are preliminary and subject to change. This Discussion Paper does not cover all the matters that the Board would cover in an exposure draft to implement its preliminary views, for example, any transition requirements. The Board will consider the comments received on this Discussion Paper before deciding whether to develop an exposure draft with proposals to amend or replace parts of IAS 32 and/or to develop non-mandatory guidance. The feedback received will also be used to inform the Board's other projects.

Invitation to comment

The Board invites comments on all matters in this Discussion Paper and, in particular, on the questions set out at the end of each section under 'Questions for respondents'. Comments are most helpful if they:

(a) respond to the questions as they are set out in this Discussion Paper;

(b) indicate the specific paragraphs or group of paragraphs to which they relate;

(c) contain a clear rationale; and

(d) describe any alternative that the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional matters.

The Board will consider all comments received in writing by 7 January 2019 (180 days).

How to comment

We would prefer to receive your comments electronically, however, comments can be submitted using any of the following methods:

Electronically	Visit the 'Open for comment' page at: https://go.ifrs.org/open-for-comment
By email	Send comments to: commentletters@ifrs.org
By post	Written comments should be sent to: IFRS Foundation 7 Westferry Circus Canary Wharf London E14 4HD United Kingdom

All comments will be on the public record and posted on our website unless confidentiality is requested. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for further details on this and on how we use your personal data.

Section 1—Objective, scope and challenges

1.1 This section discusses the objective and scope of the Financial Instruments with Characteristics of Equity research project (FICE project), the challenges the International Accounting Standards Board (Board) identified and its response to those challenges. In developing its response to the challenges identified, the Board observed that:

(a) the absence of a clear rationale for the classification requirements in IAS 32 has led to challenges concerning the application of the requirements, and to challenges with explaining classification outcomes even when the application of the requirements in IAS 32 is straightforward. Therefore, the Board decided to develop an approach that articulates the principles for classification of financial liabilities and equity instruments with a clear rationale. The approach would do so without fundamentally changing the classification outcomes that would arise when applying IAS 32.

(b) claims[5] against entities can have a wide variety of features, and their classification as liabilities or equity can only provide some information about the variety of those features. Therefore, in this Discussion Paper, the Board considers whether entities also should provide information about some aspects of claims through presentation and disclosure rather than relying solely on classification.

1.2 This section is structured as follows:

(a) Why the FICE project is on the Board's research agenda (paragraphs 1.3–1.10);

(b) The scope of the FICE project (paragraphs 1.11–1.22);

(c) The challenges the Board has identified (paragraphs 1.23–1.37);

(d) Whether the challenges merit the Board developing a standards-level solution (paragraphs 1.38–1.44); and

(e) Questions for respondents (paragraph 1.44).

Why the FICE project is on the Board's research agenda

1.3 The Board considered some aspects of distinguishing liabilities from equity as part of its project to revise the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*).[6] As part of that project the Board decided that the *Conceptual Framework* should continue to make a binary distinction between liabilities and equity.[7] However, in 2014 the Board decided to further explore how to distinguish liabilities from equity as part of a separate FICE project because it did not want to delay other much-needed improvements to the

5 This Discussion Paper refers to liabilities and equity collectively as 'claims'.
6 The Board issued the revised *Conceptual Framework* in May 2018.
7 See paragraphs BC4.89–BC4.92 of the Basis for Conclusions on the *Conceptual Framework*.

Conceptual Framework. Consequently, the 2018 *Conceptual Framework* does not address classification of financial instruments with characteristics of equity.[8]

1.4 Respondents to the Board's *2015 Agenda Consultation* agreed that adding the FICE project is needed:

(a) to follow on the Board's work on the *Conceptual Framework*;

(b) to address the issues with IAS 32 *Financial Instruments: Presentation* that have led to diversity in practice and the challenges of classifying new forms of financing; and

(c) to provide better information about financial instruments with characteristics of equity beyond that provided by classification.

1.5 Respondents to the Board's *2015 Agenda Consultation* also said that the requirements in IAS 32:[9]

(a) are, in some cases, complex, poorly understood and difficult to apply;

(b) lead to classification outcomes that do not reflect the economic substance of particular financial instruments common in some jurisdictions;

(c) have, over the years, been amended in a piecemeal fashion that has raised practical issues and resulted in diversity in practice; and

(d) are not robust enough to address the increasing complexity and sophistication of some financial instruments being issued.

1.6 Respondents to the Board's *2015 Agenda Consultation* and investors who participated in the accompanying online survey identified the FICE project as a high priority. Many respondents said that the FICE project is important to provide a more robust set of principles for distinguishing financial liabilities from equity. In their view, such principles should make it easier to resolve several long-standing issues and address possible future issues.

1.7 The Board has also become aware of challenges in distinguishing financial liabilities from equity instruments in IAS 32 from submissions to the IFRS Interpretations Committee (Interpretations Committee). The Interpretations Committee was unable to reach a consensus on some of these submissions because the Committee found it difficult to identify a clear and consistent classification principle in IAS 32. These submissions highlighted some inconsistencies and complexity as well as some disagreement about some of the classification outcomes of applying IAS 32.

1.8 In addition, the Board has previously acknowledged the differences between the definition of a liability in the *Conceptual Framework* and the definition of a financial liability in IAS 32.[10] These differences have resulted in inconsistencies in how IFRS Standards distinguish liabilities from equity (see Appendix B).

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8 Appendix B includes further discussion on the relationship between the FICE project and the *Conceptual Framework*.

9 Respondents identified similar issues with IAS 32 *Financial Instruments: Presentation* in their feedback on the *2011 Agenda Consultation* (see paragraph 1.20).

10 Most recently these differences were acknowledged in the 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (*Conceptual Framework* DP).

1.9 In response to feedback on the Board's *2015 Agenda Consultation*, and to address issues brought to the Board's attention in other ways, the Board confirmed the FICE project as a priority project and therefore as part of its active research agenda.

1.10 The purpose of the Board's research agenda is to analyse possible financial reporting problems by collecting evidence on the nature and extent of the perceived problems and assessing potential ways to improve financial reporting or to remedy identified deficiencies. Accordingly, the objective of this Discussion Paper is to obtain initial views and comments to help the Board decide whether it should add a project to its standard-setting programme to amend or replace IAS 32.

The scope of the FICE project

1.11 To set the scope of the FICE project, the Board considered the feedback from its agenda consultations and from its previous consultations on similar topics. It also received feedback from the Accounting Standards Advisory Forum (ASAF).

1.12 The Board considered two different approaches to the scope of the project:

(a) a fundamental review of the underlying concepts for distinguishing between liabilities and equity and of the requirements of IAS 32 unconstrained by existing concepts and requirements; and

(b) a narrow-scope review of the requirements of IAS 32 to address particular application challenges without reconsidering the underlying concepts in IAS 32.

1.13 To respond to emerging issues regarding the classification of financial instruments, such as particular puttable instruments and foreign currency rights issues, the Board has in the past made narrow-scope amendments to IAS 32. However, concerns about narrow scope amendments include:

(a) previous narrow-scope amendments introduced exceptions to, and inconsistencies in, the requirements of IAS 32 and may have contributed to some of the challenges identified by respondents to the Board's agenda consultations (for example, see paragraph 1.36(b)).

(b) the Board may be unable to address some of the challenges it has identified through a narrow-scope project (see paragraph 1.26). For example, reasons cited by the Committee for referring some of the submissions on IAS 32 to the Board include:

(i) the issue raised in the submission was broader than the particular fact pattern in the submission;

(ii) the difficulty in identifying a clear and consistent classification principle in IAS 32; and

(iii) the lack of a basis for conclusions to justify the outcomes of applying IAS 32.

(c) some ASAF members cautioned the Board that a narrow-scope project to address only particular application issues could introduce further exceptions and inconsistencies. Those ASAF members suggested that a fundamental review of the distinction between liabilities and equity based on sound concepts has the advantage of avoiding further inconsistencies and exceptions.

1.14 The Board performed a fundamental review of the underlying concepts for distinguishing between liabilities and equity in its predecessor FICE project.[11] To address the challenges identified in the predecessor project and simplify the distinction between financial liabilities and equity instruments, that project explored a replacement of IAS 32 that would have classified only the most subordinate claim as an equity instrument. Following feedback on that proposed approach, the Board considered other approaches that might have required a less significant change than such a classification approach. However, the Board had to reassess its agenda priorities and suspend the project before it was able to reach a consensus on a distinction between financial liabilities and equity instruments that would have provided more useful information than that provided by the classification outcomes that result from applying IAS 32.

1.15 Notwithstanding the challenges the Board identified with IAS 32, the Board has found little evidence that it needs to reconsider all, or even most of, the classification outcomes that result from applying IAS 32. The Board observed that:

(a) for most financial instruments, applying IAS 32 provides useful information to users of financial statements and creates few application challenges for preparers; and

(b) problems with IAS 32 were not evident as a result of the global financial crisis of 2007–8, although challenges have arisen when applying IAS 32 to some financial instruments that became popular as a means of addressing the crisis, such as some types of contingent convertible bonds (see paragraph 1.25(b)).

1.16 Based on these observations, many ASAF members suggested that, while a comprehensive review of the requirements should be undertaken, the Board should not disregard the principles and requirements in IAS 32 and start from a blank sheet of paper. ASAF members recommended that, instead of introducing an approach that changes well-understood classification outcomes, the project should provide a better foundation for classification outcomes by focusing on identifying the underlying rationale for distinguishing financial liabilities from equity instruments.

1.17 Accordingly, the Board decided that, while the objective of the FICE project is to respond to challenges in distinguishing financial liabilities from equity instruments when applying IAS 32, any potential solution should limit unnecessary changes to classification outcomes that are already well understood. Therefore, the Board agreed with the ASAF that while the scope of the project should be comprehensive, the starting point should be based on the

11 The predecessor project was a joint project led by the US Financial Accounting Standards Board (US FASB). That project resulted in the publication of the Discussion Paper *Financial Instruments with Characteristics of Equity* in February 2008 (the 2008 Discussion Paper). The current FICE project is not a joint project. The Board has considered the work performed and feedback received on the predecessor project in developing this Discussion Paper.

existing principles and requirements of IAS 32 with a focus on identifying the underlying rationale for distinguishing financial liabilities from equity instruments.

1.18 The Board observed that changes or refinements to classification principles might not be sufficient to resolve all the challenges it has identified. In its Conceptual Framework project, the Board explored whether enhancing presentation and disclosure requirements could help address some of those challenges. The Board's preliminary view in the *Conceptual Framework* DP was that additional information about subclasses of equity—in particular, information about the transfer of wealth among equity claims—would provide useful information to users of financial statements. However, the Board did not develop those preliminary views as part of the Conceptual Framework project; instead the Board decided to explore them further as part of the FICE project.

1.19 Some respondents to the *Conceptual Framework* DP agreed with the preliminary view to provide additional information about equity instruments. These respondents suggested that doing so would reduce the differences in the information provided about liabilities and equity, thereby mitigating the consequences when entities structure financial instruments to achieve a particular accounting outcome. Some of these respondents thought that such additional information about equity instruments might be more useful if entities presented it in a different way. These respondents suggested that the Board explore approaches to providing additional information about subclasses of equity in more detail. Some users of financial statements, in particular, supported providing this information through the statement of changes in equity. In addition, some users of financial statements suggested that entities might need to supplement that information by expanding the disclosure of potential dilution in different scenarios.

1.20 Furthermore, users of financial statements have asked for more information about the wide variety of financial instruments issued by entities. In their responses to past consultations,[12] including the Board's *2015 Agenda Consultation*, they have requested improvements to the information provided about:

(a) the nature, terms and conditions and other features of financial instruments, regardless of their classification as financial liabilities or equity instruments;

(b) the potential dilution of existing equity instruments through the issue of additional equity instruments; and

(c) an entity's overall capital structure including liquidity needs and the priority of claims on liquidation.

1.21 Accordingly, the Board decided that the FICE project should investigate the presentation and disclosure requirements for financial instruments in addition to their classification.

12 Including the *Conceptual Framework* DP, the Board's *2015 Agenda Consultation* and *2011 Agenda Consultation*, the Investor Perspectives article, *Better communication—A table is worth 1000 words*, and the 2008 Discussion Paper.

1.22 The focus of the FICE project is on the classification of financial instruments as financial liabilities, financial assets, or equity instruments. The Board decided not to consider changes to the recognition and measurement requirements that apply to financial assets and financial liabilities as part of this project. After an entity has classified a financial instrument as a financial asset or a financial liability by applying IAS 32, it then applies IFRS 9 *Financial Instruments* and, when relevant, IFRS 13 *Fair Value Measurement* for recognition and measurement. The Board has kept in mind the relationship between the requirements of IAS 32 and IFRS 9 when considering how an entity would provide information about financial liabilities.

The challenges the Board has identified

1.23 Most, if not all, possible approaches to the distinction between financial liabilities and equity instruments would classify simple financial instruments, such as simple bonds and ordinary shares, as financial liabilities and as equity instruments respectively. However, market forces, financial innovation and changes in bank capital regulations have generated a wide range of financial instruments that combine various features, including features of both simple bonds and ordinary shares (financial instruments with characteristics of equity). Such financial instruments allow entities to raise finance from investors with varied preferences for risk and expected returns and, in response to those preferences, the mix of features found in financial instruments is constantly changing.

1.24 The application of IAS 32 to many financial instruments with characteristics of equity, such as simple convertible bonds, has provided useful information to users of financial statements. Entities have also been applying IAS 32 to most of these financial instruments without any significant problems. However, a growing set of financial instruments with characteristics of equity have presented challenges when entities apply IAS 32. For some of these financial instruments, the application of IAS 32 is clear; however, some stakeholders disagree with the classification outcome, or with some of the financial reporting consequences of that outcome, such as recognising the resulting income and expense for particular financial liabilities—for example, for shares redeemable at fair value—in profit or loss. For other financial instruments, it is unclear how entities should apply the requirements of IAS 32 to classify them as financial liabilities or equity instruments and that results in diversity in practice.

1.25 Examples of financial instruments that have presented such challenges include:

(a) put options written on non-controlling interests (NCI puts) with a strike price at fair value—such instruments 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 of the NCI put (typically the non-controlling interest shareholder) (see paragraphs 1.32 and 1.36(c)).

(b) contingent convertible bonds—of the many varieties that exist in practice, the particular financial instrument that the Committee considered was one that pays interest at the discretion of the issuer and mandatorily converts to a variable number of the issuer's own shares if the issuer breaches its 'Tier 1 Capital ratio'.[13] The value of the variable number of shares an entity is obliged to deliver on conversion is equal to the face value of the claim (ie a variable number of the entity's own shares with a total value equal to a fixed amount of currency) (see paragraph 1.36(d)).

1.26 The Committee has considered the application of IAS 32 to the financial instruments described in paragraph 1.25; however, the issues in these submissions remain unresolved.

1.27 Any project that seeks to distinguish liabilities from equity will need to respond to:

(a) the conceptual challenge of identifying the rationale for distinguishing liabilities from equity (paragraphs 1.28–1.34); and

(b) the application challenge of developing principles that balance the benefits of the information provided with the costs and complexity of their application (paragraphs 1.35–1.37).

Conceptual challenges

1.28 Identifying a rationale for distinguishing liabilities from equity is difficult because of the variety of claims with different features that have different consequences for an entity's prospects for future cash flows. Different features include, for example, the timing of a required transfer of economic resources, the amount of the claim and its priority relative to other claims against the entity. Information about all those features is relevant to users of financial statements and many of those features could form a basis for distinguishing liabilities from equity. Currently, IAS 32, other IFRS Standards and the *Conceptual Framework* use various features to distinguish liabilities from equity, often without a clear basis for selecting the distinguishing features.

1.29 Applying IAS 32, an entity classifies a financial instrument as a financial liability if it gives rise to either of the following:

(a) a contractual obligation to deliver cash or another financial asset or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the issuer. If an entity has such a contractual obligation, such as an unavoidable obligation to pay cash, the financial instrument is a financial liability, regardless of how the amount payable or receivable is determined.

(b) a contractual obligation to deliver a variable number of its own equity instruments (for example, an obligation to deliver a variable number of an entity's own ordinary shares with a total value equal to CU100).[14] If an entity has such a contractual obligation, the financial instrument is a financial liability, even though the entity does not have a contractual obligation to deliver any of its economic resources.[15]

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13 'Tier 1 Capital ratio' is the ratio of a bank's Tier 1 capital to its total risk-weighted assets as defined by a prudential regulator.

14 In this Discussion Paper amounts are denominated in Currency Units (CU).

15 Equity instruments issued by an entity are not economic resources of the entity (see paragraph 4.10 of the *Conceptual Framework*).

1.30 However, IAS 32 does not use the same features consistently (see paragraph 1.36(b)) and the Board's reasons for selecting those features are sometimes unclear. For example, IAS 32 does not provide a clear rationale for the classification of the contractual obligation described in paragraph 1.29(b). The classification of obligations settled by delivering an entity's own equity instruments is one of the differences between the definition of a financial liability in IAS 32 and the definition of a liability in the *Conceptual Framework*. The *Conceptual Framework* defines a liability as 'a present obligation to transfer an economic resource as a result of past events'.[16] Like IAS 32, the *Conceptual Framework* does not provide a rationale for the classification of obligations to deliver equity instruments.

1.31 The use of different features to classify liabilities and equity both within IAS 32 and in other IFRS Standards[17] introduces inconsistencies, reduces comparability and makes financial statements less understandable. This is because the distinction between liabilities and equity is fundamental to IFRS Standards and has significant and polarised consequences for an entity's financial statements. These consequences include how the entity's financial position and financial performance is depicted, and differences in other information provided about liabilities compared to equity, such as through measurement and disclosure requirements.

1.32 The conceptual challenges can be illustrated by considering the type of NCI put as described in paragraph 1.25(a), in which the contractual obligation to transfer cash is similar to the contractual obligation to transfer cash in a simple bond. Classifying that obligation in the NCI put as a liability depicts the obligation to deliver cash in the same way as a simple bond. Unlike the bond, however, the amount of cash the entity is obliged to transfer equals the fair value of the underlying non-controlling interest share. Therefore, recognising changes in the carrying amount of that liability as income or expense would depict the return on that claim differently from how a similar economic return on ordinary shares would be depicted. In contrast, if that obligation in the NCI put were classified as equity it would depict returns similarly to how a similar economic return on ordinary shares would be depicted. However, classifying that obligation in the NCI put as equity would not reflect its similarity to a simple bond—the obligation to transfer cash.

1.33 Contrasting views about classification outcomes are inevitable because classifying a financial instrument that shares characteristics of both financial liabilities and equity instruments as one or the other inevitably results in capturing some but not all of the similarities and differences.

1.34 Consequently, given that claims against entities can have a wide variety of features, classification as liabilities or equity can provide only some information about the features of an instrument. Therefore, this Discussion Paper sets out the Board's consideration of whether it is necessary to provide information about some aspects of claims through presentation and disclosure rather than relying solely on classification.

16 See paragraph 4.26 of the *Conceptual Framework*.

17 For example, IFRS 2 classifies obligations to deliver equity instruments differently to IAS 32.

Application challenges

1.35 IAS 32 includes two main requirements for classification (see paragraph 1.29), as well as additional requirements that apply to particular transactions and circumstances. Respondents to previous consultations have suggested that some financial instruments have challenged the consistency, completeness and clarity of the requirements in IAS 32. Some of these challenges are also evident from issues submitted to the Committee, some of which remain unresolved.

1.36 Issues raised by interested parties relate to the following requirements:

(a) derivative financial instruments—IAS 32 classifies a contract as a financial asset or a financial liability if it is a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments (fixed-for-fixed condition). Questions have arisen regarding the application of the fixed-for-fixed condition to particular types of financial instruments. For example, some respondents have asked for guidance on how to apply the fixed-for-fixed condition to a written call option to deliver a fixed number of an entity's own shares in exchange for a fixed amount of cash when the number of shares changes only as a result of an anti-dilution provision.

(b) foreign currency rights issue exception—as an exception to the fixed-for-fixed condition, IAS 32 classifies rights, options, or warrants to issue a fixed number of an entity's own equity instruments in exchange for a fixed amount of any currency as equity instruments, if, and only if, the entity offers those instruments pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Interested parties question why derivative financial instruments that meet this exception should be classified differently to conversion options in foreign currency convertible bonds, which are classified as financial liabilities.

(c) contracts that contain obligations to purchase an entity's own equity instruments—paragraph 23 of IAS 32 includes requirements for some written put options and forward purchase contracts on an entity's own equity instruments. Applying those requirements results in a financial liability for the present value of the redemption amount (ie the contract is 'grossed-up'). Some respondents to previous consultations questioned:

(i) whether it is appropriate that such derivative financial instruments are grossed-up rather than measured on a net basis like other derivative financial instruments, in particular when the obligation is conditional on exercise of an option, as it is in NCI puts.

(ii) the lack of requirements in IAS 32 on how to account for some transactions within equity. For example, for NCI puts, it is not clear whether the non-controlling interest should be derecognised when the redemption liability is recognised, or whether an 'equity receivable' should be recognised as a debit to the parent interest component of equity.

(d) contingent settlement provisions—paragraph 25 of IAS 32 includes requirements for contingent settlement provisions triggered by the occurrence (or non-occurrence) of uncertain future events that are beyond the control of both the issuer and the holder (such as a change in a stock market index or changes in an entity's capital ratio). However, when applying these requirements, questions have been raised about whether the liability component should include the conditionality of the settlement outcome, in particular for some types of contingent convertible bonds.

(e) contractual terms—IAS 32 includes principles for the classification of contracts that contain an obligation to transfer cash or another financial asset through their contractual terms. The contractual terms might establish such an obligation explicitly or indirectly. However, in some circumstances, it is unclear whether obligations arise from the contractual terms or some other mechanism. For example:

(i) the terms of a contract may not establish an obligation explicitly or indirectly, but economic incentives may force an entity to transfer cash or another financial asset—for example, some types of preference shares with dividend rates that increase over time that incentivise redemption.

(ii) obligations may be introduced through a mechanism other than a contract (such as those established by statutory or regulatory requirements). For example, law or regulation in some jurisdictions obliges some entities to offer to purchase the non-controlling interests when acquiring a controlling interest (mandatory tender offer).

1.37 While the issues discussed in paragraph 1.36 are important application questions, they do not question the usefulness of information from classification outcomes resulting from the application of existing requirements to most types of simple financial instruments. Consequently, the Board decided that the FICE project's objective should be to articulate the principles for the classification of financial liabilities and equity instruments with a clear rationale, without fundamentally changing the existing classification outcomes of IAS 32. This Discussion Paper sets out the Board's consideration of how those principles would improve the consistency, completeness and clarity of the requirements for classification in IAS 32.

Whether the challenges merit the Board developing a standards-level solution

1.38 Given the consequences of distinguishing financial liabilities from equity instruments, any change to that distinction may have a pervasive effect across many jurisdictions and many different types of entities. As stated in paragraph 1.24, the application of IAS 32 to most types of simple financial liabilities and equity instruments does not present any significant challenges. However, continuing financial innovation has increased the variety of claims to which the requirements of IAS 32 apply.

1.39 The Board observed that issues with classifying financial instruments as financial liabilities or equity instruments results in challenges for the primary users of financial statements, such as investors, lenders and other creditors. Such challenges include estimating the expected return on their investments, comparing the financial position and performance among entities and understanding an entity's financial performance and financial position. Users of financial statements are also affected by diversity in practice arising from the application of IAS 32. Application challenges, if unresolved, have the potential to increase such diversity in practice, further reducing the comparability and understandability of financial statements.

1.40 The Board also observed that users of financial statements are affected not only by challenges in distinguishing liabilities from equity but also by a lack of information about other relevant distinctions within liabilities and within equity. For example, respondents to previous consultations have requested:

(a) information about claims that participate in the upside potential of an entity's economic resources;

(b) information to help users of financial statements better assess the risk and rewards for each equity instrument and to estimate the return on their investment; and

(c) information about terms and conditions of equity instruments and about equity instruments issued and redeemed during a reporting period.

1.41 IFRS Standards have more comprehensive disclosure requirements for financial liabilities than for equity instruments. The absence of specific IFRS requirements to provide more detailed information about various equity instruments is one of the reasons why some equity investors and analysts support a narrow definition of equity. Under such a classification approach, all financial instruments other than ordinary shares would have been accounted for as liabilities and consequently would have resulted in the provision of more detailed information under the more comprehensive disclosure requirements.

1.42 Parties other than the primary users of financial statements are also affected by classification issues, including:

(a) preparers who have an interest in presenting relevant information about their financial position and financial performance as faithfully as possible, and an interest in limiting the complexity and costs of applying the requirements.

(b) prudential and securities regulators who have an interest in how the financial statements represent the financial position and financial performance of entities and an interest in the enforceability of the requirements. Regulators also want to know how robust the distinction is between liabilities and equity, and to understand its relationship to other regulatory requirements. The Board expects that the preliminary views in this Discussion Paper will not have a direct impact on prudential capital requirements, as prudential regulators have their own requirements for defining regulatory capital.

(c) auditors who have an interest in the auditability of the requirements. Auditors are also interested in the clarity of the distinction between liabilities and equity, and the complexity and cost of applying the accounting requirements.

1.43 The Board observed that the challenges in the application of IAS 32 and of the understanding of its classification outcomes, relate to financial instruments with particular sets of features, and therefore will affect some entities more than others. However, in many cases, the transactions in question are large and, therefore, the classification of a financial instrument as either a financial liability or an equity instrument will have a significant effect on some entities' financial statements. For example:

(a) new capital requirements that banking regulators introduced after the global financial crisis of 2007–8 have prompted financial institutions to issue more and increasingly varied contingent convertible bonds. The contingent convertible bonds described in paragraph 1.25(b) are one type of this new financial instrument.

(b) in some economies, entities issue foreign currency convertible bonds (paragraph 1.36(b)) to access capital markets in other economies.

(c) mandatory tender offers arising from acquisitions of controlling interests are regulatory requirements in some jurisdictions but not in others.

(d) some financial instruments contain features that reflect the specific needs of particular investors in a particular entity. For example, sometimes the acquirer in a business combination offers a holder of a non-controlling interest the right to sell their shares to the acquirer at their fair value (a fair value written put option). The acquirer might make such an offer to provide liquidity to the non-controlling interest in cases when a subsidiary's shares are not listed.

1.44 Given the considerations outlined in paragraphs 1.38–1.43, the Board concluded that the challenges identified in paragraphs 1.23–1.37 merit the investigation of a standards-level solution. In response to those challenges, the Board has:

(a) developed an approach that provides the underlying rationale for the classification of liabilities and equity (Section 2). That approach is based on the Board's preliminary views on:

(i) the information that is best provided using the distinction between liabilities and equity; and

(ii) the information that is best provided through presentation and disclosure requirements.

(b) articulated principles for the classification of financial instruments as financial liabilities and equity instruments, based on the underlying rationale of the approach in (a), and considered how the principles address the challenges of applying IAS 32, including improving the consistency, completeness and clarity of the requirements in IAS 32 (Sections 3, 4 and 5).

(c) developed principles for the presentation and disclosure of financial instruments (Sections 6 and 7).

Questions for respondents

Question 1
Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes. (a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges? (b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

Section 2—The Board's preferred approach

2.1 This section sets out the Board's preliminary views regarding the underlying rationale of the distinction between liabilities and equity. The Board's preliminary views are based on its analysis of various features of claims, and their consequences for an entity's financial position and financial performance. In the Board's preliminary view, its preferred approach would strike the best balance between the information provided through classification and that provided through presentation and disclosure. The Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

2.2 This section is structured as follows:

(a) What features of claims are relevant to users of financial statements? (paragraphs 2.3–2.12)

(b) What are the consequences of the distinction between liabilities and equity? (paragraphs 2.13–2.14)

(c) What features are relevant to which assessments? (paragraphs 2.15–2.31)

(d) Which features should be depicted through classification and which through presentation and disclosure? (paragraphs 2.32–2.47); and

(e) Summary of preliminary views and questions for respondents (paragraphs 2.48–2.52)

What features of claims are relevant to users of financial statements?

2.3 The Board identified various features of claims that affect an entity's cash flows and, in particular, how an entity's cash flows will be distributed among holders of claims against the entity. Information about the features identified should help users of financial statements make assessments that will inform their decisions about providing resources to the entity.

2.4 One claim that is clearly a liability, and which would always be classified as such is a simple bond with an obligation to pay cash equal to CU100 in two years that is senior to all other claims.

2.5 One feature of the simple bond in paragraph 2.4 is that it requires the entity to transfer economic resources at a specified time other than at liquidation, ie in two years. Information about this feature of the simple bond is relevant to users of financial statements because, to meet its obligation, the entity will be required to sacrifice its assets, or to obtain some other economic resources by, say, getting a loan or issuing some other claim. In this Discussion Paper, such a feature is referred to as the timing of the required transfer of economic resources (or simply the timing feature). The timing feature might be specified as a fixed date, or for example as:

(a) payable on demand;

(b) dates of coupon or interest payments;

(c) dates of principal payment (eg at maturity or over the life of the instrument);

(d) option exercise dates; and

(e) at liquidation (ie perpetual term).

2.6 The timing of the required transfer of economic resources is often regarded as the key feature by which liabilities can be distinguished from equity. However, the simple bond in paragraph 2.4 also has a number of other features that affect the entity in different ways; information about these features is also relevant to users of financial statements.

2.7 One of the other features of the simple bond in paragraph 2.4 for which information would be relevant to users of financial statements is that the amount of cash that the entity is required to transfer is fixed. The fixed nature of the amount is relevant because such an amount does not change in response to changes in the entity's available economic resources. Therefore, the fixed nature of the amount introduces the risk that the entity may not have sufficient economic resources, or produce a sufficient return on those economic resources, to meet its obligation.[18] This Discussion Paper refers to how the amount of an obligation is specified as the 'amount' of the obligation, and it might be specified as a fixed number of currency units or:

(a) face values, interest payments, or amounts indexed to units of a selected commodity, financial asset, or a basket or index of assets.[19]

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18 The 'amount' does not refer to the fair value of the financial instrument, but rather to the amount specified in the contract (see further discussion in paragraph 3.21).

19 Typically, the amount of resources required to settle a claim will be specified using the same units as the type of resource required to be transferred; however sometimes such amounts differ. For example, many derivatives are required to be settled with cash, but the amount of cash required to settle the claim may be determined by reference to commodities or share prices.

(b) an amount indexed to a reference rate. The reference rate could be market interest rates, fixed rates or changes in the prices of a market variable such as a currency, commodity, financial asset or a basket or index of assets.

(c) a proportionate share of the entity's economic resources after deducting the economic resources required to meet all other claims.

2.8 Information would also be relevant to users of financial statements about some of the other features of the simple bond in paragraph 2.4, including:

(a) that the type of economic resource the entity is required to transfer is cash. If the entity's assets are illiquid and the entity is required to transfer cash then it will introduce the risk that the entity may not be able to obtain the cash required to meet its obligation, or incur significant costs, even if the entity has sufficient economic resources. Other claims might specify the type of economic resource as a particular financial asset or a specific type of good or service.

(b) that the simple bond is senior to other liabilities, which means that the risks arising from its other features—such as whether the entity will have a sufficient amount of cash at the required time—are lower for this simple bond than they would be for subordinated claims. The priority (sometimes referred to as the seniority or rank) of a claim is specified relative to other claims.

2.9 An ordinary share differs from a simple bond in terms of all the features discussed in paragraphs 2.5–2.8. Unlike the simple bond in paragraph 2.4, an ordinary share does not require the transfer of a specific type of economic resource, or a specific amount of economic resource at a specified time other than at liquidation. For the purposes of this Discussion Paper, an ordinary share is a claim that has the following features:[20]

(a) it is the most subordinated claim; and

(b) it requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred is equal to a pro rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.

2.10 Some other rights and obligations of a claim might indirectly affect the expected returns on the claim but might not directly relate to how future net cash inflows are distributed among claims. For example, a bond may include covenants that restrict an entity's use of resources; or an ordinary share may include a right to vote on particular matters, and the exercise of these rights could affect how the entity uses its economic resources.

2.11 Other claims could have various combinations of the features of ordinary shares and the simple bond described in paragraphs 2.4–2.9. For example:

20 Refer to Section 6 for a more detailed discussion about distinguishing other equity claims from equity instruments that have the features of ordinary shares.

(a) shares redeemable at fair value—shares that are redeemable on demand by the holder, for an amount of cash equal to the fair value of an ordinary share. The requirement to transfer economic resources, and specifically cash, on demand has implications similar to the same requirement in the simple bond, requiring an entity either to transfer or sell its assets, or to obtain cash some other way. However, the amount of the obligation will change in response to changes in the price of the entity's ordinary shares.

(b) share-settled bond—a bond that requires an entity to deliver[21] a variable number of the entity's own shares with a total value equal to CU100 in two years. Because an entity's ordinary shares are not an economic resource of the entity, this type of bond, like an ordinary share, does not have implications for the entity's economic resources. However, like the simple bond, the amount of the obligation will not change in response to changes in the entity's available economic resources, introducing the risk that the entity may not be able to meet its obligation (for example, in extreme circumstances, its own shares may not be worth CU100 in total because the amount of all other claims exceed the entity's economic resources).

2.12 Useful information about all of a claim's various features should be provided in the financial statements in one way or another. In order to decide what information is best provided through the classification of liabilities and equity and what information is best provided through presentation and disclosure requirements, the Board considered the consequences of the distinction between liabilities and equity.

What are the consequences of the distinction between liabilities and equity?

2.13 Based on the definitions of the elements of financial statements in the *Conceptual Framework* and the existing requirements in IFRS Standards, the distinction between liabilities and equity has the following primary consequences:

(a) total recognised liabilities are distinguished from total recognised equity in reporting an entity's financial position;

(b) changes in the carrying amount of recognised liabilities are included in reporting an entity's financial performance while changes in the carrying amount of equity are not;

(c) the carrying amounts of recognised liabilities are updated through subsequent measurement (such as interest accretion or, in some cases, fair value changes), while the carrying amount of total equity, a residual, changes in response to changes in the carrying amounts of recognised assets and liabilities; and

(d) the disclosure and presentation requirements in IFRS Standards are more extensive for liabilities than for equity.

21 In this Discussion Paper, unless stated otherwise, the examples assume that entities are able to issue as many shares as required to be delivered by the contract, as and when required by the contract.

2.14 Under any approach to classification, the distinction between liabilities and equity will provide only one set of information—that is, whether the claim has the features of a liability or those of equity. Therefore, any additional information about liability and equity claims will have to be provided separately. The Board intends to mitigate the consequences described in paragraphs 2.13(c)–2.13(d) by requiring entities to provide—through presentation and disclosure—information about features of claim that is not provided through its classification as a liability or equity.

What features are relevant to which assessments?

2.15 The statement of financial position of the entity provides information about the entity's economic resources (its assets) and the claims against the entity (its liabilities and equity) at a point in time. Information about the nature and amounts of an entity's economic resources and claims can help users of financial statements assess the reporting entity's financial strengths and weaknesses, its liquidity and solvency, and its needs for additional financing and how successful it is likely to be in obtaining that financing.[22]

2.16 Furthermore, to properly assess the prospects for future cash flows from the entity, users of financial statements need to be able to distinguish between changes in the reporting entity's economic resources and changes in claims that have resulted:

(a) from that entity's financial performance; and

(b) from other events or transactions such as issuing debt or equity instruments.[23]

2.17 Based on the concepts described in paragraphs 2.15 and 2.16, and feedback from users of financial statements and other interested parties to prior consultations, the Board identified two broad assessments of financial position and financial performance that depend on information about different sets of features of claims. They are:

(a) assessments of funding liquidity and cash flows, including whether an entity will have the economic resources required to meet its obligations as and when they fall due. These assessments are driven by information about requirements to transfer economic resources at a specified time other than at liquidation (the timing feature) (see paragraphs 2.19–2.25).

(b) assessments of balance-sheet solvency and returns (measured on an accrual basis), including whether an entity has sufficient economic resources required to meet its obligations at a point in time, and whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve. These assessments are driven by information about the amount of the obligation (the amount feature) (see paragraphs 2.26–2.31).

2.18 The two assessments in paragraph 2.17 are considered separately in this Discussion Paper because they are driven by different features of claims. Many

22 See paragraph 1.13 of the *Conceptual Framework*.
23 See paragraph 1.15 of the *Conceptual Framework*.

claims will have features that are relevant to both of these assessments, such as the simple bond described in paragraph 2.4. However, other financial instruments, such as those described in paragraph 2.11, contain features that are relevant to one assessment but not the other. Therefore, it is important to establish which of these features should form the underlying rationale for distinguishing liabilities from equity.

Assessments of funding liquidity and cash flows (the timing feature)

2.19 Users of financial statements assess whether an entity will have sufficient economic resources to meet its obligations as and when they fall due. Such an assessment is made because an obligation to transfer economic resources at a specified time requires the entity to generate or otherwise obtain the economic resources required by the settlement date and reduces the economic resources the entity will have available to produce future cash flows beyond that date.

2.20 By specifying the point(s) in time at which an entity is required to transfer economic resources, a financial instrument introduces the risk that the entity will not have the particular type of economic resource required to settle the claim when it is required to do so. This might be the case even if the entity has a sufficient amount of other types of economic resources to meet its obligations. Such a situation raises prospects of potential costs of financial distress or potential business disruption that might occur if the entity needs to convert illiquid assets (such as land or intangible assets) to cash, or if it needs to obtain the required economic resources by issuing new claims. For example, to the extent that the entity has to produce or convert existing economic resources, or obtain economic resources by issuing other claims, the costs incurred to meet the obligation will flow to other claim-holders (for example, losses and transaction costs on asset sales to generate cash). If an entity changes its economic resources, financial statements will reflect those changes in accordance with the recognition and measurement requirements for the affected economic resources.

2.21 In making assessments of funding liquidity and cash flows, users of financial statements typically consider:

(a) whether the expected timing of cash generated by an entity's economic resources will precede the timing of required payments;

(b) to what extent the entity has financed long-term illiquid assets using claims with short-term liquidity demands (ie whether there is a potential liquidity shortfall);

(c) to what extent the entity is exposed to changes in the market liquidity of its assets (for example, if it needs to convert its assets to cash) and the liquidity of financial markets (for example, if it needs to obtain additional financing); and

(d) whether the entity manages its cash flows efficiently and effectively.

2.22 Consequently, in the Board's preliminary view, to assess an entity's funding liquidity and cash flows, users of financial statements need information that distinguishes between claims that require the entity to transfer economic resources at a specified time other than at liquidation,[24] and those claims that do not have such a requirement. This is the primary distinction based on the timing feature that is relevant to users of financial statements making such an assessment.

2.23 The primary distinction described in paragraph 2.22 establishes the best starting point for further disaggregated information about claims that require a transfer of economic resources at different specified times other than at liquidation or of different types of economic resources. However, in the Board's preliminary view, these are secondary distinctions based on the timing feature and the type of economic resource that would help users of financial statements refine their assessments of funding liquidity and cash flows. For example, a distinction between an obligation to transfer cash within 12 months, and an obligation to transfer cash in 20 or 30 years' time would provide additional information to help a user assess an entity's funding liquidity and cash flows.

2.24 Information about secondary distinctions could be provided through additional subclassifications of claims, such as current/non-current, the order of liquidity or disclosure of a maturity analysis. Such information would allow users of financial statements to identify maturity mismatches and predict particular times when maturities are concentrated, and to produce and analyse various ratios, including:

(a) the ratio of current assets to current claims (claims that require transfers of resources within 12 months);

(b) the ratio of liquid assets to on-demand claims (claims that require a transfer of economic resources on demand); and

(c) the order of liquidity of claims (such as that required by IAS 1 *Presentation of Financial Statements*) compared to the expected timing of cash flows from assets.

2.25 The Board considered whether the timing feature is relevant to assessments of financial performance in addition to financial position. As discussed in paragraph 1.17 of the *Conceptual Framework*, accrual accounting depicts effects of transactions and other events on an entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. Such information provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during the period. Such effects on an entity's economic resources would be captured by the relevant IFRS Standard that applies to the accounting for the particular asset; and effects on an entity's claims would be captured by requirements for depicting the amount of the claim (for example, interest expense calculated using the effective interest method) (see paragraphs 2.26–2.31). In contrast, information about changes

24 If liquidation is contractually specified, such as in a limited-life entity, or occurs in tandem with a particular event or at the option of the holder, information about obligations to transfer economic resources at such dates will also be relevant to assessments of funding liquidity and cash flows. For the purposes of this Discussion Paper, liquidation does not include contractually specified liquidation. Therefore, references to contracts that require a transfer of economic resources only at liquidation include only perpetual contracts.

resulting from flows of economic resources, and in particular cash flows, during a period is relevant for assessing how the entity obtains and spends cash, including returns to investors (for example through the payment of interest and dividends that embody returns). Therefore, the Board concluded that information about the timing of the required transfer of economic resources is not relevant to assessments of financial performance.

Assessments of balance-sheet solvency and returns (the amount feature)

2.26 Users of financial statements often also assess:

(a) whether the entity has sufficient economic resources to meet its obligations at a point in time; and

(b) whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve.

2.27 How the amount of a claim is specified, and its priority relative to other claims, will determine the allocation of an entity's total economic resources among claims and how that allocation changes over time—that is, the returns on the claim (sometimes also referred to as the pay-off or yield). A claim that specifies an amount that is independent of the entity's available economic resources (eg a fixed amount of currency units) introduces the risk that the amount of the obligation may exceed the entity's available economic resources.[25] This risk arises even if the claim does not require the transfer of economic resources other than at liquidation, such as claims settled with an entity's own equity instruments. The amount of a claim affects the returns on the claim regardless of the timing of required settlement. Likewise, the changes in the amount during a reporting period will be the primary driver of the returns to holders of claims during that period, even if the resulting cash payments (or transfers of other assets) occur in a different period (see paragraph 2.25).

2.28 In making assessments of balance-sheet solvency and returns, users of financial statements typically consider:

(a) whether an entity has sufficient economic resources to meet its obligations and the potential allocation of any shortfall in economic resources among the claims.

(b) the extent to which the entity has claims that respond to future changes in the entity's available economic resources. This assessment will show how resilient the entity's financial position is to reductions in the value of its economic resources. This assessment also identifies which claims participate in future reductions and appreciation of its available economic resources.

(c) the extent to which the entity has the ability to obtain new economic resources by issuing new claims, or to retain existing economic resources by refinancing existing claims. A shortfall in available economic resources would normally impair an entity's ability to access capital markets regardless of market liquidity.

25 See further discussion of 'available economic resources' in paragraph 3.17.

2.29 Consequently, in the Board's preliminary view, to make assessments of balance-sheet solvency and returns, users of financial statements need information that distinguishes claims for an amount independent of an entity's available economic resources from those claims that do not have such a requirement. This is the primary distinction based on the amount feature that is relevant to users of financial statements making such assessments.

2.30 The primary distinction in paragraph 2.29 establishes the best starting point for further disaggregated information about how a claim specifies the amount, and the priority of the claim on liquidation. Information about these secondary distinctions would help users of financial statements make more detailed assessments of balance-sheet solvency and returns, for example in order to assess how any potential surplus or deficit in economic resources and returns will be allocated among claims. The priority of claims is commonly referred to as the 'waterfall'; and to the extent that an entity has insufficient economic resources to satisfy the amount of a claim, which claim-holder bears the cost of a shortfall will depend on each claim's priority relative to other claims.

2.31 Information about the secondary distinctions could be provided through additional subclassifications of claims, for example, the order of priority; or through additional presentation and disclosure about the various pay-offs. Such information would allow users of financial statements to assess the various pay-offs in possible future scenarios, and produce and analyse various ratios including:

(a) capital ratios;

(b) loss-absorbing capacity ratios;

(c) financial leverage ratios;

(d) interest-coverage ratios (for example, earnings before interest and tax (EBIT)/interest expense); and

(e) return-leverage analysis (for example, debt/EBIT and return on equity).

Which features should be depicted through classification and which through presentation and disclosure?

2.32 Both of the assessments identified in paragraph 2.17 are key assessments that would be affected by the distinction between liabilities and equity because of its consequences for the structure of the statement of financial position, and for what is included in the statement of financial performance.

2.33 In the Board's preliminary view, the best information to provide through the classification of liabilities and equity is information about the primary distinctions that are relevant to both of the assessments identified (see paragraphs 2.22 and 2.29). Consequently, the Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

2.34 The Board's preferred approach would define equity as 'the residual interest in the assets of the entity after deducting all of its liabilities', consistent with the definition in paragraph 4.63 of the *Conceptual Framework*. Thus, equity claims under the Board's preferred approach could not contain either of the features in paragraph 2.33.

2.35 As mentioned in paragraph 2.18, applying the Board's preferred approach, many claims would contain both of the features of a liability in paragraph 2.33, and therefore information about them would be relevant to both assessments identified in paragraph 2.17. However, some claims would be classified as liabilities because they contain only one of the two features, and hence information about them would be relevant for only one of the assessments. Therefore, to provide information that will help users of financial statements make each of the identified assessments separately, the Board's preferred approach would provide additional information by requiring separate presentation of liabilities that have only one of the two features in paragraph 2.33 (see Section 6).

2.36 The application of the Board's preferred approach is illustrated in the following table:

Distinction based on amount feature / Distinction based on timing feature	Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)	No obligation for an amount independent of the entity's available economic resources (such as an amount indexed to the entity's own share price)
Obligation to transfer economic resources at a specified time other than at liquidation (such as scheduled cash payments)	**Liability** (eg simple bonds)	**Liability** (eg shares redeemable at fair value)
No obligation to transfer economic resources assets at a specified time other than at liquidation (such as settlement in own shares)	**Liability** (eg share-settled bonds)	**Equity** (eg ordinary shares)

2.37 Information about secondary distinctions (as discussed in paragraphs 2.23 and 2.30) is also relevant to users of financial statements. Therefore, in the Board's preliminary view, information about these other features would be provided through presentation and disclosure, including:

(a) information about equity claims with pay-offs different from ordinary shares (Section 6); and

(b) information about the priority of liabilities and equity (Section 7).

2.38 The Board thinks that its preferred approach:

(a) would provide the best information about the features of claims identified through the distinction between liabilities and equity, because those features are relevant to the assessments of financial position and financial performance; and

(b) would be the best starting point for providing additional information through presentation and disclosure about both liabilities and equity.

2.39 The Board also observed that its preferred approach would provide a clear rationale without fundamentally changing the existing classification outcomes of IAS 32.

2.40 Adopting an approach based on only one of the primary distinctions might make classification simpler than the Board's preferred approach; however, such an approach would only shift the complexity of making the other primary distinction somewhere else. Given that claims against entities can have a wide variety of features, their classification as liabilities or equity can provide only some of the information about the variety of those features. Therefore, any approach to classification of liabilities and equity will require entities to provide additional information through presentation and disclosure. In particular, using only one of the primary distinctions for classification would result in more instruments being classified as equity, increasing the need to provide useful information about a greater variety of equity instruments through some combination of presentation and disclosure. Because both primary distinctions are relevant to assessments of financial position and financial performance, the Board thinks that an approach based on only one of the primary distinctions would not provide the best information from using the distinction between liabilities and equity.[26]

2.41 The Board considered an approach that would provide information through the classification of liabilities and equity that would only be relevant to assessments of funding liquidity and cash flows. However, such an approach would require entities to provide information that is relevant to assessments of balance sheet solvency and returns through other means, such as presentation and disclosure. In particular, under this approach:

(a) some claims classified as equity might contain obligations for an amount independent of the entity's available economic resources, such as share-settled bonds with a claim equal to a fixed amount. Therefore, separate presentation requirements within equity would be more important for providing information about the varied returns of different equity claims than under the Board's preferred approach.

(b) providing information that is useful for assessing an entity's financial performance would be particularly challenging because distinctions would have to be made both in liabilities and in equity. Claims that contain obligations for the same amount could be included in either

26 Appendix A considers the consequences of the approaches based on only one feature in further detail.

liabilities or equity depending on whether the claim is settled by transferring economic resources (for example, a simple bond to pay CU100 in cash), or by delivering an entity's own equity instruments (for example, a share-settled bond to deliver a variable number of the entity's own shares with a total value equal to CU100). Presentation or disclosure requirements would need to be developed to help users of financial statements assess whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve. In contrast, applying the Board's preferred approach, all changes in the carrying amounts of claims that are relevant to the assessments of balance-sheet solvency and returns would be included as income and expense and requirements would only be needed to present separately income and expenses that are not relevant to these particular assessments.

2.42 The Board considered another approach that would provide information through the classification of liabilities and equity that would only be relevant to assessments of balance-sheet solvency and returns. In particular, under this approach, some claims classified as equity might require the transfer of resources at a specified time other than at liquidation, such as shares redeemable at fair value. However, such an approach would have to provide information that is relevant to assessments of funding liquidity and cash flows through other means, such as presentation and disclosure. Therefore, in contrast to the Board's preferred approach, there would be a greater need for separate presentation requirements within equity to provide information about claims that might require the entity to transfer economic resources at a specified time other than at liquidation. Applying the Board's preferred approach, all claims that are relevant to assessments of funding liquidity and cash flows would be classified as liabilities.[27]

Other approaches to classification that provide information to support assessments other than those identified

2.43 In their response to previous consultations, many users of financial statements, in particular investors in ordinary shares, have suggested an approach that would classify only ordinary shares, or their equivalents, as equity (sometimes called a narrow equity or basic ownership instrument approach). Such an approach would classify all other claims as liabilities. Reasons for supporting such an approach include:

(a) only the most residual class of claims should be classified as equity, as that class bears the residual risk.

(b) it would be consistent with preparing financial statements from the perspective of the proprietors. Thus, such an approach would depict financial position and financial performance from the point of view of the holders of ordinary shares (see also paragraph 2.47).

27 See Section 3 for a discussion of the puttable exception.

(c) existing requirements do not include specific requirements to provide information about different equity claims, although IAS 1 contains general principles for disclosing information that is useful, and some information about different equity claims is required when presenting earnings per share applying IAS 33 *Earnings per Share*.

2.44 Classification of a claim as equity should not preclude, even in the absence of a specific requirement, the provision of relevant information about that claim. Entities can always choose to provide additional information about equity instruments. However, the Board considered different ways of improving the usefulness of information about different equity claims—some of those ways would provide approximately the same level of information as does a narrow equity approach.

2.45 A particular strength of the Board's preferred approach is that it can provide the same information as a narrow equity approach while also providing other relevant information about an entity's financial position and financial performance; and it can provide this information more directly via classification and presentation. For example, information about the most subordinate equity claim can be provided by presenting subclasses of equity (see Section 6).

2.46 The Board also considered and rejected distinguishing liabilities from equity based on features such as rights that may affect how an entity uses its economic resources (such as voting or protective rights). A financial instrument may specify voting rights or protective rights over an entity's activities, including rights to vote at shareholder meetings, debt covenants, or other restrictions over the types of activities the entity may undertake or over how it uses its resources. Specified voting and restrictive rights allocate to claim holders different levels of influence over an entity's activities. Even though such rights may only indirectly affect an entity's economic resources and the prospects for future cash flows from those resources, the disclosure of such rights may help users of financial statements to understand how claims distribute the ability to influence an entity's activities and economic resources among holders of claims.

2.47 The Board also considered whether the entity perspective adopted in financial statements has any consequences for the distinction between liabilities and equity. As stated in paragraph 3.8 of the *Conceptual Framework*, financial statements 'provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors'. The entity perspective provides a rationale for the separation of an entity from its capital providers. However, the entity perspective does not provide any explicit guidance about what information would be best provided to users of financial statements through the distinction between liabilities and equity.

Summary of preliminary views and questions for respondents

2.48 In clarifying the underlying rationale for distinguishing liabilities from equity, the Board considered:

(a) what information is best provided through classification using the distinction between liabilities and equity; and

(b) what information is best provided through presentation and disclosure requirements.

Classification

2.49 The Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

2.50 The information that would be provided through classification of liabilities and equity applying the Board's preferred approach would be relevant to the following assessments of the entity's financial position and financial performance:

(a) assessments of funding liquidity and cash flows—information about financial instruments that require a transfer of cash or another financial asset at a specified time other than at liquidation would help users of financial statements to assess whether an entity will have the cash or another financial asset required to meet its obligations as and when they fall due.

(b) assessments of balance-sheet solvency and returns—information about financial instruments that are obligations for an amount independent of the entity's available economic resources and information about how that amount changes over time would help users of financial statements to assess:

    (i) whether an entity has sufficient economic resources to meet its obligations at a point in time; and

    (ii) whether an entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve.

Presentation and disclosure

2.51 To help users of financial statements make each of the assessments in paragraph 2.50 separately, the Board's preferred approach would provide additional information through separate presentation, including about liabilities that have only one of the features of a liability in paragraph 2.49 (Section 6).

2.52 While information about other features is also relevant to users of financial statements, the Board's preliminary view is that information about such features should be provided via presentation and disclosure. Hence, the Board's preferred approach would provide useful information about other features of claims not depicted by classification through presentation and disclosure, including:

(a) information about different types of equity (Section 6); and

(b) information about the priority of liabilities and equity (Section 7).

Question 2
The Board's preferred approach to classification would classify a claim as a liability if it contains: (a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or (b) an unavoidable obligation for an amount independent of the entity's available economic resources. This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50. The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure. Do you agree? Why, or why not?

Section 3—Classification of non-derivative financial instruments

3.1 This section sets out the Board's preliminary views on the application to non-derivative financial instruments of the Board's preferred approach to classification.

Scope of the Board's preferred approach

Scope of IAS 32

3.2 IAS 32 applies to all types of financial instruments other than those that fall within the scope of another IFRS Standard that is listed in paragraph 4 of IAS 32.

3.3 IAS 32 defines a financial instrument as 'any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity'. Therefore, one defining aspect of all financial instruments is that all the rights and obligations arise from contracts. Rights and obligations that are not contractual, for example, rights and obligations that arise from statutory requirements imposed by government, are not financial instruments.[28]

3.4 IAS 32 also defines a financial asset, a financial liability and an equity instrument.[29] One of the defining aspects of financial assets and financial liabilities is the right to receive and the obligation to transfer cash or other

28 The Board is aware of the challenges in applying the existing scope requirements of IAS 32 with respect to identifying the scope of contractual terms. This Discussion Paper discusses those matters further in Section 8.

29 Other IFRS Standards, including IFRS 9 *Financial Instruments*, also use these definitions to set the scope of their application, and for some of their requirements.

financial instruments. Other IFRS Standards apply when an entity has a right or obligation to receive, transfer or exchange other types of economic resources.[30]

3.5 Given the scope of IAS 32, the Board sought to articulate classification principles for financial instruments based on its preferred approach that also:

(a) are limited to rights and obligations arising from contracts; and

(b) exclude rights and obligations to receive, transfer or exchange types of economic resources other than cash or other financial instruments.

3.6 Therefore, while the application of the Board's preferred approach might change the classification of a financial instrument as a financial asset, financial liability or an equity instrument, the scope would remain unchanged from those that are within the scope of IAS 32.

Types of contracts

3.7 IAS 32 contains separate classification principles for derivative and non-derivative financial instruments. In applying the Board's preferred approach to financial instruments, the Board also developed separate classification principles for each of derivative and non-derivative financial instruments because of particular classification challenges arising from derivatives on own equity. The classification of derivatives on own equity is considered in Sections 4 and 5. The rest of this section discusses the application of the Board's preferred approach to the classification of non-derivative financial instruments as financial liabilities and equity instruments.

Classification of non-derivative financial instruments applying the Board's preferred approach

3.8 In the Board's preliminary view, applying its preferred approach to financial instruments, a non-derivative financial instrument would be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

3.9 Applying the Board's preferred approach, an equity instrument is any contract that evidences a residual interest in the assets of the entity, after deducting all of its liabilities.[31] Consequently, a contract classified as an equity instrument would contain neither:

30 Except for some particular types of contracts to buy or sell non-financial items, for example, some contracts that can be settled in cash. For further details, see paragraphs 8–10 of IAS 32. The Board is not considering any changes to these requirements.

31 The *Conceptual Framework* defines equity as a residual interest in the assets of the entity, after deducting all of its liabilities. The definition of an equity instrument in the Board's preferred approach is consistent with this definition.

(a) an unavoidable obligation to transfer economic resources (including financial and non-financial assets) at a specified time other than at liquidation;[32] nor

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

3.10 A non-derivative financial instrument may contain more than one possible settlement outcome that might depend on future events, or on the holder or issuer exercising rights (for example, a financial instrument that requires payment in cash of a fixed principal amount in four years, and that pays discretionary dividends). A settlement outcome refers to the result of an entity fulfilling its contractual obligations. If an entity does not have the unconditional contractual right to avoid a settlement outcome that has one or both of the features of a financial liability (this could be the case, for example, for a financial instrument that requires the entity, in circumstances beyond its control, to deliver a variable number of its own shares with a total value equal to a fixed amount of currency), then the entity identifies that unavoidable obligation first and classifies that obligation as a non-derivative financial liability. If the non-derivative financial instrument also contains another possible settlement outcome that does not have the feature(s) of a financial liability (for example, it requires the entity, at the option of the holder, to transfer a fixed number of its own shares), then the entity considers whether the instrument is a compound instrument applying the requirements in paragraphs 3.25–3.28 and Section 5.

Comparison to IAS 32

3.11 The Board compared the application of its preferred approach to non-derivative instruments to the existing requirements of IAS 32. Applying IAS 32, a non-derivative financial instrument that contains the following features is classified as a financial liability:

(a) an obligation to deliver cash or another financial asset (the first feature); or

(b) an obligation to deliver a variable number of equity instruments (the second feature).

3.12 The classification requirements for non-derivative financial instruments applying the Board's preferred approach would have many similarities with the requirements in IAS 32. Under either approach, non-derivative financial liabilities include contractual obligations that contain at least one of two features. One of those two features, the requirement to transfer cash or another financial asset, is the same under IAS 32 and the Board's preferred approach and results in a financial liability classification applying both approaches.

3.13 The Board's preferred approach and IAS 32 differ in how the second feature is articulated. Instead of the second feature being articulated based on whether

32 Equity instruments would not include any obligation that meets the definition of a liability and not just financial liabilities. A non-financial liability may contain an unavoidable obligation to transfer economic resources other than cash or another financial asset at a specified time other than at liquidation.

the number of equity instruments to be delivered is variable, the Board's preferred approach would articulate the second feature by reference to whether the amount of the obligation is independent of the entity's available economic resources. The articulation of the amount feature applying the Board's preferred approach is derived from the underlying rationale in Section 2 (see paragraphs 2.26–2.31). Even with this change in articulation, the Board expects the classification outcomes would remain largely the same for most types of financial instruments. However, the classification outcomes for some instruments might differ from those applying IAS 32 because of the differences arising from clarifying the rationale and rearticulating the second feature accordingly.

3.14 One classification outcome that would not change is that of a share-settled bond as described in paragraph 2.11(b). IAS 32 classifies a share-settled bond as a financial liability because of the obligation to deliver a variable number of equity instruments. The Board's preferred approach would also classify the same financial instrument as a financial liability; however, it would do so because the obligation for a fixed amount is independent of the entity's available economic resources (paragraph 3.8(b)). By articulating the second feature based on a clear rationale, the basis for this classification outcome can be explained more easily than the requirement in IAS 32. The requirement in IAS 32 depends on whether there is an obligation to settle in a variable number of equity instruments, regardless of how the number of shares to be transferred is determined.

3.15 One classification outcome that would change as a result of the articulation of the second feature is that of irredeemable fixed-rate cumulative preference shares (see paragraph 3.23(c)). IAS 32 classifies such cumulative preference shares as equity instruments because there is no contractual obligation to transfer cash or another financial asset or to deliver a variable number of shares at a specified time other than at liquidation. In contrast, the Board's preferred approach would classify such cumulative preference shares as financial liabilities because the entity has an obligation for an amount independent of the entity's available economic resources (paragraph 3.8(b)). This is because the fixed-rate dividends accumulate over time and changes in the entity's available economic resources will not result in changes in the amount of the obligation for the cumulative preference shares, even though the entity is only required to transfer economic resources at liquidation.

3.16 In the Board's view, articulating the second feature by reference to the amount of the obligation would improve consistency in the classification of financial instruments with features that would be useful for the assessments identified in Section 2. In addition, the rationale of the articulation would help explain and support the application of the classification principles. Information about both the share-settled bond and the irredeemable fixed-rate cumulative preference shares is relevant for assessments of balance-sheet solvency and returns. The Board's preferred approach would provide information that is useful to those assessments by consistently classifying these instruments as financial liabilities. Because neither financial instrument requires the transfer of economic resources at a specified time other than at liquidation, information about these instruments is not needed for assessments of funding liquidity and cash flows. To help make the two assessments identified in Section 2 separately, additional information would be provided through presentation (see Section 6).

Further guidance on an amount independent of the entity's available economic resources

3.17 An 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). An entity should not need to determine its available economic resources to assess whether the amount of a financial instrument (that is, the amount of the contractual obligation of a financial instrument) is independent of its available economic resources. Whether the amount of a financial instrument is independent of the entity's available economic resources should be clear from the instrument's contractual terms.

3.18 An amount is independent of the entity's available economic resources if:

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

(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.

3.19 As mentioned in paragraph 3.10, a non-derivative financial instrument may contain more than one possible settlement outcome that might depend on future events, or on the holder or issuer exercising rights. For such instruments, an entity would apply paragraph 3.18 to each settlement outcome separately. If a non-derivative financial instrument contains at least one settlement outcome that is for an amount independent of the entity's available economic resources that the entity does not have the unconditional contractual right to avoid, then the entity would identify that unavoidable obligation first and classify it as a non-derivative financial liability. For example, a financial instrument requires an entity to deliver a variable number of its own shares with a total value equal to CU100 with a cap of 50 shares. Applying the Board's preferred approach, the entity would consider the unavoidable obligation to deliver a variable number of its own shares with a total value equal to CU100 separately, and would classify that unavoidable obligation as a non-derivative financial liability because the amount is independent of the entity's available economic resources. Given that the cap is a fixed number of shares, the entity considers whether the instrument is a compound instrument applying the requirements in Section 5.

3.20 The amount of a particular financial instrument might be specified using the entity's available economic resources as a reference. A link to the entity's available economic resources does not automatically mean that the amount of the financial instrument depends on the entity's available economic resources. Although the amount of a financial instrument may be affected by the entity's available economic resources, the entity would have to consider whether the amount could exceed the entity's available economic resources under any possible scenario based on the terms of the financial instrument at initial recognition. For example, if the amount of a financial instrument is indexed to twice the change in the fair value of the recognised and unrecognised net assets of the entity, then the amount of the financial instrument will increase twice as much as the available economic resources of the entity, and thus could potentially exceed the entity's available economic resources. Because the amount can exceed the entity's available economic resources it is an amount independent of the entity's available economic resources. The financial instrument would be classified as a financial liability under the Board's preferred approach. Information about the instruments would be useful for assessments of balance-sheet solvency and returns.

3.21 The 'amount' of a particular financial instrument as used in the Board's preferred approach (see paragraph 2.7) is not the fair value of the financial instrument even though the fair value of financial instruments will be affected by their amounts. The fair value of all financial liabilities and equity instruments is affected by changes in the available economic resources of the issuer entity. For example, the fair value of a financial instrument that requires a transfer of CU100 in cash in two years' time is likely to change over its life in response to a number of factors including changes in the entity's credit risk. The assessment of the amount feature for classification applying the Board's preferred approach depends on whether the amount specified in the contract (the contractual pay-off) changes in response to the available economic resources. The amount of a financial instrument with a contractual obligation to transfer CU100 is CU100 regardless of changes in the entity's available economic resources, or changes in the fair value of the instrument, and therefore the amount is independent of the entity's available economic resources.

3.22 The amount of a particular financial instrument might be specified by reference to the entity's total economic resources (excluding the effect of other claims) or to changes in the entity's total economic resources. While the amount of the financial instrument in isolation may not exceed the economic resources of the entity, when considered in combination with other claims against the entity, it could result in an amount that exceeds the entity's available economic resources. Hence, if the amount does not take into account the effect of other claims against the entity (for example, if the amount is specified as a fixed percentage of a particular recognised or unrecognised asset) the amount is independent of the entity's available economic resources. Applying the Board's preferred approach, such claims would be classified as financial liabilities.

3.23 Examples of financial instruments with amounts independent of the entity's available economic resources include:

(a) 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. An entity's available economic resources may be affected by changes in the currency or other specified variable. 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 (that is, its recognised and unrecognised assets and other claims).

(b) a financial instrument with an obligation for an amount specified by reference to a specific recognised or unrecognised asset the entity controls. Such an amount is independent of the entity's available economic resources, even if the entity controls the specific economic resource at a particular point in time. For example, if a financial instrument contains an obligation for an amount based on changes in the price of a particular asset of the entity (such as property or a brand value), the amount of the financial instrument is independent of the entity's available economic resources. That is because changes in the entity's overall economic resources and changes in the entity's other claims will not result in changes in the amount of the financial instrument. It is possible for the entity's available economic resources to fall while the price of the particular asset rises, in which case the entity may not have sufficient economic resources available to satisfy the obligation arising from the financial instrument.

(c) an irredeemable fixed-rate cumulative preference share, with a stated coupon or dividend amount that accumulates in the case of non-payment. The amount of the cumulative preference share is independent of the entity's available economic resources because changes in the entity's available economic resources will not result in changes in the amount of coupon or dividend right of the cumulative preference shares. The amount of the cumulative preference share and the amount of the bond described in paragraph 3.23(a) are both independent of the entity's economic resources.

(d) a share with a dividend feature that does not accumulate but is reset periodically when not paid. The required dividend rate resets to a higher rate each year in which the dividend is not paid, until the dividend is paid at the option of the entity or it is finally paid at liquidation. For example, the dividend rate is 5% in the first year and increases by an additional 5% each year until the dividend is paid. Even though the dividend is described as non-cumulative, it increases over time if the dividend for one year is not paid. The fact that the dividend rate increases at a specified rate when it is not paid results in an amount that is independent of the entity's available economic resources.[33]

3.24 Examples of financial instruments with amounts that are not independent of the entity's available economic resources include:

(a) an ordinary share (as described in paragraph 2.9), with a right to participate in distributions and to a pro rata share of net assets at liquidation, would always depend on the residual cash flows from the entity's economic resources minus all other claims.

33 See Section 8 for a discussion of preference shares with resets.

(b) an irredeemable 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. Because the entity has the unconditional right to avoid paying coupons or dividends, this stream of cash flows is not considered to be independent of the available economic resources. The irredeemable non-cumulative preference share may also require a fixed amount to be paid at liquidation, for example in the form of a principal amount. If so, such instruments are compound instruments. The fixed amount payable at liquidation is independent of the entity's available economic resources, however, on initial recognition, that fixed amount would be discounted back to nil or an insignificant amount if measured on a going concern basis.

(c) an ordinary share in a subsidiary held by a non-controlling interest as the ordinary share would depend on the available economic resources of the subsidiary, which are a part of the available economic resources of the consolidated group. The amount of the non-controlling interest is not independent of the subsidiary's available economic resources, because the amount will not exceed the available economic resources of the subsidiary. Unlike a financial instrument whose amount is specified as a share of total assets as described in paragraph 3.22, the group has no contractual obligation to deliver to the non-controlling interest more than the subsidiary's (and thus a portion of the group's) available economic resources.

Compound instruments with non-derivative components

3.25 The Board's preliminary view is to carry forward in the Board's preferred approach the requirement in IAS 32 that the issuer of a non-derivative financial instrument evaluate 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.

3.26 Many compound instruments include derivative components, for example, convertible bonds. This Discussion Paper discusses the application of the Board's preferred approach to such compound instruments in Section 5. However, some compound instruments include liability and equity components that are both non-derivatives. An entity classifies the components of such instruments separately as financial liabilities, financial assets and equity instruments.

3.27 For example, a financial instrument issued for CU1000 might contain a requirement to repay the principal amount in four years' time as well as to pay discretionary dividends equal to any dividends paid to ordinary shareholders while the instrument is outstanding. The entity would classify the obligation to pay CU1000 in four years' time—the liability component—as a financial liability, measured in accordance with IFRS 9 (assume CU800), because of the contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (also because of the obligation for an amount independent of the entity's available economic resources). The entity would classify the discretionary dividends as an equity instrument because the entity has the unconditional right to avoid paying the discretionary dividends. The difference between the transaction price and the liability component is allocated to the equity component (in this case CU200). The classification outcomes applying the Board's preferred approach to such an instrument are the same as would result from applying IAS 32.

3.28 Sometimes, a financial instrument specifies a fixed amount that is required to be paid at liquidation, for example in the case of some non-cumulative preference shares. That fixed amount is independent of the entity's available economic resources and therefore meets the definition of a liability, similar to the example in paragraph 3.24(b).

Questions for respondents

Question 3

The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability.

Do you agree? Why, or why not?

Puttable exception

3.29 In 2008, the Board introduced an exception to the definition of a financial liability for particular puttable financial instruments. The exception in IAS 32 requires issuers to classify obligations with particular features to transfer economic resources as equity, even though the instruments meet the definition of a financial liability (puttable exception).

3.30 Paragraphs 16A and 16B of IAS 32 require:

16A A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

(i) dividing the entity's net assets on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation; and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

continued...

...continued

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

16B For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

3.31 When revising IAS 32 in 2003, the Board initially concluded that all financial instruments that give the holder the right to put the instrument back to the issuer for cash or another financial asset meets the definition of a financial liability and should be classified as such. However, in 2007, the Board reconsidered its conclusion with regard to particular puttable instruments that represent the most subordinate claim to the net assets of the entity (paragraphs 16A and 16B of IAS 32). At that time, the following concerns were raised about classifying such instruments as liabilities as stated in paragraph BC50 of the Basis for Conclusions on IAS 32:

(a) On an ongoing basis, the liability is recognised at not less than the amount payable on demand. This can result in the entire market capitalisation of the entity being recognised as a liability depending on the basis for which the redemption value of the financial instrument is calculated.

(b) Changes in the carrying value of the liability are recognised in profit or loss. This results in counter-intuitive accounting (if the redemption value is linked to the performance of the entity) because:

    (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss is recognised.

    (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain is recognised.

(c) It is possible, again depending on the basis for which the redemption value is calculated, that the entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

(d) The issuing entity's statement of financial position portrays the entity as wholly, or mostly, debt funded.

(e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not performance.

Does the Board's preferred approach eliminate the need for the puttable exception?

3.32 Simply applying the Board's preferred approach, a puttable instrument would meet the definition of a financial liability (paragraph 3.8(a)). This is because the instrument contains an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation. The entity has the obligation to transfer cash or another financial asset in exchange for redeeming the financial instrument at the option of the holder or on the occurrence of an event other than liquidation.

3.33 The same conclusion would also apply to financial instruments that meet the requirements of the exception in paragraphs 16C and 16D of IAS 32. These financial instruments are similar to puttable financial instruments that meet the exception in paragraphs 16A and 16B of IAS 32, however, instead of the condition in paragraph 16A(e), they impose on the entity an obligation to deliver a pro rata share of the net assets of the entity only on liquidation, if liquidation is at a specified time or at the option of the instrument holder. Although such instruments impose an obligation only on liquidation, because liquidation is at a specified time (as with, for example a limited life entity) or liquidation is at the option of the holder, the entity has a contractual obligation to transfer cash or another financial asset at a specified time. Therefore, classification as a liability would provide information that is relevant to assessments of an entity's funding liquidity and cash flows.

3.34 Although a financial instrument that meets the conditions of the puttable exception in paragraphs 16A–16B or 16C–16D of IAS 32 would be classified as a liability under the Board's preferred approach, it might be eligible for separate presentation[34] due to its features as outlined in paragraph 16A(e). If separate presentation requirements apply to such instruments, some of the concerns identified in paragraph 3.31 would be addressed. In particular changes in the carrying amounts of such financial instruments would be presented separately, which may mitigate the counter-intuitive effects on profit or loss.

3.35 However, the classification and presentation principles of the Board's preferred approach do not address the challenge that arises when all an entity's claims meet the definition of a liability and no claim qualifies for classification as equity.

3.36 The absence of a claim that meets the definition of equity would:

(a) lead to the concerns identified in paragraphs 3.31(a) and 3.31(c)–3.31(d);

(b) raise questions as to what the difference between the assets and liabilities would represent, and how an entity would faithfully represent that difference in its financial statements, since equity is typically the element measured as a residual for the purposes of recognition and measurement; and

(c) raise other challenges because the definitions of income and expense assume the existence of equity (a change in an asset or a liability needs to result in a change in equity to meet the definition of income and expense).

Summary of preliminary views and questions for respondents

3.37 In the Board's preliminary view, the puttable exception would continue to be required under the Board's preferred approach. The Board came to this view because:

(a) applying the Board's preferred approach to financial instruments that meet the exception might address some, but not all, of the previous concerns that led to the exception. In particular, the incomplete recognition and measurement of assets and liabilities means that if at least one claim is not recognised and measured as a residual, the usefulness of the statement of comprehensive income is reduced.

34 This Discussion Paper discusses separate presentation requirements further in Section 6.

(b) the scope of the puttable exception is restricted to a narrow set of circumstances in which no other financial instrument or contract is more subordinated and holders of the puttable instruments represent the most residual interest in the entity's net assets.[35]

(c) the Board is not aware of any issues with the application of the puttable exception as set out in paragraphs 16A–16B or 16C–16D, of IAS 32.

3.38 Classifying particular puttable instruments as equity would not provide the information required for users of financial statements to assess the entity's funding liquidity and cash flows. This concern is mitigated by the current disclosure requirements in paragraph 136A of IAS 1, which provide some information on the entity's redemption obligations relating to puttable instruments so that users of financial statements can estimate the potential cash outflows from these claims. Hence, if the exception in paragraphs 16A–16B, and paragraphs 16C–16D, of IAS 32 is retained, the Board thinks that the disclosure requirements in paragraph 136A of IAS 1 should also be retained, enabling users of financial statements to estimate the expected cash flows on settlement for all the financial instruments within the scope of the exception.

Question 4
The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

Section 4—Classification of derivative financial instruments

4.1 As stated in Section 3, the Board developed separate classification principles to apply the Board's preferred approach to derivative financial instruments because of particular challenges associated with derivatives on own equity. This section sets out the Board's preliminary views on classification of derivatives on own equity, the rationale that supports those preliminary views and alternative views the Board has considered. Derivatives that include an obligation to extinguish[36] an entity's own equity instruments and derivatives embedded in compound instruments are discussed in Section 5. The Board's preliminary views for derivatives on own equity, other than those derivatives discussed in Section 5, are as follows:

(a) a derivative on own equity would be classified in its entirety. Such a derivative may be classified as an equity instrument, a financial asset or a financial liability in its entirety. The individual legs of the exchange would not be separately classified.

(b) such a derivative on own equity would be classified as a financial asset or a financial liability if:

35 See paragraph BC61 of the Basis for Conclusions on IAS 32.

36 In this Discussion Paper, extinguishment of financial liabilities and equity instruments includes redemption or repurchase. Since an entity's own equity instruments would not meet the definition of an asset, own equity instruments redeemed or repurchased by an entity would be deducted from equity, consistently with IAS 32.

(i) it is net-cash settled—the derivative could require the entity to deliver 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; and/or

(ii) the 'net amount'[37] of the derivative is affected by a variable that is independent of the entity's available economic resources.

4.2 This section is structured as follows:

(a) Derivatives on own equity (paragraphs 4.3–4.10);

(b) Challenges associated with classification of derivatives on own equity (paragraphs 4.11–4.14);

(c) Applying the Board's preferred approach to derivatives on own equity (paragraphs 4.15–4.37);

(d) Summary of preliminary views and questions for respondents (paragraphs 4.38–4.44); and

(e) Further guidance on variables that affect the net amount of derivatives on own equity (paragraphs 4.45–4.66).

Derivatives on own equity

4.3 IFRS 9 defines a derivative as 'a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) it is settled at a future date.'[38]

4.4 Derivative financial instruments contain contractual rights and obligations to exchange underlying financial assets, financial liabilities or equity instruments with another party.[39] Consequently, derivative financial instruments can also be described as exchange contracts that have two 'legs', with each leg representing one side of the exchange. 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 own 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 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 this Discussion Paper.

37 See paragraphs 4.28–4.29 for further discussion on the net amount of a derivative on own equity.

38 See Appendix A of IFRS 9.

39 This description of derivatives is based on paragraphs AG15–AG19 of the Application Guidance of IAS 32.

4.5 Derivatives on own equity can be unconditional (eg a forward contract), or they can be conditional on one or more of the following:

(a) rights within the control of the entity (eg purchased options);

(b) rights within the control of the holder of the claim (eg written options); or

(c) events beyond the control of both the entity and the holder (eg contracts that are exercised automatically if an uncertain future event occurs and the event is outside the control of both the entity and the holder).

4.6 In addition, derivatives on own equity might be settled in various ways. For example, they might be:

(a) settled by exchanging the underlying financial instruments (gross physically settled);

(b) settled net in cash (net-cash settled); or

(c) settled net in equity instruments (net-share settled).

4.7 Finally, derivatives on own equity could exist as standalone derivatives, or could be embedded in another non-derivative host financial instrument (eg a hybrid instrument).

4.8 Sections 4 and 5 set out the Board's discussion on classification of derivatives on own equity. When considering the subject, the Board considered the following two types of exchanges, which may either be gross physically settled or net-settled in cash or shares:

(a) contracts to receive cash or another financial asset in exchange for delivering own equity instruments. In this Discussion Paper, we refer to these types of exchanges as 'asset/equity exchanges'.

(b) contracts to extinguish a financial liability in exchange for delivering own equity instruments and contracts to extinguish own equity instruments in exchange for another obligation that has one or both features of a financial liability in paragraph 3.8.[40] For example, a forward contract to buy back own shares for cash. The obligation to deliver cash in this contract meets the definition of a financial liability. In this Discussion Paper, we refer to these types of exchanges as 'liability/equity exchanges'.

4.9 While the exchanges in paragraph 4.8 may look similar in that they involve delivering or receiving own equity instruments, there is a difference, which is that:

(a) for gross physically settled asset/equity exchanges, neither the underlying financial assets to be received nor the underlying equity to be delivered are existing financial assets or equity instruments of the entity.

40 A contract may extinguish own equity instruments in exchange for delivering cash, ie a gross physically settled contract, or may require delivery of own shares, ie a net-share settled contract. The requirement to transfer cash or a variable number of shares in these contracts has the feature(s) of a financial liability.

Thus, settling gross physically settled asset/equity exchange derivatives results in an increase in both the entity's assets and equity.[41]

(b) for gross physically settled liability/equity exchanges, the financial liabilities or equity instruments that are extinguished on settlement of the derivative are existing financial liabilities or equity instruments of the entity.

4.10 This section discusses the application of the Board's preferred approach to asset/equity derivatives and liability/equity derivatives, but only those liability/equity derivatives that extinguish a financial liability in exchange for delivering equity instruments. The discussion of embedded derivatives on own equity and derivatives that include an obligation to extinguish an entity's own equity instruments is set out in Section 5.

Challenges associated with classification of derivatives on own equity

4.11 The Board observed that classification of derivatives on own equity gives rise to both conceptual and practice challenges when applying IAS 32. The conceptual challenge is that derivatives on own equity combine both an equity leg and an asset or a liability leg. If the two legs existed independently of each other as separate instruments, the financial reporting consequences for the equity leg would be different from that of the asset or liability leg. For example, changes in the asset or liability leg would meet the definition of income and expense and would be recognised as such, while changes in the equity leg would not.

4.12 Any approach to classifying derivatives on own equity requires striking a balance between:

(a) representing the characteristics of the equity leg and asset or liability legs of the derivative consistent with what the classification of those legs would have been had they existed separately; and

(b) the cost and the complexity of depicting the characteristics of the legs separately instead of classifying the derivative as a whole.

4.13 IAS 32 addresses some of the challenges of classifying derivatives on own equity by:

(a) classifying derivatives in their entirety, using the fixed-for-fixed condition,[42] as an equity instrument, a financial asset or a financial liability; and

(b) including additional requirements that identify liability and equity components for compound instruments and for contracts that include an obligation to redeem equity instruments for cash or for another financial asset—for example, a written put option on own shares.

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41 Applying IAS 32, an entity's own shares are not recognised as financial assets. If an entity reacquires its own shares (treasury shares), such treasury shares are deducted from equity. This requirement would remain unchanged applying the Board's preferred approach.

42 Applying the fixed-for-fixed condition in IAS 32, 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.

4.14 However, the Board is aware of a number of practice challenges in applying the requirements of IAS 32 relating to the classification of derivatives on own equity as stated in paragraph 1.36, including:

(a) practice questions regarding the application of the fixed-for-fixed condition to particular types of instruments;

(b) whether it is appropriate for derivatives that meet the foreign currency rights issue exception to be classified differently from conversion options in foreign currency convertible bonds;[43]

(c) whether it is appropriate that written put options and forward purchase contracts on an entity's own equity instruments are presented grossed-up rather than on a net basis like other derivatives; and

(d) how to account for transactions within equity when an entity has an obligation to extinguish its own equity instruments.

Applying the Board's preferred approach to derivatives on own equity

4.15 The Board considered different ways of applying its preferred approach to derivatives on own equity to address the conceptual challenges identified in paragraph 4.11. In particular, the Board considered:

(a) whether such derivatives should be classified in their entirety (paragraphs 4.16–4.20); and

(b) whether all such derivatives should be classified as financial assets or financial liabilities (paragraphs 4.21–4.24).

4.16 In the Board's preliminary view, consistent with the existing approach in IAS 32 and the approach to accounting for derivatives in IFRS 9, an entity would apply the Board's preferred approach to:

(a) classify derivatives on own equity in their entirety; and

(b) classify derivatives on own equity as equity instruments, financial assets or financial liabilities.

4.17 Classifying derivatives on own equity in their entirety as equity instruments, financial assets or financial liabilities would provide information that is useful in assessing financial positions and financial performance of the entity as described in Section 2 compared with classifying all derivatives on own equity in their entirety as financial assets or liabilities. The Board thinks that such an approach will strike the right balance between representing the characteristics of the individual legs of the derivatives on own equity and the cost and the complexity of doing so.

4.18 One of the consequences of classifying derivatives on own equity in their entirety is that some derivatives with an equity leg may be classified as financial

43 Applying IAS 32, issued rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. The same does not apply to conversion options in convertible bonds with otherwise identical features.

assets or financial liabilities, and vice versa. As described in paragraph 4.11, classifying derivatives on own equity in their entirety as financial assets or financial liabilities would lead to inconsistent classification between the equity leg of the derivatives and a similar obligation to deliver equity instruments in a non-derivative financial instrument. Consider, for example, a derivative to deliver 100 shares of the entity in exchange for receiving 110 units of foreign currency. Applying the Board's preferred approach, if the two legs were considered in isolation, the obligation to deliver 100 units of own shares has the features of equity. However, still applying the Board's preferred approach, if considered in its entirety, the derivative would not be classified as an equity instrument.

4.19 The Board considered whether, instead of classifying a derivative on own equity in its entirety, the entity should separate and classify separately the individual legs of the derivative. For example, a warrant to deliver own shares in exchange for receiving cash would have been classified as an equity component (the obligation to deliver own shares) and an asset component (the right to receive cash). The advantages of classifying the legs of a derivative separately include:

(a) that such classification would have been more consistent with how similar rights and obligations would have been classified if each leg had existed as a non-derivative financial instrument; and

(b) that it would have applied the same classification principle as that for non-derivative financial instruments, thus eliminating the need for developing a separate classification principle that applies to derivative financial instruments and eliminating the need for developing additional requirements for compound instruments and redemption obligations.

4.20 However, the Board rejected separating derivatives into components because of several challenges that it identified. The challenges include:

(a) conceptual challenges about whether the resulting components meet the definitions of assets, liabilities or equity given the interdependence of the rights and obligations of the contract.[44]

(b) the resulting 'gross-up' of the statement of financial position with assets that the entity may not control and equity that has not yet been issued (eg the receipt of assets and issuance of equity that is contingent on the holder exercising an option). This gross-up would have been inconsistent with the underlying objective of the Board's preferred approach, which is to depict whether the entity has sufficient economic resources to meet its obligations by providing information to assess funding liquidity and cash flows and to assess balance-sheet solvency and returns.

(c) practical challenges of separating a derivative into its components and measuring them separately, in particular for option derivatives.

44 As noted in paragraph 4.57 of the *Conceptual Framework* an executory contract establishes a combined right and obligation to the exchange. The right and obligation are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability.

(d) inconsistency with other IFRS Standards such as IFRS 9 because derivatives are not further separated into components in IFRS 9.

(e) in the predecessor FICE project, the Board and the US Financial Accounting Standards Board (the FASB) considered the Reassessed-Expected-Outcomes approach, which would have separated derivatives into components using option pricing techniques. However, the FASB and the Board ultimately decided not to pursue the approach given its complexity and cost.

4.21 The Board also considered whether, instead of classifying derivatives on own equity as equity instruments, financial assets or financial liabilities, it would be more appropriate to classify all derivatives on own equity as financial assets or financial liabilities. In previous consultations, some respondents have suggested that all derivatives on own equity should be classified as such on the grounds that no approach to classifying derivatives in their entirety can completely eliminate the conceptual challenges described in paragraph 4.11.

4.22 However, the Board rejected classifying all derivatives on own equity as financial assets or financial liabilities because it would:

(a) reduce the usefulness of the information provided through classification to make the assessments identified in Section 2.

(b) exacerbate the issue of recognising changes relating to the equity leg as income or expense, because more derivatives with an equity leg would be classified as financial assets or financial liabilities.

(c) have limitations similar to the basic ownership approach considered in the predecessor project. The approach not only classified all derivatives as financial assets or financial liabilities, but also classified all financial instruments other than the most subordinate claim against the entity (eg ordinary shares) as financial liabilities. While a basic ownership approach would eliminate the inconsistency between classification of derivative and non-derivative financial instruments discussed in paragraph 4.11, it would not provide any of the information through classification to make the assessments identified in Section 2.

4.23 Challenges described in paragraph 4.22 might be mitigated through additional presentation and disclosure requirements. However, mitigation through presentation and disclosure requirements would have shifted from classification to presentation and disclosure the challenges of providing useful information to help users of financial statements make the assessments identified in Section 2.

4.24 The Board reached the preliminary view as described in paragraph 4.16. The Board is seeking to address the practice challenges identified (see paragraph 4.14) when applying IAS 32 by:

(a) articulating the classification principle of the Board's preferred approach for derivatives on own equity in their entirety[45] (see paragraphs 4.25–4.66), which would clarify the rationale for distinguishing derivative financial assets or derivative financial liabilities from equity without fundamentally changing the existing classification outcomes of IAS 32; and

(b) improving the requirements and guidance for identifying liability and equity components for compound instruments and derivatives that include an obligation to extinguish own equity instruments (see Section 5).

Classification of derivatives on own equity applying the Board's preferred approach

4.25 As discussed in Section 3, the Board's preliminary view is that the Board's preferred approach would classify a non-derivative financial instrument as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (the timing feature); and/or

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

4.26 The Board considered how the classification principle can be applied to derivatives on own equity in their entirety. In the Board's preliminary view, the Board's preferred approach would classify a derivative on own equity as a financial asset or financial liability if:

(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); and/or

(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).

Asset/equity exchange derivatives

4.27 This section sets out the Board's discussion on classification of an asset/equity exchange derivative as described in paragraph 4.8(a). The assessment of the timing feature—determining whether a derivative on own equity requires the transfer of cash or another financial asset, and/or contains a right to receive cash, at a specified time other than at liquidation—is relatively straightforward. Applying the Board's preliminary view set out in paragraph 4.26(a):

45 The requirement to separate embedded derivatives in a compound instrument would not change. Application of this requirement would mean that standalone derivatives or embedded derivatives—once separated from the host contract—would not be required to be separated further for the classification purposes.

(a) if a derivative on own equity is net-cash settled and could require the entity to transfer cash at a specified time other than at liquidation, it would be classified as a financial liability;

(b) if a derivative on own equity is net-cash settled and could result in the entity receiving cash, for example, a net-cash settled purchased option on own equity, it would be classified as a financial asset because such a financial instrument represents a contractual right to receive cash; and

(c) if a derivative on own equity is either gross physically settled or net-share settled, the derivative would not oblige the entity to transfer cash or another financial asset at a specified time other than at liquidation; for those derivatives, an entity would consider the amount feature to determine their classification.

4.28 As discussed in paragraph 2.7, the amount of a financial instrument refers to how the financial instrument contract specifies the quantity of cash, other financial assets or own equity instruments that are required to be transferred. A derivative financial instrument represents an exchange contract of two legs. As a consequence of the decision to classify derivatives on own equity in their entirety, an entity would need to consider the combined effects of the two legs to determine the amount of such derivatives. In other words, the amount of a derivative on own equity would be determined as the *net amount* of the two legs of the exchange.

4.29 The Board observed that the net amount of a derivative on own equity is affected by the variables introduced by each leg of the exchange. In order for the net amount of a derivative to be not independent of the entity's available economic resources, all the variables that affect the net amount of the derivative must not be independent of the entity's available economic resources. For example, consider a derivative that requires an entity to deliver 100 ordinary shares of the entity for receiving CU100 in cash. The net amount of the derivative is determined by the combined effect of receiving CU100 and delivering 100 shares. The asset leg does not introduce a variable that affects the net amount because it is a fixed amount of cash in the entity's functional currency. Since the equity leg is a fixed number of ordinary shares to be delivered, the amount of the equity leg is determined by the ordinary shares' right to the pro-rata share of the net assets of the entity (paragraph 2.9). Therefore, the only variable affecting the net amount of the derivative is changes in the entity's available economic resources.[46] The net amount of this derivative is unaffected by any variable that is independent of the entity's available economic resources.

4.30 In assessing the amount feature of a derivative on own equity, the Board therefore considered how various variables, for example, interest rate, foreign currency or share price affect the net amount of the derivative. The variables can be categorised into two types:

46 When such derivatives are valued, a variable such as the entity's share price might be used as a proxy for changes in the entity's available economic resources.

(a) a variable that is independent of the entity's available economic resources ('independent variable'), for example, the receipt of an amount of cash indexed to a commodity index; and

(b) a variable that is not independent of the entity's available economic resources ('dependent variable'), for example, the price of the entity's own share.

4.31 Classification challenges arise for derivatives on own equity whose net amounts are affected by both independent variables and dependent variables. The classification would be clear if variables affecting both legs of a derivative are either all dependent on or all independent of the entity's available economic resources. An entity would classify a derivative on own equity as an equity instrument—if only affected by dependent variables—or as a financial asset or a financial liability—if only affected by independent variables. However, the net amount of many derivatives on own equity will be affected by both types of variables. For convenience, this Discussion Paper refers to these types of derivatives as 'partly independent derivatives'.

4.32 In the Board's preliminary view, partly independent derivatives would be classified as financial assets or financial liabilities for the reasons discussed in paragraphs 4.33–4.34.[47]

4.33 Classifying partly independent derivatives in their entirety as equity instruments would have raised a number of questions. These questions include:

(a) whether an equity classification would have been appropriate when changes in the carrying amounts resulting from independent variables would have been included in profit or loss if they arose from a separate contract that is classified as a financial asset or a financial liability;

(b) whether the presentation requirements for equity instruments that the Board is considering could adequately represent the effects of variables that are independent of the entity's available economic resources (see Section 6); and

(c) if only some such derivatives were to be classified as equity instruments, whether some types of variables, such as foreign currency indexation, should have different treatment from other variables, such as commodity indexation.

4.34 On the other hand, if all partly independent derivatives were classified in their entirety as financial assets or financial liabilities, changes in the carrying amounts of the derivatives resulting from changes in the entity's available economic resources would be recognised as income or expenses. For example, the net amount of a derivative that requires an entity to receive a fixed amount in a foreign currency in exchange for delivering a fixed number of the entity's own shares will change due in part to changes in the entity's available economic resources but also in response to changes in the foreign currency exchange rate. The Board thinks that this consequence can be mitigated by separate

47 Applying the fixed-for-fixed condition in IAS 32, all partly independent derivatives are classified as financial assets or financial liabilities subject to one exception with respect to particular foreign currency rights, options and warrants.

presentation of income and expenses arising from changes in the entity's available economic resources (see Section 6).

4.35 Thus, the Board's preferred approach would classify a standalone asset/equity exchange derivative on own equity, in its entirety, as a financial asset or financial liability if:

(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; and/or

(b) the net amount of the derivative is affected by an independent variable.[48]

Liability/equity exchange derivatives

4.36 Consistent with asset/equity exchange derivatives, in the Board's preliminary view, the Board's preferred approach would classify a standalone liability/equity derivative that extinguishes a financial liability in exchange for delivering equity instruments as a financial asset or financial liability if:

(a) it is net-cash settled—the derivative could require the entity to deliver 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; and/or

(b) the net amount of the derivative is affected by an independent variable.

4.37 A liability/equity exchange derivative typically exists as an embedded derivative in a non-derivative financial instrument (host instrument) and may extinguish existing financial liabilities or equity instruments of the entity as explained in paragraph 4.9. Because of this relationship, in the Board'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. In order to consider how the Board's preferred approach could be applied consistently to various arrangements with the same rights and obligations, this Discussion Paper explores liability/equity exchange derivatives, in particular contracts to extinguish equity instruments, further in Section 5.

Summary of preliminary views and questions for respondents

4.38 In the Board's preliminary view, applying the Board's preferred approach, a derivative on own equity, would be:

(a) classified in its entirety; as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

(b) classified as a financial asset or a financial liability if:

   (i) it is net-cash settled—the derivative requires the entity to deliver 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; and/or

48 Thus, applying the Board's preferred approach, partly independent derivatives on own equity would be classified as financial assets or financial liabilities.

(ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.

Comparison of preliminary view to IAS 32

4.39 Applying IAS 32, a derivative on own equity is classified as a financial asset or financial liability unless it meets the fixed-for-fixed condition or meets an exception for particular foreign currency derivatives, as described in paragraph 4.13(a).

4.40 The classification of derivatives on own equity applying the Board's preferred approach has many similarities in its requirements with those in IAS 32, including:

(a) classifying derivatives in their entirety;

(b) classifying as financial assets or financial liabilities all derivatives that are net-cash settled; and

(c) classifying as financial assets or financial liabilities[49] all derivative financial instruments with a net amount that is affected by an independent variable, such as a commodity index.

4.41 The classification principle of the Board's preferred approach for derivatives on own equity is based on the timing and the amount features, which are also used for classifying non-derivative financial instruments. As discussed in Section 3, the main difference between IAS 32 and the Board's preferred approach is how the classification principle is articulated with respect to the amount of a financial instrument. Instead of using a specific condition such as the fixed-for-fixed condition, the Board's preferred approach articulates the classification principle by reference to the amount of a financial instrument.

4.42 The Board expects that classification outcomes would remain largely the same for most types of derivatives on own equity. For example, all derivatives that meet the fixed-for-fixed condition applying IAS 32 are expected to be classified as equity instruments applying the Board's preferred approach. However, the classification outcomes for some derivatives on own equity might differ from those under IAS 32 because of the differences arising from clarifying the rationale and rearticulating the amount feature. For example:

(a) net-share settled derivatives to deliver a fixed number of an entity's own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount of the entity's functional currency[50] would be classified as equity instruments under the Board's preferred approach, but are classified as financial assets or financial liabilities under IAS 32. The Board's preferred approach considers whether there is a contractual obligation to transfer economic resources at a specified time other than at liquidation and as a result, gross

49 This is the case under IAS 32 (as a consequence of the fixed-for-fixed condition) except for particular foreign currency derivative financial instruments subject to the 'FX rights issue exception' noted in the footnote to paragraph 4.14(b).

50 The reverse, ie derivatives to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares are discussed in Section 5 because the derivatives result in extinguishment of a fixed number of own equity instruments.

physically settled instruments and 'net-share settled' instruments are classified consistently given that neither require the transfer of economic resources. Thus, if both types of instruments also have net amounts that are unaffected by a variable that is independent of the entity's available economic resources, the Board's preferred approach would classify both as equity instruments whereas IAS 32 classifies only 'gross-settled' derivatives as equity instruments.

(b) foreign currency rights issues that meet the exception in IAS 32 would be classified as financial assets or financial liabilities applying the Board's preferred approach. Such classification is consistent with derivatives on own equity whose net amount is affected by other independent variables, including other derivatives in foreign currency[51] such as the embedded conversion option in a foreign currency convertible bond.

4.43 Articulating the classification principle by reference to the amount feature would improve consistency in classification of derivatives on own equity that have similar consequences for the assessments identified in Section 2. Clarifying the underlying principle for classifying derivatives on own equity would also address application issues concerning the fixed-for-fixed condition in IAS 32 without fundamentally changing the classification outcomes of IAS 32. Paragraphs 4.45–4.66 discuss how identifying the underlying principle might help address some of these practical application issues.

4.44 One of the consequences of applying the Board's preferred approach to derivatives on own equity as set out in paragraph 4.38 is that entities would continue to classify partly independent derivatives as financial assets or financial liabilities. This means that changes in such financial assets or financial liabilities would include changes in the entity's available economic resources and those changes would be recognised as income or expense—the same way they are recognised when applying IAS 32. The Board considered whether separate presentation requirements could help alleviate these consequences and improve the information provided to users of financial statements (see Section 6).

51 The Board's preferred approach would include separate presentation requirements for foreign currency derivative financial instruments as discussed in Section 6.

Question 5
The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows: (a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and (b) a derivative on own equity is classified as a financial asset or a financial liability if: (i) it is net-cash settled—the derivative requires the entity to deliver 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; and/or (ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources. Do you agree? Why, or why not?

Further guidance on variables that affect the net amount of derivatives on own equity

4.45 This section considers how different variables in derivatives on own equity affect their classification applying the Board's preferred approach, in particular, variables that have resulted in questions and difficulties when applying the fixed-for-fixed condition in IAS 32.[52]

4.46 One application problem that arises when applying the fixed-for-fixed condition in IAS 32 is that IAS 32 does not define the term 'fixed' and is unclear about the rationale for the fixed-for-fixed condition. The Board considered whether its preferred approach would help address the application problems. For example, questions arise as to whether the fixed-for-fixed condition is met if:

(a) the amount of cash or another financial asset an entity will receive changes as a result of variables such as an interest rate.

(b) the unit of financial assets an entity will receive is fixed but the financial assets are exposed to changes in market prices that are independent of the entity's available economic resources. For example, the right to receive 100 ounces of gold is fixed in terms of the unit of gold, but is not fixed in terms of the entity's functional currency, and is exposed to changes in the market price of gold.

(c) the number of equity instruments an entity will deliver changes as a result of:

    (i) changes in the number of shares outstanding, such as share splits; and

52 Based on submissions to the Committee and other consultations.

(ii) changes based on dividends paid on existing equity instruments, so that the number of equity instruments to be delivered is adjusted only to reflect the dividend paid.

4.47 The Board considered the following variables and discussed which variables would affect the net amount of a derivative on own equity in a way that is independent of the entity's available economic resources and which would not. Applying the Board's preferred approach, the Board thinks that:

(a) the following variables would be independent variables in all circumstances:

(i) currency—other than the entity's functional currency—and fixed units of financial assets (paragraphs 4.49–4.51); and

(ii) variables that depend on the entity's economic resources—before deducting all other claims against the entity (paragraph 4.52).

(b) on the other hand, the following variables could be considered as dependent variables in some but not all circumstances such that adjustments for these variables might not result in the amount feature being independent of the entity's available economic resources:

(i) time value of money (paragraphs 4.53–4.54);

(ii) dilution (paragraphs 4.55–4.58);

(iii) distributions to holders of equity instruments (paragraphs 4.59–4.61);

(iv) non-controlling interests (paragraph 4.62); and

(v) contingencies (paragraphs 4.63–4.66).

4.48 The discussion in paragraphs 4.49–4.66 is limited to identifying whether a given variable is independent of the entity's available economic resources in order to assess the amount of a derivative on own equity; and does not consider other variables or other features that may be relevant to the classification of the derivative as whole.

Currency or fixed units of financial assets

4.49 An entity's economic resources and claims against the entity, which make up the entity's available economic resources, are measured in the functional currency of the entity. Therefore, in assessing how a particular variable affects the net amount of a derivative on own equity, an entity would consider the net amount of the derivative in the entity's functional currency. If a derivative on own equity includes a foreign currency underlying, for example, the exercise price of an option is set in a foreign currency, the net amount of the derivative, in the entity's functional currency, would be affected by the exchange rate between the foreign currency and the entity's functional currency, which would change in a way that is independent of the entity's available economic resources. If the net amount of a derivative on own equity is affected by foreign currency, the reference to foreign currency is an independent variable and the derivative would be classified as a financial asset or a financial liability.

4.50 In some cases, an entity may enter into a derivative contract on equity instruments of another entity within the same group. The Board considered, in the context of the consolidated group financial statements, which entity's functional currency should be the reference point for assessing whether the net amount of the derivative is affected by a foreign currency variable. The Board thinks that the functional currency of the entity whose equity instruments form the underlying of the derivative should be the reference point. If a derivative represents a claim on the available economic resources of a specific entity within a group, the exposure to a currency other than the functional currency of that entity introduces an independent variable.

4.51 If the net amount of a derivative is affected by a fixed unit of financial assets that are linked to an independent variable (eg receipt of 100 units of a bond that is linked to a commodity index), the reference to the fixed units of financial assets would be an independent variable. Changes in the value of the fixed units of financial assets are independent of the entity's available economic resources.

Dependency on the entity's economic resources before deducting all other claims

4.52 As discussed in paragraphs 3.17–3.24, the entity's available economic resources are the total recognised and unrecognised assets[53] of the entity that remain after deducting all other claims against the entity.[54] Consequently, a variable that depends on the entity's total economic resources or a specific component thereof (ie before deducting *all* other claims against the entity) is an independent variable. The presence of the variable in a derivative on own equity could result in the net amount of the derivative changing independently of potential changes in other claims. For example, some derivative financial instruments might promise a share of total assets of an entity or a share of a performance measure that reflects changes in those assets such as EBIT. For example, consider a derivative that requires a transfer of 1% of EBIT of an entity. The net amount of the derivative would increase as long as the entity's EBIT increases, even when the entity makes a net loss resulting in a decrease in the entity's available economic resources. Such a variable is an independent variable.

Time value of money

4.53 The time value of money, whether implicit or explicit, is an inherent component of any financial instrument and is also inherent in any entity's available economic resources and therefore all equity instruments. Share price, a variable that often acts as a proxy for changes in the entity's available economic resources, also therefore include a time value of money component. Time value of money is an inherent component for derivatives in particular, because the definition of a derivative includes the requirement to be settled at a future date. The right to receive cash or another financial asset or the right to extinguish a financial liability in a derivative on own equity may be specified in terms of a

53 An entity should not need to determine its available economic resources to assess whether the amount of a financial instrument is independent of its available economic resources. This should be clear from the instrument's contractual terms.

54 All other claims against the entity including all liabilities and equity, except the financial instrument in question.

present value or a future value. Therefore, a variable that reflects compensation for the time value of money that is relevant to the derivative, such as an interest rate, could be a dependent variable. However, if a variable that represents the time value of money is leveraged or is unrelated to the derivative instrument (eg the benchmark interest rate of an unrelated currency), such a variable is an independent variable. Such a variable could change the net amount of a derivative independently of the entity's available economic resources.

4.54 For example, a written call option on own shares may have multiple exercise dates and a strike price that increases based solely on a relevant interest rate (in the entity's functional currency) at each exercise date. In a contract such as this, the strike price is specified in terms of the present value. Other contracts may specify the strike price as a fixed amount, in terms of the future value to be transferred at a future date of exercise. Both approaches to specifying the fixed amount can result in a dependent variable.

Dilution

4.55 Many equity instruments, including ordinary shares and derivatives that require delivery of a fixed number of an entity's own ordinary shares, are exposed to the 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 mitigate the consequences of dilution, some derivatives on own equity, such as conversion options embedded in convertible bonds, may contain an anti-dilution provision. An anti-dilution provision adjusts the terms of exchange, for example, the conversion ratio, in the event of dilution to keep the derivative holder in the same economic position (for example, by entitling the holder to 1% of the ordinary shares in the entity at settlement).

4.56 An entity would need to determine whether an 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. If the net amount of a derivative on own equity is unaffected by any independent variable, adding such an anti-dilution provision to the derivative would not result in the net amount of the derivative being independent of the entity's available economic resources. Given that many equity instruments are exposed to dilution, the presence or the absence of the anti-dilution provision would not change the assessment of the amount feature of a derivative on own equity, as long as the provision does not introduce an independent variable.

4.57 Some anti-dilution provisions are asymmetric, for example, the provisions adjust the number of shares to be delivered either only when there is an increase in the total number of shares (ie in the event of dilution), while others are symmetric—the provisions adjust the number of shares to be delivered for both increases and decreases in the total number of shares outstanding. The symmetric or asymmetric nature of the anti-dilution provision, on its own, does not determine whether the anti-dilution provision introduces an independent variable. Given that the presence or absence of the anti-dilution provision would not preclude equity classification—derivatives could be either fully dilutive or fully protected from any dilution, and could be classified as equity instruments, its presence or absence in particular scenarios would also not preclude equity classification. An example of such a provision is an asymmetric anti-dilution provision triggered for some dilution events, but not others.

4.58 Consider the following examples:

(a) a derivative may require an entity to deliver a variable number of shares that represent a fixed *proportion* of the entity's available economic resources (for example, 25% of issued shares) for a fixed amount of functional currency of the entity. By promising a fixed proportion of the entity's shares in issue, the net amount of the derivative will only be affected by changes in the entity's available economic resources. Such a contractual term does not introduce an independent variable.

(b) a derivative may require an entity to deliver a fixed number of shares subject to an adjustment that will occur in the event of dilution so that the holder receives shares worth at least CU100. Such a contractual term has the effect of the entity promising a delivery of an amount that is independent of the entity's available economic resources, at least in some scenarios in which the fixed number of shares are worth less than CU100, requiring the entity to deliver additional shares totalling CU100.[55] The amount of the obligation to deliver CU100 worth of own shares is independent of the entity's available economic resources because the amount of the obligation does not change in response to changes in the entity's available economic resources.[56]

Distributions to holders of equity instruments

4.59 A contractual term may adjust the amount of a derivative on own equity, such as adjustments in the conversion ratio or strike price, to compensate the holder for missed distributions to which holders of existing equity instruments would be entitled, eg dividends.

4.60 Such contractual terms may be a dependent variable. Although equity instruments contain no contractual obligation to transfer the entity's available economic resources at a specified time other than at liquidation, an entity may choose to distribute part of its available economic resources, for example, in the form of dividends. An entity would make such dividend payments out of the entity's available economic resources; therefore, the amount of dividends depends on the entity's available economic resources. The distribution of an entity's available economic resources to its existing equity instrument holders will reduce the entity's available economic resources available to future equity instrument holders including the derivative holder. From the perspective of the

55 If a derivative on own equity could require the entity to transfer an amount independent of the entity's available economic resources in at least one possible settlement outcome, the derivative would be classified as a financial asset or a financial liability. See paragraphs 4.63–4.66.

56 The amount of the obligation is determined as CU100. The number of equity instruments to be delivered for such an obligation might change in response to changes in the share price, but the amount of the obligation remains unchanged at CU100.

net amount of the derivative on own equity, the distribution has a similar effect to a dilution event, unless there is an adjustment for such distribution.

4.61 Similar to an anti-dilution provision, contractual terms that seek to compensate the holder for missed dividend distributions may be a dependent variable provided that those terms do not introduce another independent variable. Contractual terms that compensate for issued dividends seek to compensate the holder from the reduction in available economic resources resulting from dividend distributions, similar to an anti-dilution provision seeking to protect the holder from dilution resulting from increases in the total number of equity instruments. Similar to an anti-dilution provision, the presence or absence of this type of contractual term does not in itself introduce an independent variable.

Non-controlling interests

4.62 As discussed in paragraph 3.24(c), ordinary shares in a subsidiary held by non-controlling interests are equity instruments of the group. Therefore, an entity would apply the Board’s preferred approach to derivatives on non-controlling interests in the same way as for derivatives on other own equity instruments. For example:

(a) the net amount of a written call option to deliver a fixed number of equity instruments of a subsidiary for receipt of a fixed amount of cash in the functional currency of the subsidiary would depend on the subsidiary’s available economic resources and therefore would not preclude equity classification in the consolidated financial statements. This applies even if the consolidated group financial statements are presented using another currency or if the parent has another functional currency.[57]

(b) the net amount of a written call option to exchange a fixed number of the parent’s own shares for a fixed number of its subsidiary’s shares would depend on the available economic resources of the parent and of the subsidiary and therefore would not preclude equity classification in the consolidated financial statements.

Contingencies

4.63 The exercise of derivatives on own equity can be optional or non-optional. The exercise of non-option derivatives such as a forward contract is certain to occur whereas the exercise of option derivatives will be conditional upon the contingencies specified in the contract. The exercise may be at the option of the holder of the instrument or the entity, or contingent on an event beyond the control of both the holder and the entity.

4.64 Consistent with the classification of a non-derivative financial instrument discussed in paragraph 3.10, if an entity does not have the unconditional right to avoid a settlement outcome of a derivative on own equity that has the feature(s) of a financial asset or a financial liability, the derivative in its entirety would be classified as such regardless of whether its exercise is contingent on

57 See paragraph 4.50.

the holder or on an uncertain future event that is beyond the control of both the holder and the entity. A settlement outcome is considered avoidable only if its avoidance is within the control of the entity. From the perspective of the entity, the entity does not have unconditional ability to avoid a settlement outcome that has a feature(s) of a financial liability when exercise is contingent on the holder or on an uncertain future event that is beyond the control of the holder and the entity.

4.65 Applying the Board's preferred approach, contingencies that do not affect either the timing feature or the amount feature of a derivative on own equity[58] would not affect the classification of the derivative. However, if a contingency affects the net amount of a derivative on own equity, the entity would need to determine whether it introduces another variable that is independent of the entity's available economic resources. A contractual term may be such that the occurrence of a specified contingent event would vary the amount of cash receivable, or vary the number of equity instruments to be delivered, in a way that is independent of the entity's available economic resources. In such cases, the contingency introduces an independent variable.

4.66 For example, consider a derivative on own equity that requires the exchange of CU100 for delivering 100 ordinary shares and that is mandatorily exercised if event A occurs. If event A does not occur, the derivative is not exercised similar to an option that lapses if not exercised. The contingency does not affect the net amount of the derivative and does not affect its classification.

Section 5—Compound instruments and redemption obligation arrangements

5.1 As stated in Section 3, the Board developed separate classification principles for non-derivative and derivative financial instruments because of particular challenges arising from classification of derivatives on own equity. As stated in paragraph 4.37, additional requirements would be needed to support the consistent classification of arrangements that include liability/equity exchange derivatives. This section sets out the Board's discussion of the classification of embedded derivatives and derivatives that include an obligation to extinguish own equity instruments.

5.2 To provide comparable information for users of financial statements to make the assessments described in Section 2, classification should be consistent for all similar contractual rights and obligations regardless of how an entity has structured those rights and obligations. Otherwise, the information provided in the financial statements may reflect the form rather than the economic substance of the contractual arrangements. The Board's aim is to achieve consistency between the classification of all arrangements that have the same settlement outcomes but are structured differently as described in paragraphs 5.3–5.7 below.

58 Changes in the probability of the contingent event occurring are likely to affect the *fair value* of derivatives that include such a contingency. However, it does not always affect the net amount of such derivatives.

5.3 The Board 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. For example, an entity can issue a bond to pay CU110 in two years' time and write an option to convert that bond to 100 ordinary shares as part of the same contract, or as a separate option contract. Whichever way those rights and obligations are structured, they result in the entity having an obligation that has the feature(s) of a financial liability (the obligation to pay CU110) and an alternative obligation, at the holders' option, to exchange the obligation to pay CU110 for an obligation to deliver 100 ordinary shares.

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

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

(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.

5.5 For example, an entity could issue 100 ordinary shares and separately write an option for the holder to put the shares back to the entity in exchange for CU110 in two years' time. Alternatively, the entity could issue 100 puttable shares that can be put back to the entity in exchange for CU110 in two years' time. The combination of the ordinary shares and the written put option creates substantially the same contractual rights and obligations as the puttable shares, and both of these arrangements have similar settlement outcomes to the convertible bond example in paragraph 5.3. In all cases, at the end of year two, the entity will either have to pay CU110 or deliver 100 ordinary shares (or have 100 ordinary shares remain outstanding if the written put option is not exercised), but not both. For convenience, this Discussion Paper refers to these types of financial instruments as financial instruments with alternative settlement outcomes.

5.6 The Board also observed that both: (a) financial instruments with alternative settlement outcomes that are contingent on an uncertain future event beyond the control of both the entity and the holder; and (b) those that depend on the holder exercising rights, are beyond the control of the entity (the issuer). In both cases the entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability.

5.7 To reflect the economic substance of contractual arrangements with similar contractual rights and obligations in a consistent manner, the classification of financial instruments with alternative settlement outcomes should be consistent regardless of whether:

(a) the financial instrument to be extinguished is:

(i) a financial liability—that is combined with a derivative that could result in the extinguishment of that financial liability in exchange for delivering own equity instruments; or

(ii) an equity instrument—that is combined with a derivative that could result in the extinguishment of that equity instrument in exchange for an obligation that meets the definition of a financial liability;

(b) the liability/equity exchange derivative is part of the same contract—an embedded derivative—or a separate contract; or

(c) the settlement outcomes are controlled by the holder or are contingent on an uncertain future event beyond the control of both the entity and the holder.

5.8 To achieve consistency in classification, in the Board's preliminary view, the entity would:

(a) 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.

(b) for a compound instrument or a redemption obligation arrangement, classify separately the financial liability and equity components. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:

(i) classify that unavoidable contractual obligation as a non-derivative financial liability, applying the non-derivative classification principle of the Board's preferred approach; and

(ii) classify any remaining contractual rights and obligations as an equity instrument, a financial asset or a financial liability, applying the derivative classification principle of the Board's preferred approach.

(c) if an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that have the feature(s) of a financial liability, the financial instrument does not contain a financial liability component.

5.9 This section is structured as follows:

(a) Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer):

(i) Compound instruments (paragraphs 5.12–5.14);

(ii) Redemption obligation arrangements (paragraphs 5.15–5.18);

(b) Further guidance on accounting for compound instruments and redemption obligation arrangements:

(i) Whether the liability component should include the effect of any conditionality (paragraphs 5.20–5.26);

(ii) Accounting within equity (paragraphs 5.27–5.32);

(c) Illustrative Examples of accounting for convertible bonds and written put options on own equity instruments (paragraphs 5.33–5.34);

(d) How the Board's preferred approach would address the challenges identified (paragraphs 5.35–5.42);

(e) Financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer) (paragraphs 5.43–5.47); and

(f) Summary of preliminary views and questions for respondents (paragraph 5.48).

Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)

5.10 The Board first considered the classification of financial instruments with alternative settlement outcomes in which the entity (the issuer) does not control the settlement outcomes. That is because applying the Board's preferred approach as discussed in paragraph 3.10, when classifying a non-derivative financial instrument with alternative settlement outcomes, an entity would consider whether the entity has the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability. If it does not have such a right, the entity would classify that unavoidable contractual obligation as a non-derivative financial liability. Financial instruments with alternative settlement outcomes controlled by the entity are discussed in paragraphs 5.43–5.47.

5.11 To achieve consistency in classifying financial instruments with alternative settlement outcomes as discussed in paragraph 5.7, the Board considered the application of the classification principles in Sections 3 and 4 to the following:

(a) compound instruments—contracts that include both a liability and an equity component, for example, convertible bonds and puttable shares[59] (paragraphs 5.12–5.14).

(b) redemption obligation arrangements—arrangements that contain a non-derivative equity instrument and a standalone derivative to extinguish that equity instrument. An example of this type of arrangement is ordinary shares and a written put option on ordinary shares (paragraphs 5.15–5.18).

Compound instruments

5.12 In the Board's preliminary view, applying the Board's preferred approach, the issuer of a non-derivative financial instrument would evaluate its terms to determine whether it contains both a liability and an equity component. Such

59 The puttable shares discussed in this section are those that are not subject to the puttable exception.

components would be classified separately as financial liabilities, financial assets or equity instruments. This requirement is consistent with the requirement for compound instruments in IAS 32. Examples of compound instruments include convertible bonds and puttable shares.

5.13 Applying the classification principle of the Board's preferred approach for non-derivative financial instruments, if an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would identify that unavoidable contractual obligation first and classify it as a non-derivative financial liability.

5.14 Once the financial liability component has been identified, the entity would consider whether the remaining rights and obligations would be classified as an equity instrument if they existed as a separate contract.[60] Because the remaining rights and obligations would represent a liability/equity exchange derivative, the entity would apply the classification principle for derivative financial instruments as set out in Section 4 to classify those remaining rights and obligations as if they were included in a standalone derivative.

Redemption obligation arrangements

5.15 As discussed in paragraph 4.9, the Board distinguished between asset/equity exchange derivatives and liability/equity exchange derivatives because a liability/equity exchange derivative involves an extinguishment of an existing financial instrument whereas an asset/equity exchange derivative does not. The Board's preliminary view is that for a derivative that may result in an extinguishment of an existing non-derivative equity instrument of the entity, the entity should analyse the package of contractual rights and obligations arising from the derivative together with those arising from the existing equity instrument (ie consider the whole of the redemption obligation arrangement).

5.16 Once an entity identifies the package of contractual rights and obligations that arise from a redemption obligation arrangement as a whole, the entity would apply the compound instrument requirements under the Board's preferred approach as discussed in paragraphs 5.12–5.14. The entity would evaluate the package of contractual rights and obligations of the redemption obligation arrangement as if they were contained in a single compound instrument and would determine whether there are liability and equity components. If so, the entity would classify those components separately as financial liabilities, financial assets or equity instruments.

5.17 The additional requirement in paragraphs 5.15–5.16 to consider the package of contractual rights and obligations arising from a redemption obligation arrangement as a whole would apply only to derivatives that may extinguish own equity instruments in exchange for an obligation that has the feature(s) of a

60 Such an approach would be consistent with the existing compound instrument requirements of IAS 32. The financial liability component that is identified would also be allocated in a manner consistent with IAS 32 with any equity component measured as a residual.

financial liability; the requirement would not apply to derivatives to extinguish a financial liability by delivering own equity instruments[61] and asset/equity exchange derivatives.

5.18 The Board noted that the additional requirement for derivatives to extinguish an equity instrument in exchange for an obligation that has the feature(s) of a financial liability is necessary to achieve consistent classification of similar contractual rights and obligations, and to provide useful information for the assessments identified in Section 2. For example, if an entity had a forward contract to repurchase 100 of its own ordinary shares in exchange for cash equal to CU110 in two years' time, the entity would classify its obligation to pay CU110 as a financial liability. The entity has an unconditional obligation to pay CU110, which has similar consequences for the entity's cash flows and creates similar information needs for users of the entity's financial statements as a simple bond.[62] If the forward contract were accounted for in the same way as other derivative financial instruments, it would be presented as the net amount of the exchange, CU110 net of the fair value of 100 equity instruments. Classifying the forward contract separately on a net basis while continuing to recognise the underlying equity instruments as outstanding would not provide information about the contractual obligation to transfer CU110 in two years' time, which would be useful for the assessments identified in Section 2.

Further guidance on accounting for compound instruments and redemption obligation arrangements

5.19 The Board noted that the application of its preferred approach as discussed in paragraphs 5.12–5.16 would also help address a number of challenges and questions arising from the existing requirements of IAS 32, including:

(a) whether the effect of any conditionality in settlement outcomes should be included in the liability component of a compound instrument or a redemption obligation arrangement (paragraphs 5.20–5.26); and

(b) the lack of clear requirements for the accounting within equity (paragraphs 5.27–5.32).

Whether the liability component should include the effect of any conditionality

5.20 When applying IAS 32, questions arise regarding whether the conditionality in settlement outcomes should be included in:

(a) the non-derivative financial liability component, for example, by probability-weighting the liability component based on the likelihood of the liability settlement outcome occurring; or

61 For arrangements containing a non-derivative financial liability and a standalone derivative to extinguish that financial liability by delivering equity instruments, classifying the package of rights and obligations arising from the arrangement as a whole results in the same classification as classifying the financial liability and the derivative separately.

62 The only difference is that the equity instruments underlying the exchange will remain outstanding for the two years and grant the holder of the equity instruments the rights linked to those shares for that limited time (for example, the receipt of dividends).

(b) the derivative representing the rights and obligations remaining after the non-derivative financial liability component is separately accounted for.

5.21 As stated in paragraph 5.10, applying the Board's preferred approach, if a financial instrument does not give an entity the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, it would give rise to a financial liability of the entity, regardless of whether the settlement outcome is controlled by the holder or is determined by an uncertain future event that is beyond the control of both the entity and the holder. In either case, the entity has an unavoidable contractual obligation that has the feature(s) of a financial liability until that obligation is waived by the holder, or extinguished as a consequence of the occurrence or non-occurrence of the contingent event. Examples of such contingent events include events such as changes in the entity's future revenues, profit or loss, financial position ratios or own share price. Hence, any conditionality would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability (see also paragraphs 4.63–4.66).

5.22 Consider, for example, a mandatorily convertible instrument that requires the entity to deliver a variable number of its own shares with a total value equal to CU100, subject to a cap of 100 shares. The cap will be triggered automatically if the share price falls below CU1 per share. This means that the entity has an obligation to deliver either:

(a) CU100 in shares, if the share price is higher than CU1; or

(b) 100 shares, if the share price is equal to or lower than CU1.

5.23 Applying the Board's preferred approach, the obligation to deliver CU100 in paragraph 5.22 would be classified as a financial liability because of the amount feature—ie the obligation for an amount independent of the entity's available economic resources. The entity has an unavoidable contractual obligation to deliver CU100 of shares unless the share price falls to or below CU1. Such a contingent event is beyond the control of the entity. Therefore, applying the Board's preferred approach, the entity would first classify that obligation to deliver a variable number of its own shares with a total value equal to CU100 as a non-derivative liability component. In identifying the liability component, the entity would not consider the uncertainty that arises from conditionality, ie the likelihood of the share price falling below CU1. Once the liability component is identified, the entity would classify the remaining rights and obligations applying the classification principle of the Board's preferred approach for derivative financial instruments.

5.24 In compound instruments and redemption obligation arrangements, once a financial liability is identified, the remaining obligation would represent an obligation to exchange that financial liability with an equity instrument. Consequently, the effect of any conditionality in settlement outcomes would be part of the obligation to exchange, ie would be part of the derivative. The non-derivative financial liability component would not include the effect of conditionality.

5.25 The consequence of excluding the effect of the conditionality from the non-derivative financial liability component is that the financial liability recognised—reflecting the unavoidable contractual obligation to transfer economic resources—would be the same for the obligation arising from a forward contract and a written option. For example, an entity would recognise the same non-derivative financial liability for a mandatory share repurchase and a written put option on own shares that has the same terms except for the option feature. Any other alternative settlement outcome arising from a written put option would be recognised as a derivative on own equity, which represents a potential exchange of the financial liability for equity instruments.

5.26 The Board also observed that the consequence described in paragraph 5.25 is consistent with the conclusion that there is no carrying amount attributable to the equity component in an obligation to extinguish an equity instrument at its fair value. The liability component would represent the redemption amount—the obligation to pay the fair value of the equity instrument—as if it were unconditional. The remaining obligation for the entity is to exchange that obligation for an equity instrument with the same value. Therefore, the equity component has a zero value regardless of whether the redemption obligation was exercisable at the option of the holder or was contingent on an event beyond the control of both the entity and the holder—or whether the redemption was mandatory. Recognising the redemption obligation for the fair value of the equity instruments as a financial liability[63] provides the information required to help assessments of funding liquidity and cash flows as discussed in Section 2.

Accounting within equity

5.27 When applying IAS 32, questions arise with respect to accounting within equity because IAS 32 does not provide explicit requirements, in particular for obligations to extinguish own equity instruments. For example, if an entity has an obligation to purchase its own equity instruments for cash or another financial asset, paragraph 23 of IAS 32 requires recognition of the present value of the redemption amount as a financial liability and reclassification of the same amount from equity. However, it does not specify how to reclassify that amount.

5.28 Applying the Board's preferred approach to a redemption obligation arrangement, an entity would identify the unavoidable contractual obligation to extinguish its own equity instruments as a liability component and recognise this component as a financial liability by derecognising[64] the existing equity instruments. For a redemption obligation arrangement that includes a written put option,[65] there are remaining rights and obligations that need to be classified—the obligation to exchange the financial liability for own equity

63 Because the amount of the obligation would not be independent of the entity's available economic resources, income and expenses arising from such an obligation would be subject to the separate presentation requirements discussed in Section 6.

64 Although the equity instruments are derecognised on issuance of a written put option, it does not mean that the equity instruments have been extinguished at that point. The presence of a written put option on own equity instruments has changed the characteristics of the equity instruments to those of a financial liability.

65 For a forward contract to repurchase own equity instruments, there will be no other rights and obligations once a financial liability is recognised and own equity instruments derecognised.

instruments in the event that the holder of the put option does not exercise the option. That exchange obligation would be classified as a financial asset, a financial liability, or an equity instrument applying the classification principle of the Board's preferred approach for derivative financial instruments.

5.29 Any written put option on own shares comprises three parts—the strike price of the option (ie the redemption amount) less the fair value of the underlying shares plus the time value of the holder's right to exercise the option. One part of the exchange in the written put option, the obligation to pay the strike price, will be recognised as a financial liability. However, until the option is exercised, the holder has the choice not to exercise the option and, in such an event, the ordinary shares would remain outstanding. To faithfully represent the remaining rights and obligations, the entity would need to recognise a liability/equity exchange derivative representing that option of the holder. Such an option would be similar to a written call option contract to exchange that liability for equity instruments. This similarity is best illustrated by considering a scenario in which the share price of the entity approaches zero at the maturity of the put option. In this scenario, the fair value of the written put option is the strike price. This is already recognised as a financial liability under the Board's preferred approach. The fair value of the written call option, which would be required to be recognised applying the Board's preferred approach, would be worth nothing as the share price of the entity approaches zero at the maturity.[66]

5.30 Therefore, if an entity issues a written put option with a strike price of CU110 on 100 ordinary shares of the entity and receives CU10 as an option premium, the accounting applying the Board's preferred approach would be as follows:

(a) a financial liability would be recognised for the present value of CU110, the put option strike price.

(b) 100 units of the entity's own shares would be derecognised at fair value at the date when the written put option 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.

5.31 If the entity were to derecognise the underlying shares at the redemption amount recognised as a financial liability (ie the present value of CU110), the remaining component as described in paragraph 5.30(c) would equal CU10. This amount would represent the premium received for the written put option

66 The same issue described in this paragraph would apply even if the remaining rights and obligations are classified as derivative financial assets or financial liabilities. The Board's preferred approach clarifies the accounting for the remaining rights and obligations after identifying the financial liability for the redemption amount regardless of whether they are classified as equity or as a financial asset or liability.

contract, even though the remaining obligation represents that of a written call option. By derecognising the equity instrument at fair value, the amount effectively attributed to the option reflects the value of a similar written call option.

5.32 Consistency in accounting between a compound instrument and a redemption obligation arrangement would also be achieved after initial recognition. For example, if the written put option is not exercised and, hence, the holder does not exercise their right to put the entity's own shares to the entity in exchange for receiving the strike price, this outcome would be accounted for in a similar manner to the exercise of a conversion option in a convertible bond. On conversion of the convertible bond, the financial liability and equity components would be derecognised and the ordinary shares would be recognised. The entity would account for non-exercise of the written put by the holder in the same way. Even though the ordinary shares were never physically redeemed or issued, the written put option was issued and expired. The expiry of the written put option gives rise to similar consequences for the entity's financial position and financial performance as would arise in the case of conversion of the convertible bond.

Illustrative examples of accounting for convertible bonds and written put options on own equity instruments

5.33 The following examples illustrate how the Board's preferred approach would apply to contracts for an exchange of a financial liability and equity:

(a) Example 1—convertible bond: the entity issues a bond for CU100,000[67] in cash, which requires the entity to pay the holder an amount equal to CU110,000 in cash, two years from the date of issue. The bond also grants the holder the right to receive 100,000 ordinary shares of the entity instead of the CU110,000 in cash (the conversion option). Assume that:

(i) the bond has no interest payments and early settlement is prohibited;

(ii) the present value of CU110,000 payable in two years' time is CU82,000; and

(iii) the entity's ordinary share price at the end of two years is CU1.25 per share.

(b) Example 2—written put option on own equity: the entity issues 100,000 ordinary shares for CU0.9 each.[68] Simultaneously, the entity issues a written put option on 100,000 ordinary shares at a strike price of CU1.1 each. The put option is exercisable in two years' time and in return the entity received CU10,000 in cash as a premium. The present

67 Currency unit of the entity's functional currency.

68 For purposes of the illustration, the example assumes that the shares and the written put are issued simultaneously. However, the analysis would remain unchanged if the written put option and the shares were issued at different times.

value of the redemption amount (CU110,000) is CU82,000. The entity's ordinary share price at the end of two years is CU1.25 per share.[69]

5.34 In both examples:

(a) the obligation to pay CU110,000 in cash in two years' time would meet the definition of a financial liability applying the Board's preferred approach because it requires the transfer of cash at a specified time other than at liquidation, and it is for an amount independent of the entity's available economic resources. The subsequent accounting for the financial liability, including the unwinding of the discounting effect from CU82,000 to CU110,000, would be in accordance with IFRS 9. In both examples, because the amount of cash to be transferred is independent of the entity's available economic resources, the financial liability would not qualify for separate presentation applying the Board's preferred approach.[70]

(b) the option to exchange the liability in paragraph 5.33(a) for 100,000 ordinary shares is an equity component. The option has the feature of an equity instrument applying the Board's preferred approach as the option represents an exchange of a fixed amount of a financial liability in the entity's functional currency for a fixed number of own shares. The example considers both exercise and non-exercise of the option at the end of two years.

Journal entries

In Currency Units (CU)	**Example 1: convertible bond**	**Example 2: written put option**
Identification of components and initial recognition	Debit (Dr) Cash 100,000 Credit (Cr) Financial liability 82,000 Cr Equity—Conversion option 18,000 *On initial recognition, the convertible bond is separated into its liability and equity components.*	Dr Cash 90,000 Cr Equity—Ordinary Shares 90,000 *On initial recognition of 100,000 ordinary shares @ CU0.9 per share* Dr Cash 10,000 Dr Equity—Ordinary Shares 90,000 Cr Financial liability 82,000 Cr Equity—Conversion option 18,000 *On initial recognition of the put option, the entity would derecognise the ordinary shares at fair value at the date the written put is issued, and recognise a liability for the redemption amount and an equity component.*

continued...

69 In our example, the ordinary shares do not pay dividends in the intervening period. The bond is not convertible or redeemable by the holder or the entity before the conversion date at the end of year two (ie it is a European style option) and does not meet the puttable exception.

70 If the amount of the obligation were not independent of the entity's available economic resources—for example, the redemption amount is equal to the fair value of the underlying shares—separate presentation requirements would apply to the financial liability. See Section 6.

...continued

In Currency Units (CU)	**Example 1: convertible bond**	**Example 2: written put option**
Recognition of accretion of interest over the life of the bond/written put option (after initial recognition)	Dr Interest expenses (profit or loss) 28,000 Cr Financial liability 28,000 *Over the period between initial recognition and the end of year 2, interest accrues on the bond and is recognised in profit or loss.*	Dr Interest expenses (profit or loss) 28,000 Cr Financial liability 28,000 *Over the period between initial recognition and the end of year 2, the financial liability accretes to the redemption amount and the accretion is recognised as interest in profit or loss.*
If equity settlement outcome is selected in year 2	Dr Financial liability 110,000 Dr Equity—Conversion option 18,000 Cr Equity—Ordinary shares 128,000 *If the bond is settled by delivering ordinary shares, the financial liability and conversion option shall be derecognised, and ordinary shares would be recognised.*	Dr Financial liability 110,000 Dr Equy—Conversion option 18,000 Cr Equity—Ordinary shares 128,000 *If the written put option is not exercised, the financial liability and conversion option would be derecognised, and ordinary shares would be recognised.*
If liability settlement outcome is selected in year 2[(a)]	Dr Financial liability 110,000 Cr Cash 110,000 Dr Equity—Conversion option 18,000 Cr Equity attributable to ordinary shares 18,000 *If the bond is settled by delivering cash, the financial liability would be derecognised, and the carrying amount of the conversion option would be reclassified within equity.*	Dr Financial liability 110,000 Cr Cash 110,000 Dr Equity—Conversion option 18,000 Cr Equity attributable to ordinary shares 18,000 *If the written put option is exercised and settled by delivering cash, the financial liability would be derecognised, and the carrying amount of the conversion option would be reclassified within equity.*

(a) Any requirements to reclassify amounts within equity will depend on what the Board decides on presentation requirements within equity. For example, if the Board decides to require attribution of total comprehensive income to equity instruments other than ordinary shares (see Section 6), the reclassification within equity would have more significant consequences on presentation.

How would the Board's preferred approach address the challenges identified?

5.35 Although IAS 32 requires similar accounting for a financial liability component in a compound instrument and an obligation to extinguish own equity instruments for cash or another financial asset, it does not discuss the relationship between these accounting requirements. This has resulted in a number of questions, including:

(a) whether the requirements in IAS 32 for an obligation to extinguish own equity instruments apply if a written put option is settled by transfer of a variable number of own shares. This question arises because requirements in paragraph 23 of IAS 32 refer only to obligations to transfer cash or another financial asset and are silent regarding settlement in own shares.

(b) how to account for transactions within equity. For example, IAS 32 requires the initial recognition of a financial liability for the present value of the redemption amount and a reclassification of this amount from equity. However, it does not specify how to reclassify the amount.

5.36 One transaction that illustrates the challenges that arise is accounting for NCI puts. In 2012, the Committee published a draft interpretation that addressed the recognition of changes in the measurement of the liability.[71] However, respondents to that draft interpretation suggested that the Board should address the accounting for NCI puts more comprehensively. The respondents pointed out that other aspects of the accounting for NCI puts have resulted in diversity in practice. The aspects of accounting that raise diversity in practice include:

(a) the account the debit is recognised in when reclassifying the present value of the redemption amount from equity. For NCI puts, in particular, the question is whether the non-controlling interest is derecognised, or a contra-equity account is recognised within parent equity.

(b) how to account within equity for any premium received for NCI puts, and for the expiration or exercise of the NCI puts.

5.37 Answering these questions for NCI puts would have consequences for the accounting for transactions such as dividends or other distributions. Answering these questions would also affect whether a portion of the subsidiary's profit or loss should continue to be attributed to the NCI as required by paragraph B94 of IFRS 10 *Consolidated Financial Statements*, after NCI puts are written.

5.38 As discussed in paragraphs 5.19–5.32 and demonstrated by the illustrative examples set out in paragraphs 5.33–5.34, the Board's preferred approach would require consistent accounting for redemption obligation arrangements, including NCI puts and compound instruments. Consistent accounting for these arrangements would improve the usefulness of the financial statements because both have similar contractual rights and obligations that result in similar liability and equity outcomes. By clarifying the relationship between the requirements for such arrangements, the Board's preferred approach would improve the consistency and completeness of the requirements. The requirement to identify the liability component would also apply to redemption obligation arrangements that require a transfer of a variable number of own shares, if the amount of the contractual obligation to transfer own shares is independent of the entity's available economic resources, thus answering the question described in paragraph 5.35(a).

5.39 The Board's preferred approach would also clarify accounting for equity components. For NCI puts, the accounting in the consolidated financial

71 The redemption obligation requirements in this regard would be carried forward under the Board's preferred approach. The separate presentation requirements under the Board's preferred approach consider the presentation of changes in the measurement of such liabilities.

statements would be the same as that in Example 2 set out in paragraphs 5.33–5.34 except that the underlying equity instruments are shares that represent the NCI. Applying the Board's preferred approach would thus require:

(a) recognition of a liability component at the redemption amount (which will be subsequently measured in accordance with IFRS 9);

(b) derecognition of the NCI—the ordinary shares of the subsidiary that represent 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; and

(c) recognition of an equity component for the—implicit—written call option on the subsidiary's shares.

5.40 Similar entries would be required for the expiry or exercise of the NCI puts as shown in Example 2 set out in paragraphs 5.33–5.34. However, if the puts expire unexercised, instead of ordinary shares of the parent set out in paragraphs 5.33–5.34, the shares of the subsidiary would be recognised.

5.41 Gains or losses, including those arising from subsequent measurement of the liability component, are recognised as income and expense, while changes in the equity components are recognised in the statement of changes in equity.

5.42 If the NCI put is a fair value put, consistent with the discussion in paragraph 5.26, the equity component would be nil. The financial liability would be remeasured in accordance with IFRS 9—reflecting the change in the fair value of the NCI. The returns on the put would be reflected in the liability component with changes in the carrying amount of the liability recognised as income or expenses. The separate presentation requirements might apply to the gains and losses on the financial liability component (see Section 6).

Financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer)

5.43 As stated in paragraph 5.10, the Board considered how the Board's preferred approach would classify a financial instrument with alternative settlement outcomes controlled by the entity.

5.44 Some financial instruments have alternative settlement outcomes and give the entity an unconditional right to choose the settlement outcome. Consider, for example, a so-called reverse convertible bond that grants the entity the unconditional right to settle the bond either by delivering 100 of its own shares at any time, or by paying cash of CU110 at the bond's maturity. The entity has the obligation to settle the bond in one of two ways, but the entity has the unconditional right to avoid the liability settlement outcome by choosing to deliver 100 shares. Such a financial instrument can be analysed as containing an obligation to deliver a fixed number of equity instruments together with a right—not an obligation—of the entity to extinguish that obligation by delivering cash instead. The reverse convertible bond does not contain a financial liability component, unless the bond establishes an obligation that has the feature(s) of a financial liability indirectly (see Section 8). Applying the Board's preferred approach, the entity would classify the bond as an equity instrument reflecting the right to deliver 100 shares and thus avoid cash settlement.

5.45 The Board considered whether, and if so, how the information about the entity's right to choose the alternative settlement outcome—paying CU110 in cash in the example in paragraph 5.44—should be provided in the financial statements. The Board discussed potential ways to provide information about the alternative settlement outcome, including:

(a) separation of embedded derivatives from the equity host instrument; and

(b) presentation and disclosure, such as attribution within equity.

5.46 The entity's right to deliver CU110 instead of 100 shares for the financial instrument described in paragraph 5.44 is an embedded derivative—a purchased call option on own shares. The Board considered whether the embedded derivative should be separated from an equity host instrument. Separation would mean that if the embedded derivative does not have the features of an equity instrument applying the Board's preferred approach, the derivative would be classified as a financial asset. The Board discussed the following as the potential benefits and challenges of such separation:

(a) more information about the alternative settlement outcomes would be provided through classification and the resulting recognition and measurement of the embedded derivative, which would decrease the pressure on the presentation and disclosure requirements in providing information about the embedded derivative. Separation of the embedded derivative would also enhance consistency of classification between different arrangements with similar contractual rights and obligations.

(b) on the other hand, the challenges with separating embedded derivatives from equity host instruments include identifying and defining the host instrument, and specifying the order of separation. There are many possible ways of performing the separation, and clarifying these aspects would be necessary for financial instruments with similar contractual rights and obligations to be classified consistently. The Board also observed that separating embedded derivatives from an equity host instrument would lead to a gross-up of assets and equity in the statement of financial position and that the effect will be more significant for deep out-of-the-money options.[72] Requiring separation may also result in a change in practice.

5.47 The Board observed that the need for the information described in paragraph 5.45 arises not only when applying the Board's preferred approach; it also arises when applying IAS 32. However, the Board is not aware of the extent

72 Consider an example of an issuer-held share conversion option in a reverse convertible bond that is deep out of the money. A deep out-of-the-money share conversion option suggests that the share settlement option is much more expensive than the cash settlement option. This in turn means that the entity's option to pay cash (effectively reflecting the right to call back the shares) instead of delivering shares is highly valuable. If the embedded option were to be separated from the host, the entity would recognise shares as if they are issued and recognise the entity's right to pay cash to call those shares back as a financial asset. Since the entity's option to pay cash (rather than to issue shares) is highly valuable, a high value option asset and a high value equity instrument are recognised although it is unlikely that the entity would actually choose to deliver shares and thus it is unlikely that ultimately the equity would remain outstanding.

of the significance and prevalence of challenges associated with this issue applying IAS 32. In view of the limited information about the significance of the issue and the complexity associated with the potential solutions, the Board did not develop a preliminary view. After receiving feedback on this Discussion Paper, the Board intends to discuss whether to address this issue and if so, how.

Summary of preliminary views and questions for respondents

5.48 In the Board's preliminary view, applying the Board's preferred approach, an entity would:

(a) for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the non-derivative equity instrument that will, or may, be extinguished. Once identified, the package of the contractual rights and obligations would be analysed for classification purposes consistent with a compound instrument.

(b) for a compound instrument or a redemption obligation arrangement, classify separately the financial liability and equity components. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:

(i) classify that unavoidable contractual obligation as a non-derivative financial liability, applying the non-derivative classification principle of the Board's preferred approach; and

(ii) classify any remaining rights and obligations as an equity instrument, a financial asset or a financial liability, applying the derivative classification principle of the Board's preferred approach.

(c) if an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that have the feature(s) of a financial liability, the financial instrument does not contain a financial liability component.

Question 6
Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34. For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47. (a) Do you think the Board should seek to address the issue? Why, or why not? (b) If so what approach do you think would be most effective in providing the information, and why?

Section 6—Presentation

6.1 As discussed in Section 2, the Board considered what information is best provided through classification using the distinction between liabilities and equity and what information is best provided through presentation and disclosure requirements. This section sets out the Board's preliminary views on the information that would be provided through presentation applying the Board's preferred approach. This section considers:

(a) presentation of financial liabilities (paragraphs 6.2–6.54); and

(b) presentation of equity instruments (paragraphs 6.55–6.95).

Presentation of financial liabilities

6.2 The Board's preferred approach would classify financial instruments as financial liabilities or derivative financial assets or liabilities[73] if they have either one or both features of a financial liability, because those features are relevant to the assessments that the Board identified in Section 2. Consequently, some financial liabilities and derivatives on own equity that are classified as financial assets or financial liabilities will have features relevant to only one of those assessments. As discussed in paragraph 2.35, to provide information that will help users of financial statements make each of the identified assessments separately, the Board developed presentation requirements that would provide information about financial liabilities and derivative financial assets and liabilities that have only one of the two features. As discussed in paragraph 2.37, this section also considers how information about the secondary distinctions—such as further

73 In this section, derivative financial assets and liabilities refer to derivatives on own equity that are classified as financial assets or financial liabilities applying the Board's preferred approach set out in Section 4.

disaggregated information about the timing and the amount features of financial liabilities and the priority of financial liabilities—could be provided through presentation.

6.3 This section is structured as follows:

(a) assessments of balance-sheet solvency and returns—providing information through presentation about the amount feature, which would be relevant to this assessment (paragraphs 6.6–6.48);

(b) assessments of funding liquidity and cash flows—providing information through presentation about the timing feature, which would be relevant to this assessment (paragraphs 6.49–6.52); and

(c) a summary of preliminary views and questions for respondents (paragraphs 6.53–6.54).

6.4 In the Board's preliminary view, to facilitate assessments of balance-sheet solvency and returns, an entity should, applying the criteria-based approach:[74]

(a) in the statement of financial position, present separately carrying amounts of:

  (i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

  (ii) derivative financial assets and derivative financial liabilities that have net amounts unaffected by any independent variable; and

  (iii) partly independent derivatives that meet the criteria in paragraph 6.34.

(b) in the statement of financial performance, present in other comprehensive income (OCI), without subsequent reclassification, income and expenses arising from:

  (i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

  (ii) derivative financial assets and derivative financial liabilities that have net amounts unaffected by any independent variable; and

  (iii) partly independent derivatives that meet the criteria in paragraph 6.34.

6.5 In the Board's preliminary view, no presentation requirements need to be developed to provide information about the timing feature of financial liabilities because existing presentation and disclosure requirements in other IFRS Standards provide sufficient information to facilitate assessments of funding liquidity and cash flows.

Assessments of balance-sheet solvency and returns

6.6 This subsection sets out how the Board developed its preferred approach to presentation of financial liabilities—including derivative financial assets and liabilities—and how these presentation requirements would provide further

74 See paragraphs 6.21–6.48.

information about the amount feature of financial liabilities and derivative financial assets and liabilities to facilitate assessment of balance-sheet solvency and returns. The Board considered the following:

(a) statement of financial position (paragraphs 6.7–6.9);

(b) statement of financial performance (paragraphs 6.10–6.15);

(c) financial instruments to which the presentation requirements would apply (paragraphs 6.16–6.20);

(d) how the presentation requirements would apply (paragraphs 6.21–6.41); and

(e) whether the presentation requirements should be achieved using OCI (with or without subsequent reclassification) or using a separate line item within profit or loss (paragraphs 6.42–6.48).

Statement of financial position

6.7 The Board considered whether separate presentation of financial liabilities and derivative financial assets and liabilities using additional line items or subclassifications would provide further disaggregated information about how a financial instrument contract specifies the amount and the priority of the claims on liquidation. As discussed in paragraph 2.30, additional information about these secondary distinctions would help users of financial statements make more detailed assessments of balance-sheet solvency and returns. For example, financial liabilities that do not contain an obligation for an amount that is independent of the entity's available economic resources (eg shares redeemable at fair value) would be presented in a separate line item from those that do contain such an obligation (eg ordinary bonds). This distinction is not currently required under IFRS Standards.

6.8 The Board also considered whether providing information about financial liabilities—and for that matter, equity instruments—that have different priority levels on liquidation of the entity (for example, in order of priority:[75] senior ordinary bonds, unsecured bonds, share-settled debt and cumulative preference shares) should be required on face of the statement of financial position. As discussed in Section 2, arranging claims by priority on liquidation would help users of financial statements assess in more detail how any potential shortfall or surplus in economic resources is allocated among claims.

6.9 In the Board's preliminary view, an entity should:

(a) present, on the face of the statement of financial position, financial liabilities and derivative assets or liabilities that do not contain an obligation for an amount that is independent of the entity's available economic resources separately from those that do. The Board's consideration about the set of financial instruments to which this

75 The order of priority of financial instruments determines how an entity's total economic resources are allocated on liquidation. The order of maturity of financial instruments is determined by the timing of required settlement.

presentation requirement would apply is set out in more detail together with a discussion of the presentation requirements for income and expense in paragraphs 6.10–6.48.

(b) present financial liabilities and equity in order of priority on the face of the statement of financial position, or disclose this information in the notes to the financial statements. If 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. Otherwise, the information about the priority of financial liabilities and equity on liquidation would be disclosed in the notes to the financial statements. The Board's considerations about how the information could be provided about the priority of financial instruments through disclosure is outlined in paragraphs 7.4–7.12.

Statement of financial performance

6.10 The Board considered whether it would be useful to present income and expenses that result from changes in the entity's available economic resources separately from other income and expenses, so that users of financial statements would be able to distinguish them for the purposes of making assessments of an entity's financial performance as identified in Section 2.

6.11 Applying the Board's preferred approach to classification, some financial instruments are classified as financial liabilities even though they do not contain an obligation for an amount independent of the entity's available economic resources. Income and expenses that arise from such instruments are affected by changes in the entity's available economic resources. The Board identified the following instruments that would include such effects in income and expenses:

(a) 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. One example of such an instrument is shares redeemable at fair value that do not meet the puttable exception.

(b) derivative financial assets and liabilities[76] 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).

(c) partly independent derivatives.[77] 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.

76 Derivative financial instruments that have a net amount that is unaffected by any independent variables would be classified as financial assets or financial liabilities if they are net-cash settled. See Section 4.

77 Applying the Board's preferred approach, all partly independent derivatives (ie derivatives on own equity whose net amounts are affected by both independent and dependent variables) are classified as financial assets or financial liabilities. See Section 4.

6.12 The Board thinks that it would be useful to separately present income and expenses of the financial assets and financial liabilities described in paragraph 6.11. Such separate presentation would be useful because:

(a) such income and expenses are not relevant to the assessments of an entity's financial performance as identified in Section 2; and

(b) recognising changes in the carrying amount of such financial instruments in profit or loss may also appear counter-intuitive due to the accounting mismatch that arises from incomplete recognition of changes in the value of other assets and other liabilities of an entity.

6.13 This apparent counter-intuitive accounting was also one of the concerns that led to the puttable exception, because:

(a) when an entity performs well, the carrying amount of the liabilities increases and a loss would be recognised on those liabilities; and

(b) when an entity performs poorly, the carrying amount of the liabilities decreases and a gain would be recognised on those liabilities.

6.14 However, the concerns regarding the counter-intuitive effects on the income statement are not limited to financial instruments subject to the puttable exception but apply to all financial instruments classified as financial assets or financial liabilities that contain an obligation for an amount that is affected by changes in the entity's available economic resources—the financial instruments identified in paragraph 6.11. Respondents also expressed similar concerns to the May 2012 Draft Interpretation on the accounting for NCI puts,[78] in particular, for written puts with a fair value strike price.

6.15 Consequently, the Board developed presentation requirements that would provide the information in paragraph 6.12 for financial instruments identified in paragraph 6.11. The Board did so considering its preferred approach to classification and the requirements of IFRS 9 because IFRS 9 sets out how financial instruments identified in paragraph 6.11 are accounted for. In particular, the Board considered the following:

(a) financial instruments to which the separate presentation requirements would apply (paragraphs 6.16–6.20);

(b) how the separate presentation requirements should apply (paragraphs 6.21–6.41); and

(c) whether the separate presentation requirements should apply within profit or loss, or using OCI (with or without subsequent reclassification) (paragraphs 6.42–6.47).

Financial instruments to which the separate presentation requirements would apply

6.16 Presentation of income and expenses from financial assets and financial liabilities is affected by how those financial assets and financial liabilities are measured and accounted for under IFRS 9. Consequently, any new or additional

78 See paragraph 5.36 for further detail.

subclass of financial liabilities to which the Board's presentation requirements would apply needs to be considered within the context of the classification and measurement requirements in IFRS 9.

6.17 After initial recognition, IFRS 9 requires that an entity measures a financial liability at either amortised cost or fair value through profit or loss.[79] For particular financial liabilities such as derivatives, measurement at fair value through profit or loss is required,[80] whereas for some others, designation at fair value through profit or loss is permitted, subject to specific conditions (the fair value option).[81]

6.18 IFRS 9 contains specific requirements for accounting for an embedded derivative, which it describes as a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.[82] If the economic characteristics and risks of an embedded derivative are not closely related to those of the host, IFRS 9 requires the entity to separate the embedded derivative from the host unless the hybrid contract is measured at fair value through profit or loss.[83] These requirements apply to hybrid contracts that contain a host that is not an asset within the scope of IFRS 9.[84]

6.19 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 are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar. Consequently, if a hybrid contract contains an embedded derivative that is not independent of the entity's available economic resources, the embedded derivative would be required to be separated from the host instrument, unless the fair value option is applied to the entire instrument.

6.20 Accordingly, the financial instruments identified by the Board in paragraph 6.11 would be measured at fair value through profit or loss applying IFRS 9. The instruments would be one of the following types of financial instruments:

(a) a standalone derivative on own equity that:

  (i) has a net amount that is unaffected by a variable that is independent of the entity's available economic resources; and

  (ii) is classified as a financial asset or a financial liability because of the requirement to transfer cash or another financial asset (for example, a net-cash settled derivative on own equity).

(b) a standalone derivative on own equity that:

79 See paragraph 4.2.1 of IFRS 9. We have not considered the classification of financial guarantee contracts and loan commitments, because they are not relevant to this Discussion Paper.

80 See paragraph 4.2.1(a) of IFRS 9.

81 See paragraphs 4.2.2 and 4.3.5 of IFRS 9.

82 See paragraph 4.3.1 of IFRS 9.

83 See paragraph 4.3.3 of IFRS 9.

84 See paragraph 4.3.2 of IFRS 9.

(i) is partly independent of the entity's available economic resources, ie the net amount of the derivative is affected by both independent variables and dependent variables (for example, a contract to deliver a fixed number of the entity's own shares in exchange for a fixed amount of foreign currency); and

(ii) is therefore classified as a financial asset or a financial liability, because applying the Board's preferred approach, all partly independent derivatives are classified as such (see Section 4).

(c) a hybrid instrument that:

(i) contains a non-derivative financial liability and an embedded derivative that has the same features as a standalone derivative in (a) or (b); and

(ii) is designated as measured at fair value through profit or loss as a whole applying the fair value option, ie the embedded derivative is not separated.

(d) an embedded derivative that:

(i) has the same features as a standalone derivative in (a) or (b); and

(ii) is separated from the non-derivative host contract.[85]

How would the separate presentation requirements apply?

6.21 The Board considered applying the following approaches to the presentation requirements to the types of financial instruments described in paragraph 6.20:

(a) disaggregation approach; and

(b) criteria-based approach.

6.22 As far as derivatives on own equity are concerned, the Board observed that the choice of approach would only matter for partly independent derivatives because for derivative financial assets or liabilities that have a net amount that is unaffected by any independent variable (ie standalone or embedded derivatives described in paragraph 6.20(a)), applying either approach in paragraph 6.21 would result in the same presentation.

6.23 Applying the disaggregation approach, an entity would disaggregate, for presentation purposes, income and expenses arising from all partly independent derivatives (ie standalone or embedded derivatives described in paragraph 6.20(b)) into:

(a) the portion of income and expenses that result from the effect of dependent variables, which would be subject to separate presentation; and

(b) the portion of income and expenses that result from the effect of independent variables, which would not be subject to separate presentation. In other words, this portion of the income and expenses

85 The host contract may be a non-financial liability.

would be presented together with income and expenses arising from other derivatives which are affected by independent variables.

6.24 Applying the criteria-based approach, an entity would apply the presentation requirements to the total income and expenses arising from a partly independent derivative, if the derivative meets particular criteria. Unlike the disaggregation approach, the separate presentation requirements would only apply to some partly independent derivatives that meet particular criteria (ie the total income and expenses in respect of those derivatives, including the effect of independent variables).

Relative benefits of the criteria-based approach and the consequences of its application

6.25 In the Board's preliminary view, the criteria-based approach better achieves the objective of the presentation requirements. The criteria-based approach has the following advantages over the disaggregation approach:

(a) applying the criteria-based approach, income and expenses arising from a derivative financial asset or liability are presented in their entirety; therefore, they reflect the effects on the fair value of the derivative of all variables in the instrument, including interdependencies between the variables.

(b) applying the criteria-based approach would be less complex and less costly than the disaggregation approach, both for preparers to implement and users of financial statements to understand. The Board observed that there is no consistent way to disaggregate the income and expenses in a manner that is comparable. The Board considered different ways of disaggregating changes in the fair value of derivatives by keeping constant the independent variables, but concluded that it is often difficult to isolate the effect of a change in particular variables due to their interdependency.

(c) the criteria-based approach could be applied in a consistent manner for the purposes of separate presentation in the statement of financial position (see paragraph 6.9) and statement of financial performance. In contrast, the disaggregation approach would require additional consideration as to how the disaggregation would be applied in the statement of financial position. Applying the disaggregation approach in a consistent manner in the statement of financial position and statement of financial performance would require a disaggregation of the carrying amount of partly independent derivatives. Such a requirement would present additional challenges for derivatives with non-zero fair value at initial recognition such as options.

(d) the criteria-based approach is more consistent with the proposed approach to classifying derivatives on own equity under the Board's preferred approach and the requirements in IFRS 9, in that a derivative is classified and accounted for in its entirety.

6.26 However, applying the criteria-based approach to partly independent derivatives, the income and expenses presented separately would include the effect of some independent variables—to the extent permitted by the criteria selected—reducing the usefulness of the presentation requirements. This is a disadvantage of applying the criteria-based approach, but the Board thinks that this could be mitigated by the criteria selected (see paragraphs 6.28–6.34).

6.27 The Board also noted that applying the criteria-based approach requires additional consideration of how the approach would apply to hybrid instruments with embedded derivatives, whereas the disaggregation approach could be applied to standalone derivatives and hybrid instruments in the same way without the need for further requirements. The Board's discussion on this issue is set out in paragraphs 6.37–6.41.

Developing the criteria-based approach

6.28 In developing the criteria, the Board sought to strike an appropriate balance, bearing in mind the following:

(a) if the criteria are too complicated it would be costly for preparers to apply them and difficult for users of financial statements to understand the resulting information.

(b) if the criteria are too broad, the income and expenses separately presented would include the effects of too many independent variables, which would reduce the usefulness of the separate presentation of income and expenses. Also, broad criteria could lead to opportunities to structure contracts to achieve an accounting result and could also lead to diversity in practice. For example, an entity could avoid presenting in profit or loss the income and expenses arising from a financial instrument by simply including a minor reference to a variable that depends on the entity's available economic resources (for example, share price). The criteria therefore need to be effective at mitigating these risks. The need for stringent criteria is similar to the basis for the accounting requirements for embedded derivatives in IFRS 9, which aim to prevent entities from circumventing the requirements for derivatives by embedding a derivative in a non-derivative host contract using the 'closely-related' concept.

6.29 The Board considered the existing requirements for assessing whether an embedded derivative is closely related to the host in a hybrid instrument. In particular, it examined some of the examples of closely related economic characteristics set out in paragraph B4.3.8 of IFRS 9 and considered whether those examples could be used as the criteria for identifying whether and if so, what type of partly independent derivatives should be subject to the presentation requirements.

6.30 The Board initially identified an interest rate and a foreign currency variable as potential candidates[86] but concluded that the only variable that might be

86 The Board considered other examples of closely related economic characteristics and risks in paragraph B4.3.8 of IFRS 9 but concluded that they are not relevant to derivatives on own equity. Those examples relate to very specific types of contracts and cannot be applied to derivatives on own equity in a meaningful way. These other examples include prepayment features in a principal-only or interest-only strip, unit-linking features and other lease or insurance contract related examples.

relevant in considering the criteria for the presentation requirements is a foreign currency variable. That is because, applying the Board's preferred approach, a derivative on own equity would not typically be classified as a financial asset or a financial liability as a consequence of the presence of an interest rate variable as discussed in paragraphs 4.53–4.54.

6.31 In relation to embedded foreign currency derivatives, paragraph B4.3.8(d) of IFRS 9 does not require separation of embedded foreign currency derivatives in the following circumstances:

> ... an embedded foreign currency derivative... is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
>
> (i) the functional currency of any substantial party to that contract;
>
> (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
>
> (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

6.32 Some derivatives on own equity may have a foreign currency variable for similar reasons to those described in paragraph B4.3.8(d) of IFRS 9. For example, some entities enter into derivatives on own equity with a strike price denominated in a foreign currency for reasons such as:

(a) the entity's shares are listed on a foreign stock exchange; and

(b) there is no market for convertible bonds denominated in the entity's functional currency, or the costs of issuing convertible bonds in the entity's functional currency are prohibitive.

6.33 The Board noted that in limited circumstances, IFRS 9 does not require separation of embedded foreign currency derivatives (see paragraph 6.31). The Board, therefore, considered whether it would be appropriate to separately present income and expenses arising from some particular derivatives if the independent variable is a foreign currency variable that arises for similar reasons. The Board acknowledged that requiring separate presentation for only some types of foreign currency derivatives would result in two foreign currency exposures with the same economic effect being presented differently by different entities. This risk was incorporated into the Board's considerations in setting the criteria for separate presentation.

6.34 In the Board's preliminary view, in addition to separately presenting income and expenses arising from financial instruments described in paragraphs 6.11(a)–6.11(b), an entity should include all income and expenses arising from a partly independent derivative in the amounts presented separately, if all of the following criteria are met:

(a) 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.

(b) the foreign currency exposure is not leveraged.

(c) the foreign currency exposure does not contain an option feature.

(d) 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.

6.35 If a derivative that is partly independent does not meet the criteria in paragraph 6.43, an entity would present all income and expenses from that derivative in profit or loss without separate presentation.

6.36 In addition, for presentation in the statement of financial position, an entity would present separately the carrying amount of the partly independent derivatives that meet the criteria. Specifically, the total carrying amount of all such derivatives would be presented as a separate line item on the face of the statement of financial position.

Application of the criteria-based approach to hybrid instruments

6.37 As noted in paragraph 6.27, the Board considered the application of the criteria-based approach to hybrid instruments. A hybrid instrument may contain an embedded derivative with a net amount that is unaffected by any independent variables. For example, a bond may include an 'equity kicker' that, at maturity, obliges the entity to pay cash equal to the difference between the value of a fixed number of the entity's ordinary shares and the contractual amount of the bond.[87] Other hybrid instruments may contain embedded derivatives that are partly independent of the entity's economic resources.

6.38 If an embedded derivative in a hybrid contract is separated from the host (ie embedded derivatives described in paragraph 6.20(d)), the separate presentation requirements using the criteria-based approach discussed in paragraphs 6.21–6.36 would apply. However, some embedded derivatives may not have been separated from the host because the hybrid instrument as a whole is measured at fair value through profit or loss (ie hybrid instruments described in paragraph 6.20(c)).[88] For such instruments, the Board considered the following two alternatives:

(a) Alternative A—apply these separate presentation requirements only to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, do not contain any obligation for an amount independent of the entity's available economic resources, for example, shares redeemable at fair value.

87 A derivative with these features, even if it had existed on its own, would be not be classified as an equity instrument because the entity is required to transfer cash at maturity of the instrument, ie at a specified time other than at liquidation.

88 Derivatives embedded in a hybrid contract described in paragraph 6.20(c) would not be closely related to the host contract for the reason discussed in paragraph 6.19.

(b) Alternative B—apply these separate presentation requirements to all embedded derivatives regardless of whether they are separated from the host. Under this alternative, the entity would be required to separate all embedded derivatives for purposes of applying the presentation requirements even though the entity measures the hybrid contract as a whole at fair value through profit or loss.

6.39 The choice between the two alternatives does not affect how the separate presentation requirements would apply to embedded derivatives that are separated from the host. Under either alternative, they would be subject to the separate presentation requirements discussed in paragraphs 6.21–6.36.

6.40 The Board observed that making a decision between the two alternatives would need to consider striking a balance between:

(a) maximising the benefits of improved comparability by applying the criteria in paragraph 6.34 to both standalone and embedded derivatives—whether separated or not from the host contract—in the same way; and

(b) minimising the costs and complexity of the requirements. One of the reasons for allowing an entity to designate a hybrid instrument as a whole at fair value through profit or loss is to reduce the costs and complexity of separating embedded derivatives from the host.

6.41 The Board did not reach a preliminary view on the application of the criteria-based approach to hybrid instruments, and decided to seek feedback using this Discussion Paper.

Whether the separate presentation requirements should apply within profit or loss, or using OCI

6.42 The Board considered whether income and expenses that meet the criteria for the separate presentation requirements should be presented as a separate line item in profit or loss, or as a separate line item in OCI. If presented in OCI, the question also arises whether those amounts should be subsequently reclassified to profit or loss. In the Board's preliminary view:

(a) an entity should separately present in OCI income and expenses arising from financial liabilities and derivative financial assets and liabilities described in paragraphs 6.11(a)–6.11(b) as well as from partly independent derivatives that meet the criteria in paragraph 6.34; and

(b) an entity should not reclassify these amounts presented in OCI to profit or loss.

6.43 The Board's preliminary view is that using OCI would be a more effective way of applying the separate presentation requirements to income and expenses. The relative advantages of applying these presentation requirements using OCI over separate presentation within profit or loss include:

(a) separate presentation using OCI would provide a clearer distinction between income and expenses that result from changes in the entity's available economic resources, and income and expenses presented in profit or loss;

(b) separate presentation using OCI would enhance the relevance of profit or loss[89] for the purpose of assessing whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige the entity to achieve; and

(c) separate presentation using OCI would alleviate the concern over the accounting mismatch described in paragraph 6.14.

6.44 The relative disadvantages of applying these presentation requirements using OCI include:

(a) doing so would expand the use of OCI to a new type of income or expenses, which adds additional complexity to OCI. The default requirement for presenting income and expenses—in the *Conceptual Framework*—is to present them in profit or loss.

(b) profit or loss will not include some recognised changes in the value of financial assets or financial liabilities. These gains or losses are economic gains or losses on claims against the entity.

(c) entities might have stronger incentives to try to structure financial instruments that would be presented in OCI to avoid presenting income and expenses in profit or loss.

6.45 The fact that changes in the value of financial instruments that do not contain an obligation for an amount independent of the entity's available economic resources might be volatile had no bearing on the Board's preliminary view that separate presentation should be in OCI.

6.46 The Board considered whether the amounts presented in OCI should be subsequently reclassified (recycled) to profit or loss. In the Board's preliminary view, an entity should not reclassify these amounts separately presented in OCI to profit or loss, because the nature of these income and expenses will not be different in the future and will therefore not be relevant to assessments of performance at a future date. In reaching this preliminary view, the Board acknowledged the points set out in paragraphs 6.47–6.48.

6.47 One of the consequences of separate presentation using OCI without subsequent recycling into profit and loss is that changes in the value of some financial liabilities will never be included in profit or loss. For example, consider a share redeemable for its fair value. As share price increases over time, the value of the financial liability will increase, and so will the amount of cash the entity has to pay on redemption. The information about the increase in the amount of the future cash outflow will not be presented in profit or loss, even when the payment is made.

6.48 The Board compared the income and expenses arising from financial instruments that do not contain an obligation for an amount independent of the

89 Paragraph 7.17 of the *Conceptual Framework* states that '[...] all income and expenses are, in principle, included in [the statement of profit or loss]. However, in developing Standards, the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period.'

entity's available economic resources with gains and losses arising from changes in own credit risk of financial liabilities designated as measured at fair value through profit or loss. Such income and expenses:

(a) are similar in the sense that both are affected by changes in the available economic resources of the entity. Therefore, presenting such gains and losses similarly in OCI, without recycling, would help users of financial statements in making the assessments of balance sheet solvency and returns.

(b) are however different in the following way—if the entity repays the contractual amount, the cumulative effect over the life of the financial instrument of any changes in the liability's credit risk will net to zero because its fair value will ultimately equal the contractual amount.[90] This is one reason why IFRS 9 requires presentation of such gains or losses in OCI without recycling. In contrast, changes in the fair value of financial instruments that do not contain an obligation for an amount independent of the entity's available economic resources will not be reversed over the instrument's life.

Assessments of funding liquidity and cash flows

6.49 The Board considered whether separate presentation of financial liabilities and derivative financial assets and liabilities using additional line items or subclassifications would be helpful in providing further disaggregated information about the timing feature—the required transfer of economic resources at different specified times other than at liquidation. As discussed in paragraph 2.23, information about these secondary distinctions would help users of financial statements make more detailed assessments of funding liquidity and cash flows. For example, additional subclassifications within liabilities might be useful to show:

(a) financial liabilities that are specified as payable on demand (eg demand deposits, shares redeemable at fair value at any time);

(b) financial liabilities payable at specified times other than liquidation (eg ordinary bonds, trade payables); and

(c) financial liabilities that require a transfer of economic resources only at liquidation (eg irredeemable cumulative preference shares).

6.50 IAS 32 sets out requirements for classifying financial instruments as liabilities or equity while IAS 1 and IFRS 7 *Financial Instruments: Disclosure* sets out presentation and disclosure requirements for financial liabilities and other financial instruments. Some IAS 1 requirements provide information relevant to assessments of funding liquidity and cash flows. IAS 1 requires entities to present current and non-current liabilities separately, or to present the liabilities in the order of liquidity thus:[91]

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90 See paragraph BC5.53 of Basis for Conclusions on IFRS 9.
91 See paragraph 60 of IAS 1.

(a) applying the current or non-current presentation[92] requirements, for example:

 (i) shares redeemable at fair value on demand would be classified as current liabilities; and

 (ii) irredeemable cumulative preference shares would be classified as non-current liabilities.

(b) applying an order of liquidity presentation, different classes of liabilities are presented, ranked based on maturity. Under this presentation, for example, shares redeemable at fair value on demand would be presented before irredeemable cumulative preference shares.

6.51 The Board considered but rejected requiring separate presentation of financial liabilities that have a contractual obligation to transfer cash or another financial asset only at liquidation from other non-current liabilities. Distinctions between longer maturities are less relevant for assessments of funding liquidity and cash flows than are distinctions between shorter maturities. In addition, IFRS 7 already requires a maturity schedule for financial liabilities in the notes to the financial statements.

6.52 Therefore, in the Board's preliminary view, the requirements in existing IFRS Standards are sufficient for providing the information necessary for making assessments of funding liquidity and cash flows when considered together with the information that would be provided through classification of financial instruments applying the Board's preferred approach.

Summary of preliminary views and questions for respondents

6.53 In the Board's preliminary view, to facilitate assessments of balance-sheet solvency and returns, an entity, applying the criteria-based approach, should:

(a) in the statement of financial position, present separately carrying amounts of:

 (i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

 (ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

 (iii) partly independent derivatives that meet the criteria in paragraph 6.34.

(b) in the statement of financial performance, present in OCI, without subsequent reclassification, income and expenses arising from:

 (i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

92 See paragraph 69 of IAS 1.

(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

6.54 In the Board's preliminary view, no presentation requirements need to be developed to provide information about the timing feature because presentation and disclosure requirements in other IFRS Standards provide sufficient information to facilitate assessments of funding liquidity and cash flows.

Question 7
Do you agree with the Board's preliminary views stated in paragraphs 6.53–6.54? Why, or why not? The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

Separate presentation of equity instruments

6.55 Currently, IFRS Standards require more useful information to be presented and disclosed by the issuing entity for financial instruments classified as financial liabilities than for those classified as equity instruments. One objective of the FICE project is to consider how to improve the information provided about equity instruments by issuing entities.

6.56 Applying the Board's preferred approach, financial instruments classified as equity instruments would contain neither an obligation for the entity to transfer economic resources, nor an obligation for an amount independent of the entity's available economic resources. However, different equity instruments may have differences between their rights and obligations. These differences may result in the allocation of different amounts of the residual return to different classes of equity instruments based on features that are not reflected by their classification as equity. These different features could include differences in:

(a) the priority of the claim on liquidation (eg non-cumulative preference shares and ordinary shares);

(b) pay-offs (eg warrants with different exercise prices) and contingencies (eg options and forwards); and

(c) restrictions on dividends, buy-backs or other distributions.

6.57 Information about the different features of equity instruments would be useful for users of financial statements in assessing the distribution of returns among those equity instruments. Existing IFRS Standards do not specifically require entities to provide information about different equity instruments, even if some equity instrument features are similar to those of financial liabilities.

6.58 The Board considered requiring entities to provide information about equity instruments using one or more of the following methods:

(a) enhancing the presentation requirements for different classes of equity through the statement of changes in equity and providing information about the distribution of returns by expanding the attribution of total comprehensive income to equity instruments other than ordinary shares (see paragraphs 6.60–6.86); and/or

(b) improving disclosure requirements about equity instruments, in particular, providing better information about the potential dilution of ordinary shares from financial liabilities and equity instruments (see Section 7) and better information about the fair value of derivative equity instruments (see paragraphs 6.87–6.90).

6.59 Requiring entities to provide more information through presentation and disclosure would respond to the requests from users of financial statements for information about classes of equity other than ordinary shares. Doing so should also reduce the differences in information that financial statements provide about financial liabilities and equity instruments, thus mitigating one of the consequences of classification (see paragraph 2.13).

Statement of changes in equity and attribution of total comprehensive income

6.60 Requirements in IAS 1 include principles for the presentation of equity on the face of the statement of financial position and the statement of financial performance as well as in the statement of changes in equity, including:

(a) profit or loss and OCI are allocated between amounts attributable to non-controlling interests and owners of the parent (holders of equity instruments of the parent);[93]

(b) total equity in the statement of financial position and statement of changes in equity is disaggregated into classes, at a minimum between non-controlling interests and parent equity interests;[94] and

(c) the statement of changes in equity includes information about changes resulting from:[95]

(i) the amounts of total comprehensive income attributable to non-controlling interests and parent equity interests; and

(ii) transactions with owners in their capacity as owners, such as contributions and distributions.

6.61 In addition to the requirements of IAS 1, basic earnings per share and diluted earnings per share, calculated applying the requirements in IAS 33, provide

93 See paragraph 81B of IAS 1.
94 See paragraph 54(q)–54(r) of IAS 1.
95 See paragraph 106 of IAS 1.

some information about the effects of equity instruments other than ordinary shares on the returns on ordinary shares. However, that information is limited because:

(a) both basic and diluted earnings per share calculations include the effect of some, but not all, equity instruments other than ordinary shares, for example, these calculations do not include the effect of antidilutive equity instruments;

(b) the workings of the calculation of earnings per share are not presented on the face of the statement of financial performance and the carrying amounts of equity instruments are not updated; and

(c) only a few disclosure requirements provide information about attributing total comprehensive income between different types of equity instruments.

6.62 In the Board's preliminary view, the information required by IAS 1 should be improved to require total equity and changes in equity to be disaggregated between ordinary shares and equity instruments other than ordinary shares. In particular, expanding the attribution of total comprehensive income to other equity instruments would improve the information provided about the effects that different features of equity instruments have on the distribution of returns between equity instruments. The residual total comprehensive income would be allocated to ordinary shares after the attribution to all other equity instruments. For these purposes, an ordinary share is the class of equity that:[96]

(a) is the most subordinate claim; and

(b) requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred at liquidation is equal to a pro rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.[97]

6.63 The advantage of expanding attribution to other equity instruments is that such attribution would present, in a single place, the effect on ordinary shares of having other classes of equity instruments outstanding. As a result, the attribution of returns to all equity instruments would provide a complete picture of how equity instruments affect each other's returns. The attribution of returns would also result in the carrying amounts for each class of equity being updated for the amount of total comprehensive income attributed to it, and presenting such changes in carrying amounts in the statement of changes in equity, similar to non-controlling interests. Such a requirement, together with the improvements to the identification of different equity components as discussed in Section 5, would improve the information provided about equity instruments and the consistency, completeness and clarity of the requirements for equity instruments.

96 Ordinary shares may include two or more classes that present the same priority and rights at liquidation, but that could have different rights such as voting rights.

97 Similar characteristics were identified in the definition of a Basic Ownership Instrument in the predecessor FICE project.

6.64 In the Board's preliminary view, attribution of total comprehensive income to all equity instruments should be presented on the face of the statement of financial performance.

6.65 In considering how total comprehensive income should be attributed to various equity instruments, the Board considered the existing requirements of IAS 33 as a starting point.

6.66 This project is not reconsidering the requirements in IAS 33. Therefore, entities would continue to disclose basic and diluted earnings per share as currently required by IAS 33. Furthermore, the objectives of the proposed attribution requirements in this Discussion Paper are similar to, but not the same as, the objectives of IAS 33. Nevertheless:

(a) the distinction between liabilities and equity is related to the requirements in IAS 33—hence this project could lead to consequential amendments to IAS 33; and

(b) preparers will incur costs to provide the information required; however, using IAS 33 as the starting point would both reduce the cost of applying the attribution requirements and limit the implications for IAS 33.

Determining the amount to attribute to classes of equity

6.67 The Board considered the attribution of total comprehensive income to:

(a) non-derivative equity instruments other than ordinary shares (see paragraphs 6.68–6.69); and

(b) derivative equity instruments (see paragraphs 6.70–6.91).

Non-derivative equity instruments other than ordinary shares

6.68 In the Board's preliminary view, the attribution of total profit or loss and OCI to non-derivative equity instruments (for example, non-cumulative preference shares and participating equity instruments) should follow the existing calculation for basic earnings per share in IAS 33. Applying IAS 33, the numerator for basic earnings per share is calculated by adjusting profit or loss attributable to the parent entity for the after-tax amounts of preference dividends, the differences arising on the settlement of preference shares and other similar effects of preference shares classified as equity instruments. In addition, for the purposes of calculating basic and diluted earnings per share, IAS 33 has requirements for 'participating equity instruments' (paragraphs A13–A14 of IAS 33).

6.69 Thus, the attribution requirements for non-derivative equity instruments would be for an entity to present on the face of the statements of financial performance the calculation of basic earnings per share applying IAS 33. Doing so would align the attribution requirements with the calculation of basic earnings per share, which would reduce the costs of these attribution requirements.

Derivative equity instruments

6.70 Applying IAS 33, diluted earnings per share is calculated by adjusting basic earnings per share for the effects of all dilutive potential ordinary shares.[98] However, IAS 33 requires only limited information about various equity instruments of the entity because there is no specific requirement to disclose the effect of options or warrants that are antidilutive. Some written options that are out-of-the-money and all purchased options are antidilutive under IAS 33.

6.71 As mentioned in paragraphs 6.62–6.63, the objective of the attribution requirements is to provide information about the distribution of returns among all equity instruments. Therefore, attributing total comprehensive income to all equity instruments would provide useful information regardless of whether those equity instruments are currently dilutive or antidilutive.

6.72 The Board discussed the following three approaches for calculating the attribution of total comprehensive income to derivative equity instruments:

(a) a full fair value approach—total profit or loss and OCI would be attributed to derivative equity instruments based on changes in their fair value, with the residual being attributed to ordinary shares (see paragraphs 6.74–6.78).

(b) an average-of-period approach—total profit or loss and OCI would be attributed to derivative equity instruments using relative average fair values through the period (see paragraphs 6.79–6.82).

(c) an end-of-period approach—total profit or loss and OCI would be attributed to derivative equity instruments indirectly. This would be 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. The attribution amount would then be based on the changes in the carrying amounts attributed from one period to another (see paragraphs 6.83–6.86).

6.73 The Board acknowledges that any approach to attribution would entail additional costs to prepare the information. In particular, all three approaches would require the entity to measure the fair value of equity derivatives, which could be difficult if those fair values are not observable. Therefore, the Board also considered whether a better balance between the benefits and costs would be achieved if preparers were required to provide information about such equity instruments only through disclosure and the requirements of IAS 33 (see paragraphs 6.87–6.90).

Full fair value approach

6.74 Applying this approach, each derivative equity instrument would be measured at fair value at the end of each reporting period and total comprehensive income attributed to the derivative would equal the change in fair value of that

98 IAS 33 defines *potential ordinary shares* as a financial instrument or other contract that may entitle its holder to ordinary shares. Potential ordinary shares are dilutive when their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

instrument in the period. Ordinary shares would receive the residual amount of total comprehensive income after attributing portions to each derivative equity instrument.

6.75 The advantages of attribution based on full fair value would be that:

(a) it would provide similar information as is provided for derivatives classified as liabilities. Thus, the information would be similar to that provided by applying a classification approach in which all derivatives are classified as financial assets or financial liabilities, such as approaches that classify only ordinary shares as equity instruments.

(b) the fair value of an option contract would reflect the probability that the ordinary shares will be issued. In contrast, applying IAS 33, the calculation of diluted earnings per share reflects only the intrinsic value of the option (ie it effectively assumes that the option will be exercised immediately).

(c) the fair value measurement would be an understandable measurement basis for the carrying amount of the derivative equity instruments.

6.76 Users of financial statements could also use information about the fair value of derivative equity instruments for estimating the value of an entity's ordinary shares. For example, this information could be used by equity investors and analysts to estimate the value of an entity's ordinary shares by first estimating the value of total equity and then deducting from that total the fair value of derivative equity instruments.

6.77 The disadvantages of attribution based on fair value are that:

(a) the change in a derivative equity instrument's fair value is unlikely to have significant predictive value for returns on the instrument unless the entity also discloses the inputs to that valuation (for example, the strike price);

(b) total changes in the fair value of derivative equity instruments may exceed total comprehensive income, which would result in a negative amount being attributed to ordinary shares, even when the economic returns on both derivative equity instruments and ordinary shares are positive (also see similar challenges in 6.12(b)); and

(c) it could distort an entity's price-to-earnings ratio and price-to-book ratio for ordinary shares (see illustrative example after paragraph 6.91).

6.78 Unlike the full fair value approach, the average-of-period approach (see paragraphs 6.79–6.82) and the end-of-period approach (see paragraphs 6.83–6.86) are both based on relative fair values. Thus, they would mitigate the consequences of incomplete recognition and mixed measurement because they would be based on the recognised net assets of the entity or on changes in the recognised net assets, alleviating the concerns about a fair value-based attribution approach (see paragraph 6.77(b)).

Average-of-period approach

6.79 Applying the average-of-period approach, the entity would calculate the amount of total comprehensive income attributed to a derivative equity instrument as follows:

(a) calculate the ratio for the derivative equity instrument as its average fair value for the period compared with the average fair value of all derivative equity instruments and ordinary shares for the period; and

(b) apply the ratio in (a) to the total comprehensive income of the period.

6.80 The rationale behind the average-of-period approach is to use the average-of-period fair value ratio to apportion the entity's total comprehensive income for the period. The objective would be to achieve an attribution amount that could be used by users of financial statements in a similar way as diluted earnings per share calculated by applying IAS 33. Similar to earnings per share calculations, the amount attributed to derivative equity instruments and ordinary shares applying this approach would be proportionate to their fair values; therefore, it would not be possible to attribute a negative amount in the case of a positive total comprehensive income (and vice versa).

6.81 The average-of-period approach might better depict the returns in the period on ordinary shares and derivative equity instruments than other approaches to attribution, because this approach would treat the derivative equity instruments as common share equivalents based on their relative average fair value during the period (see comments in the illustrative example after paragraph 6.91). Such an approach is similar to calculating the additional dilutive shares required for calculating diluted earnings per share applying IAS 33. However, the average-of-period approach uses the fair value of the derivative equity instruments instead of their strike price, and is not limited to instruments that are dilutive at the reporting date.

6.82 The amount attributed to ordinary shares after applying the average-of-period approach could be used as an input to frequently used earnings ratios, similar to diluted earnings per share, and as an input for the purposes of calculating earnings multiples, for example, the price-to-earnings multiple of ordinary shares. In the illustrative example after paragraph 6.91, the price-to-earnings ratio for ordinary shares calculated using the average-of-period approach arguably accurately reflects the ratio of the price of the ordinary shares to the total comprehensive income that is attributable to ordinary shares because this approach would take into account both the dilutive and anti-dilutive effects, unlike diluted earnings per share. However, the average-of-period approach might not provide useful information about the end-of-period carrying amounts.

End-of-period approach

6.83 Applying the end-of-period approach, the entity would calculate the amount of total comprehensive income attributed to a derivative equity instrument as follows:

(a) calculate the ratio for each derivative equity instrument as its fair value at the end of the period compared to the fair value of all derivative equity instruments and ordinary shares at the end of the period;

(b) apply the ratio in (a) to the total carrying amount of equity attributed to all derivative equity instruments and ordinary shares (ie excluding other non-derivatives) to calculate the carrying amount to be allocated to the derivative; and

(c) calculate the amount of attribution required to update the carrying value of the derivative equity instrument to equal the amount in (b).

6.84 The rationale of the end-of-period approach is to reallocate the end-of-period carrying amount of equity among the various derivative equity instruments and ordinary shares so as to reflect the end-of-period fair value ratio. Thus, the end-of-period approach might better depict the relative carrying amounts of the total of the different components of equity at the end of the period than would the other approaches.

6.85 Users of financial statements could use such information for calculating book ratios of ordinary shares, for example, the price-to-book ratio of ordinary shares. In the illustrative example set out in paragraph 6.91, the price-to-book ratio for ordinary shares that is calculated using this approach represents the ratio of the price of the ordinary shares to the carrying value attributed to ordinary shares on a relative fair value basis.

6.86 However, the end-of-period approach may not accurately depict the distribution of returns during the period because the changes in the carrying amounts of derivative equity instruments would include catch-up and other adjustments. These would arise because equity instruments other than ordinary shares would be issued at fair value whereas the carrying amount of equity prior to the issuance would typically be different to the fair value of the equity instruments. This results in a catch-up adjustment to the issued equity instruments in the period they are issued (see further comments in the illustrative example after paragraph 6.91).

Disclosure only

6.87 Given the costs and complexity of any approach to attribute total comprehensive income to equity derivatives, the Board considered whether sufficient information about the effect of derivative equity instruments on ordinary shares could be provided by diluted earnings per share and other disclosures. This Discussion Paper discusses disclosures about potential dilution in paragraphs 7.13–7.25 of Section 7. Those disclosures would apply to all potentially dilutive financial instruments and could provide some of the information requested by users of financial statements.

6.88 In addition, to respond to users' requests for more information about equity instruments, the disclosure requirements related to the fair value of financial liabilities in IFRS 7 could be extended to equity instruments other than ordinary shares. This information could help users of financial statements understand the distribution of returns among different equity claims. It would also result in similar information being provided about derivatives on own equity regardless of whether they are classified as financial assets, financial liabilities or equity instruments.

6.89 Any new disclosures would impose costs because preparers would need to collect and prepare the fair value information. However, the Board observed that:

(a) IFRS 7 currently requires disclosures about the fair value of financial liabilities that have similar risks to derivative equity instruments (such as cash-settled derivatives on own equity). Therefore, determining the fair value of equity derivatives should not be more difficult or costly than financial liabilities with similar risks.

(b) the disclosure would be similar to the disclosures required by IFRS 2 for equity settled share-based payments and other disclosures about fair value required by IFRS 13.

6.90 However, some of the disadvantages of a disclosure-based approach are that:

(a) disclosure would provide information on the fair value of derivatives classified as equity instruments, but would not show the full effect of such derivatives on the distribution of returns among equity instruments.

(b) disclosures would not be as responsive as the other approaches discussed in paragraphs 6.74–6.86 to requests from users of financial statements for better information about the effect of other classes of equity on ordinary shares. Disclosure about dilutive earnings per share and fair value would not provide information as complete as attribution. As noted in paragraph 2.43 the Board thinks that one reason some users of financial statements favour a narrow equity approach is because applying the approach would provide the same information for all claims other than ordinary shares. In particular, users of financial statements are interested in an analysis of claims down to ordinary shares on the face of the financial statements. A disclosure-only approach is unlikely to provide the information requested by such users.

Illustrative example of attribution approaches for derivatives

6.91 The following example illustrates the different attribution approaches discussed in paragraphs 6.74–6.86:

At 1 January 20X0 an entity has recognised net assets of CU149,266. The entity's equity consists of:

– 100,000 ordinary shares that were issued for total proceeds of CU100,000 and retained earnings of CU18,667
– 100,000 warrants that were issued for proceeds of CU30,599 on 1 January 20X0 that are classified as equity.

The warrants have the following terms:

– exercise date 31 December 20X1 (cannot be exercised earlier)
– exercisable by the warrant holder
– strike price of CU1.70 per share
– 100,000 shares to be delivered if exercised

During the year ending 31 December 20X0, the entity recognised total comprehensive income of CU16,419.

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Other relevant information:	
Market price of shares on 1 January 20X0	CU1.78 per share
Market price of shares on 31 December 20X0	CU1.95 per share
Fair value of warrants on 1 January 20X0	CU30,599
Fair value of warrants on 31 December 20X0	CU34,719

In CU	Fair value approach	Average-of-period approach	End-of-period approach
Total comprehensive income for year ended 31 December 20X0	**16,419**	**16,419**	**16,419**
Attributed to:			
Warrants [(a)]	4,120	2,447	(5,558)
Ordinary shares [(b)]	12,299	13,972	21,977
Carrying amount of equity attributable to ordinary shares at 1 January 20X0	118,667	118,667	118,667
Carrying amount of equity attributable to ordinary shares at 31 December 20X0	130,966	132,639	140,644
Price-to-book ratio	149% (CU1.95 per share × 100,000 shares / CU130,966)	147% (CU1.95 per share × 100,000 shares / CU132,639)	139% (CU1.95 per share × 100,000 shares / CU140,644)
Amount attributed to ordinary shares/total number of shares	0.123 per share (12,299 / 100,000)	0.140 per share (13,972 / 100,000)	0.220 per share (21,977 / 100,000)
Price-to-earnings ratio	15.9	13.9	8.9
Diluted earnings per share applying IAS 33 [(c)]	0.151 per share (16,419 / 108,847)		
Price-to-earnings ratio (diluted earnings per share)	12.9		

[(a)] Calculated as the difference between total profit for the period and the amount attributed to the warrants.

[(b)] The amounts attributed have been calculated as follows under each approach:

Fair value approach
Warrants: based on the change in the fair value of the warrant (CU34,719 – CU30,599 = CU4,120)

Average-of-period approach	
Average fair value of warrants and ordinary shares for the period (for convenience, based on simple average)	
Ordinary shares (100,000 × (1.78 + 1.95) / 2)	CU186,500
Warrants ((30,599 + 34,719) / 2)	CU32,659
Total fair value	CU219,159
Relative average fair value of warrants = 32,659 / 219,159	
Total profit	CU16,419
Total profit attributable to warrants based on relative average fair value (CU16,419 × 32,659 / 219,159)	CU2,447
Commentary The CU2,447 amount attributed to the warrants is the same amount that would have been attributed to 17,512 (32,659 / 1.865) additional ordinary shares, if they, instead of the warrants, had been outstanding. The 17,512 additional shares would be the number of shares issued in exchange for the average fair value of the warrants during the period. The updated carrying amount of the warrants after the attribution under the average-of-period approach would be CU33,046 (CU30,599 + CU2,447). This amount would have no meaning on its own, or in relation to the carrying amount of ordinary shares.	

End-of-period approach	
Fair value of warrants and ordinary shares at the end of the period	
Ordinary shares (100,000 × CU1.95)	CU195,000
Warrants	CU34,719
Total fair value	CU229,719
Relative fair value of warrants = 34,719 / 229,719	
Net assets attributable at end of period (118,667 + 30,599 + 16,419)	CU165,685
Net assets attributable to warrants based on relative fair value (CU165,685 × 34,719 / 229,719)	CU25,041
Beginning carrying amount of warrants	CU30,599
Total profit attributed to warrants	(CU5,558)

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End-of-period approach
Commentary The amount attributed to the derivative equity instrument is (CU5,558), which is the amount required to adjust the carrying amount from CU30,599 to CU25,041. The beginning carrying amount of the warrant, the CU30,599, is the fair value of the warrant on issue, not the relative fair value. So, the (CU5,558) update to the carrying amount includes an amount that results from readjusting the carrying amount to get to a relative fair value, in addition to any other changes in the period.

(c) Diluted earnings per share applying IAS 33 are calculated as follows:

Diluted earnings per share applying IAS 33	
Weighted-average shares	100,000
Add: dilutive potential ordinary shares from assumed conversions of warrants	8,847
Adjusted weighted-average shares	108,847
Dilutive potential ordinary shares from exercising warrants = 100,000 – 91,153 = 8,847 CU1.70 (exercise price) × 100,000 shares = CU170,000 CU170,000 / CU1.865 (average share price) = 91,153 shares	

Summary of preliminary views and questions for respondents

6.92 The Board thinks that attributing profit or loss and OCI to all equity instruments other than ordinary shares could provide useful information to users of financial statements. In the case of non-derivative equity instruments other than ordinary shares, the attribution should follow the existing calculation for basic earnings per share in IAS 33 but present these amounts on the face of the statement of financial performance. However, in the case of derivative equity instruments, the Board does not have a preliminary view about which of the three approaches would best balance the costs and benefits of improving information provided to users of financial statements.

6.93 If the attribution calculation were consistent with the calculation of earnings per share in IAS 33, the incremental costs of preparing such information about the distribution of returns would be minimal. However, users of financial statements have requested better information about derivative equity instruments than that provided by the current requirements of IAS 33, which would entail additional costs.

6.94 In the Board's preliminary view:

(a) a full fair value approach would provide information about derivative equity instruments that is equivalent to the information provided by a narrow equity approach to classification. It would provide understandable information about the derivative equity instruments.

However, one disadvantage of this approach would be that it would amplify the consequences of incomplete recognition and mixed measurement on the amount ultimately attributed to ordinary shares (see paragraphs 6.77(b)).

(b) possible approaches to calculating attribution based on relative fair values alleviate some of the disadvantages of the full fair value approach. However, these approaches would also be costlier, because the fair value of ordinary shares would be needed as an input, and the average-of-period approach would be costlier than the end-of-period approach because of the requirements for additional data to calculate the average.

(c) performing a calculation based on relative fair values would result in carrying values and amounts attributed that would not represent a specific measurement attribute of individual equity instruments in isolation.

(d) a relative fair value approach, depending on the approach used for the calculation, however, would provide users of financial statements with better information to calculate price-to-book ratios and calculate earnings multiples, such as price-to-earnings.

6.95 Given the costs and complexity of any approach to attribution for equity derivatives, the Board considered whether it should instead continue to focus on providing information about the effect of derivative equity instruments through diluted earnings per share and improve other disclosures (see paragraphs 7.13–7.25). In the Board's view, improving disclosures would entail extending the fair value disclosure requirements in IFRS 7 to derivative equity instruments. Additional disadvantages of such an approach are that:

(a) the disclosure would not show the full effect of derivatives and non-derivatives classified as equity instruments on the income attributable to ordinary shares of derivatives and non-derivatives classified as equity; and

(b) the approach would not be a sufficient response to calls from users of financial statements for better information about the effect on ordinary shares of other classes of equity.

Question 8
The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not? The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not? The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including: (a) a full fair value approach (paragraphs 6.74–6.78); (b) the average-of-period approach (paragraphs 6.79–6.82); (c) the end-of-period approach (paragraphs 6.83–6.86); and (d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25. Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

Section 7—Disclosure

7.1 In response to various consultations, users of financial statements have consistently requested that preparers be required to provide more information about equity instruments and about the priority of financial liabilities and equity instruments on liquidation.

7.2 In developing preliminary views about how to improve disclosures about financial liabilities and equity instruments, the Board:

(a) reviewed the information requested by users of financial statements about liabilities and equity in their responses to other Board consultations;

(b) considered what information can be communicated through disclosure to meet user information needs and to support the classification and presentation requirements of the Board's preferred approach; and

(c) considered disclosure requirements in IFRS Standards to see whether they can be improved, or removed if they are not providing useful information; for example, the potential attribution requirements for equity instruments might reduce the need for some disclosures about dividends on preference shares, such as the disclosures required by paragraph 137 of IAS 1.

7.3 Based on the activities described in paragraph 7.2, the Board identified the following potential improvements to the disclosure requirements for financial liabilities and equity instruments:

(a) priority on liquidation (paragraphs 7.4–7.12);

(b) potential dilution of ordinary shares (paragraphs 7.13–7.25); and

(c) contractual terms and conditions (paragraphs 7.26–7.29).

Priority on liquidation

7.4 As discussed in Section 2 (paragraph 2.30), 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). IFRS Standards currently do not require any particular information about the priority of financial liabilities and equity instruments.

7.5 Users of financial statements have asked for more information about the priority of financial liabilities and equity instruments on liquidation of an entity. For example, many user respondents to earlier consultations have suggested a disclosure requirement similar to the 'capitalisation table' required by the Securities and Exchange Commission in Form S-1 for the initial listing of securities in the US market. Such a disclosure provides information about an entity's capital structure in a single place (a table, unless another format would be more appropriate), which alleviates the need for users of financial statements to compile this information from multiple sources.

7.6 As discussed in paragraphs 6.8–6.9, the Board's preliminary view is that it would be useful to provide financial liabilities and equity instruments in their order of priority. The Board thinks that an entity could elect to provide this information on the face of the statement of financial position, or in the notes to the financial statements.

7.7 An entity would be permitted to group financial instruments together if the contractual terms and conditions of the financial instruments indicate that the instruments have the same level of priority. The objective would be to provide information to users of financial statements about the relative ranking of financial liabilities and equity instruments. The objective would not be to depict the value of those financial liabilities and equity instruments in a hypothetical liquidation.

7.8 The information provided might include:

(a) a list of all financial liabilities and equity instruments in the order of their priority;

(b) for each group or category of financial liability and equity instrument, information about:

(i) terms and conditions that indicate the priority within the entity's capital structure (eg liquidation preference, the existence of guarantees, collateral, and other payment conditions that might establish a priority between contracts);

(ii) terms and conditions that could lead to changes in priority (eg conversion features and contingent features);

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

(iv) any other contractual features that could affect holders' rights to share in an entity's economic resources and returns; and

(c) if there is any change in the priority of any group of financial instruments, information about the reason(s) for the change (eg any changes in relevant terms and conditions or circumstances).

7.9 Providing the information in paragraph 7.8(a) in a table would result in a presentation that is similar to the capitalisation table discussed in paragraph 7.5, for example:

Order of priority	**As of 1 January 20XX in CU million**
Senior secured loan	X
Junior secured loan	X
Subordinated notes	X
Total liabilities	**XX**
Non-cumulative preference shares	X
Ordinary shares	X
Total equity	**XX**
Total capitalisation	**XXX**

7.10 In order to provide the information described in paragraph 7.8, entities would need to analyse the terms and conditions of their financial instruments to determine each instrument's priority relative to other financial instruments. The Board identified a number of challenges in determining the priority of financial instruments, for example:

(a) the priority of a particular financial instrument may be determined by a combination of its own terms and conditions and the terms and conditions of other financial instruments;

(b) the priority might be affected by the group structure of the entity, for example, when a claim is against a particular subsidiary;

(c) the priority of a financial instrument might be contingent on uncertain future events; and

(d) limiting this disclosure to financial instruments and not applying the same to non-financial liabilities beyond the scope of IAS 32 might reduce the usefulness of the disclosure.

7.11 Despite such challenges, the Board observed that, in the absence of information about the priority of financial liabilities and equity instruments, users of financial statements would need to perform their own assessments, which would require making assumptions based on limited information. Information about the priority of an entity's financial liabilities and equity instruments would be useful to users of financial statements, even if such information is prepared with some limitations. Those limitations could include simplifying assumptions or requiring the provision of this information only for a particular set of financial instruments (such as limiting it to financial liabilities and equity instruments of, or against, the parent entity).

7.12 The Board discussed but did not reach a preliminary view on whether the amounts included for financial liabilities should be the carrying amounts presented in the statement of financial position, the fair value amounts required by IFRS 7, or both. The Board noted that different measurement bases might be useful for different purposes.

Potential dilution of ordinary shares

7.13 Some information about dilution is currently provided in the disclosure of diluted earnings per share required by IAS 33. However, users of financial statements have indicated that such information is not useful for particular assessments because IAS 33 defines dilution narrowly. Specifically, users of financial statements say the definition of dilution in IAS 33 is incomplete because potential ordinary shares are considered dilutive only if the potential ordinary shares decrease earnings (or increase loss) per share from continuing operations.[99] The Board also observed that IAS 33 has other limitations; in particular, it only considers the effect of equity instruments that are in-the-money. Hence, users of financial statements are not able to determine how many potential ordinary shares might be issued if equity instruments that are out-of-the-money at the reporting date become in-the-money.

7.14 Furthermore, users of financial statements noted a lack of information around the calculation of the weighted average number of ordinary shares applying IAS 33. For example, the following information is not specifically required to be disclosed:

(a) the total number of ordinary shares potentially outstanding at the end of the period; and

(b) the number of ordinary shares that could be issued to settle instruments that could dilute basic earnings per share in the future, but were excluded from the calculation because they are antidilutive for the period(s) presented.

7.15 IAS 1 requires an entity to disclose, for each class of share capital, a reconciliation of the number of shares outstanding at the beginning and at the end of the period. However, neither IAS 1 nor IAS 33 require an entity to provide information about potential changes in the number of shares outstanding at the end of the period arising from existing rights and obligations of the entity.

7.16 Given the limitations of IAS 1 and IAS 33, in the Board's preliminary view more information about the potential dilution of ordinary shares should be provided

99 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.

to meet the needs of users of financial statements.[100] 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. Information about such potential dilution is useful for existing and potential investors in the entity's ordinary shares.

7.17 One way the Board has considered addressing some of these information needs is through improving presentation on the face of the financial statements, including the statement of changes in equity. As discussed in Section 6 paragraphs 6.60–6.95, the potential attribution approaches for equity instruments other than ordinary shares would result in the entity attributing the remaining total comprehensive income to ordinary shares; therefore, ordinary shares will be the ultimate residual after applying the attribution. Information about potential dilution would be even more important if the Board does not proceed with those attribution requirements. As discussed in Section 6, disclosure in the notes to the financial statements can complement, or be a substitute for, the potential attribution requirements for equity instruments other than ordinary shares.

7.18 In addition to information about potential dilution, users of financial statements also requested information about the effect of new issues of ordinary shares on the voting rights of existing shareholders. Such information about voting rights could be provided along with information about dilution.

7.19 Based on paragraphs 7.13–7.18, in the Board's preliminary view, additional disclosure in the notes to the financial statements about potential dilution would be useful. Users of financial statements have expressed various preferences on the form of a dilution analysis. The Board has not considered the merits of those various forms but instead focused on identifying the specific information that would be useful.

7.20 Applying the Board's preferred approach, derivatives to deliver ordinary shares could be classified as financial assets, financial liabilities or as equity instruments. Therefore, the return to ordinary shares could be diluted by instruments classified as assets or liabilities or equity instruments. The potential dilution of a financial liability settled by delivering a variable number of shares equal to a fixed cash amount is unlimited. In contrast, the potential dilution of an equity instrument settled by delivering a fixed number of shares (such as a fixed-for-fixed warrant) is limited.

7.21 The objective would be for an entity to provide information to help users of financial statements assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares. To address the limitations of IAS 33, these disclosures in the notes to the financial statements would provide information about dilution that could arise from any potential increase in the number of issued ordinary shares.

7.22 The information to meet the disclosure objective might include:

100 In this Discussion Paper, potential dilution is any actual or potential increase in the number of issued ordinary shares as the result of settling a financial instrument.

(a) a list at the end of each reporting period of all financial instruments that could dilute the ordinary shares;

(b) the following information for each group of potentially dilutive financial instruments:

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

  (ii) dates of share settlement; and

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

(c) a reconciliation of the movement in the number of ordinary shares outstanding, and in the maximum number of additional potential ordinary shares,[101] 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 issues, stock splits, warrant issues etc);

  (iii) settlement dates which led to changes in the number of ordinary shares outstanding; and

  (iv) the details of any share repurchase plans.

Illustrative example of dilution disclosure

7.23 The following example illustrates the disclosures discussed in paragraph 7.22:

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

	Ordinary shares outstanding	**Maximum additional number of potential ordinary shares**
1 January 20X1	5,000,000	900,000[(a)]
1 January 20X1		
Issue of warrants	–	600,000
1 March 20X1		
Issue of ordinary shares for cash	200,000	–
1 June 20X1		
Conversion of bonds	20,000	(20,000)[(b)]

continued...

101 Assuming the conversion of all financial instruments that require share settlement.

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1 September 20X1		
Exercise of warrants	400,000	(400,000)[(c)]
31 December 20X1	5,620,000	1,080,000

(a) Includes 800,000 related to convertible preference shares issued in the second quarter of 20X0, and 100,000 related to convertible bonds issued in the last quarter of 20X0.
(b) Bonds converted are no longer a source of potential dilution. Therefore, the conversion of bonds reduces the number of potential ordinary shares.
(c) Warrants exercised are no longer a source of potential dilution. Therefore, the exercise of warrants reduces the number of potential ordinary shares.

7.24 Most of the information needed for the disclosures discussed in paragraph 7.22 is already required for calculating earnings per share (for entities applying IAS 33). Additionally, the Board thinks that the disclosures discussed in paragraph 7.22 could be integrated with existing disclosures, for example, with the disclosures regarding outstanding shares required by IAS 1. These disclosures should be useful as a complement to any of the attribution alternatives considered in Section 6. These disclosures would become more essential as a substitute for attribution if the Board does not proceed with one of the attribution alternatives.

7.25 The disclosures would provide a summary of all potentially dilutive financial instruments. Such information would help users of financial statements to assess the distribution of returns among equity instruments and how this may change in the future.

Contractual terms and conditions

7.26 Information about terms and conditions of financial liabilities and equity instruments would help a user of financial statements make both assessments identified in Section 2 as well as other assessments such as the distribution of returns under different future scenarios.

7.27 In the Board'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:

(a) terms and conditions that are relevant to determining the settlement amount. Such terms and conditions might include information about the financial instrument's 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; and

(b) the timing of settlements, including the effect of any options and contingencies.

7.28 In this Discussion Paper (see paragraphs 7.8 and 7.22), the Board has identified particular information that should be disclosed about terms and conditions that affect a financial instrument's priority or its potential to dilute ordinary shares. User feedback indicates that disclosures about terms and conditions should be provided in a single place in the notes to the financial statements.

7.29 The Board acknowledges that aggregating this information could be challenging when an entity has a large number of financial instruments that fall within the scope of the disclosure. The Board notes that there are possible approaches to arranging this information, such as stratifying the set of financial instruments depending on their possible effect on an entity's prospects for future cash flows and requiring different disclosures based on the significance of those possible effects. If the Board decides to finalise this disclosure requirement, the Board will consider information that entities are already required to provide by other requirements.

Questions for respondents

Question 9

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).

(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).

(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

Section 8—Contractual terms

8.1 The focus of this project is limited to financial instruments within the scope of IAS 32. As mentioned in paragraph 3.3, all financial instrument definitions in IFRS Standards, including those of financial assets, financial liabilities and equity instruments, refer to rights or obligations arising from contracts. Paragraph 13 of IAS 32 states that:

> In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

8.2 However, determining whether rights and obligations arise from the contractual terms or from some other mechanism can sometimes be challenging. The Board considered:

(a) economic compulsion and indirect obligations (paragraphs 8.4–8.26); and

(b) the relationship between contracts and law (paragraphs 8.27–8.36).

8.3 In the Board's preliminary view, the Board's preferred approach should be applied to the rights and obligations established by the *contractual terms* of a financial instrument, including obligations that are established indirectly through the terms of the contract. This is consistent with the requirements of IAS 32. Economic incentives that might influence the issuer's decision to exercise its rights would not be considered when classifying a financial instrument as a financial liability or equity instrument.

Economic compulsion and indirect obligations

8.4 Some financial instruments grant the entity (the issuer) the right to choose between alternative settlement outcomes, instead of granting that right to the holder. For example, the terms might grant the entity the right to settle the financial instrument in a way that would have met the definition of a liability if it were the only possible outcome.

8.5 In classifying such financial instruments as financial liabilities or equity instruments, challenges include determining whether the financial instrument, in substance, establishes an obligation that would meet the definition of a financial liability.

8.6 The Committee and the Board have considered and resolved some of these challenges in the past. Some types of financial instruments considered included:

(a) issued preference shares the entity is allowed to redeem on specific dates. However, if the entity does not redeem the preference shares, the dividend rate and resulting redemption amount increases at an increasing rate over time (in 2006 the Committee considered a similar type of instrument, 'callable preferred shares with a 'step-up' dividend clause').

(b) instruments that can be converted to a fixed number of ordinary shares at the issuer's option (the Committee considered a type of this instrument in 2013).

8.7 If an entity has settlement options, economic incentives may prompt the entity to exercise the liability settlement outcome even though it has the right to select the equity settlement outcome (or vice versa). The strength of the economic incentive will depend on the entity's rights and obligations and other facts and circumstances.

8.8 In some circumstances, the incentives may be so strong that some would view the entity as being 'economically compelled' to exercise a particular outcome, eg a liability settlement outcome. Interested parties disagree whether the classification of financial liabilities and equity instruments should consider economic incentives and, if so, how strong those economic incentives need to be to equate to economic compulsion.

Does application of the Board's preferred approach address these challenges?

8.9 The Board's preferred approach is based not only on whether the financial instrument requires the entity to transfer economic resources, but also on how the amount of the obligation is determined. In particular, if the obligation is for an amount independent of the available economic resources of the entity (such as a non-derivative financial instrument with contractual cash flows based on interest rates), the financial instrument would be classified as a liability. This would be the case even if the entity has the right to defer payment indefinitely until liquidation (for example, callable preference shares with a step-up dividend clause) or the right to settle the obligation by issuing a variable number of shares with a total value equal to that independent amount.

8.10 As noted in paragraph 3.23, applying the Board's preferred approach, an entity would classify as financial liabilities claims such as callable preference shares with a step-up dividend clause and cumulative preference shares without considering whether the entity is obliged to transfer economic resources. That is, because the Board's preferred approach also considers how the amount of the obligation is determined, it would classify as financial liabilities financial instruments that contain an obligation for an amount independent of the entity's available economic resources but allow the entity to defer payment indefinitely. For such claims, the amount of the payment is known, even though the timing of the payment is unknown. Therefore, the Board's preferred approach would address the classification concerns about the callable preference shares with a step-up dividend clause without the need to consider economic incentives and compulsion.

8.11 Nevertheless, applying the Board's preferred approach, there would be other types of financial instruments with alternative liability and equity settlement outcomes within the control of the entity for which the Board considered the questions regarding economic incentives and economic compulsion.

8.12 For example, a reverse convertible bond is convertible at the issuing entity's option. The issuer has the option to deliver either a specified amount of cash or a fixed number of its own shares.[102] Effectively, the entity's right to choose how to settle the claim means the amount of the entity's obligation is limited to the lower of the value of the specified number of shares and the specified amount of cash.

8.13 When classifying the reverse convertible bond in paragraph 8.12 as a financial liability or as an equity instrument, the question is whether economic compulsion should be considered, and, if so, how strong economic incentives to settle the claim in a particular way need to be to equate to economic compulsion.

8.14 To help illustrate the issue, the Board first considered a 'typical' convertible bond. A typical convertible bond is denominated in the issuer's functional currency and convertible at the holder's option. The holder has the option to receive either a specified amount of cash, or a fixed number of shares. Effectively, a typical convertible bond obliges the entity to deliver an amount that is equal to the higher of the value of the specified number of shares and the specified amount of cash.

8.15 The Board then compared typical and reverse convertible bonds, applying the Board's preferred approach:

(a) the component of the typical convertible bond in paragraph 8.14 under which the entity could be obliged to transfer cash at the option of the holder would be a liability component measured at the present value of the cash settlement alternative. The right of the holder to convert to shares would be a separate equity component. This separate classification of the two components would apply even if the conversion option is highly likely to be exercised by the holder (for instance because the value of the shares is higher than the cash payment amount). If the holder did not exercise the conversion right, the entity would be obliged to transfer economic resources.

(b) the reverse convertible bond in paragraph 8.12 would be equity in its entirety because the entity has the right to settle the financial instrument by issuing a fixed number of ordinary shares, instead of transferring cash. This instrument would be classified as equity even if it is highly likely that the entity will not issue shares but pay cash instead (for instance, because the value of the shares is higher than the cash payment amount). Contractually, the entity does not have an unavoidable contractual obligation to transfer economic resources.

102 Other instruments would have similar alternative settlement outcomes, including (a) a callable share—an ordinary share that includes an unconditional right of the entity to repurchase the share for a fixed amount of cash (the share would be equivalent to an ordinary share but for the embedded call option) and (b) a purchased call option—a derivative that is gross physically settled that grants the right to the entity to repurchase a fixed number of ordinary shares, for a fixed amount of cash. Such an instrument is the standalone equivalent to the embedded derivative in the callable share. As noted in paragraphs 5.43–5.47, the Board has not discussed the details of possible separation methods for such embedded derivatives and will do so in the light of the feedback on the proposals in this Discussion Paper.

8.16 There are two views about these classification outcomes:

(a) View A—the classification results in paragraph 8.15 faithfully represent the different rights and obligations of the entity. For the typical convertible bond, the entity has no right to decide whether to transfer economic resources. That right is controlled by the holder and hence it is an obligation of the entity to transfer economic resources until the holder decides not to exercise that right. For the reverse convertible bond, the entity has a right to decide whether to transfer economic resources or to transfer a fixed number of shares, hence it is not an obligation to transfer economic resources until the entity waives its equity settlement right and commits to make the transfer of cash.

(b) View B—the classification results in paragraph 8.15 are counter-intuitive. They can result in a convertible bond that is highly likely to be converted to shares being classified as a liability for the present value of the cash settlement alternative. Similarly, they can result in a reverse convertible bond that is highly likely to be settled in cash being classified as equity. Holders of this view suggest that to avoid the counter-intuitive result, the requirements of IAS 32 should be amended. In the case of the reverse convertible bond, they think that the entity should consider the economic incentive for settling the bond by transferring cash to determine whether the financial instrument has a liability component. In other words, they think that the economic incentive should be regarded as creating an unavoidable settlement outcome.

8.17 An entity typically has the right to satisfy in whole or in part all claims against it, including those of ordinary shares, by transferring economic resources at some point in time, for example, by repurchasing the claim on the market, paying a dividend, or making some other distribution. If there is no possibility of transferring economic resources, the entity may not have a claim against it at all.

8.18 The Board thinks that, when considering whether a financial instrument should be classified as a financial liability or an equity instrument:

(a) the fact that the entity can waive its right to the equity settlement outcome and settle the financial instrument by transferring economic resources prior to liquidation is not relevant to the analysis. What is relevant is whether the entity has an unavoidable obligation to transfer economic resources at a specified time other than at liquidation, not whether it has the right to do so. The entity has the right to settle most claims against it, in whole or in part, by transferring economic resources at different points in time prior to liquidation (for example, by making discretionary distributions).

(b) economic incentives are not rights or obligations, but are factors that impact the likelihood of an entity or holder exercising particular rights, which may change over time. Classifying a financial instrument as a financial liability or an equity instrument based on economic incentives might represent the likely outcome, but it would not provide information about whether the entity has an unavoidable contractual obligation with the feature(s) of a financial liability.

8.19 The Board agreed with its previous conclusions in AG26 of IAS 32 that:[103]

> ... The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
>
> (a) a history of making distributions;
>
> (b) an intention to make a distribution;
>
> (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
>
> (d) the amount of the issuer's reserves;
>
> (e) an issuer's expectations of a profit or loss for a period; or
>
> (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

8.20 A reverse convertible bond is a claim against the entity. However, its features differ from that of a typical convertible bond.[104] Because the entity has the right to settle a reverse convertible bond by delivering a fixed number of its own ordinary shares, classifying it as equity shows that:

(a) it would not affect a user's assessment of whether the entity has sufficient economic resources to meet its obligations. Similar to ordinary shares, the amount of the financial instrument will depend on the entity's available economic resources because the entity always has the right to settle the claim by issuing a fixed number of its own ordinary shares.

(b) because the financial instrument can be settled with a fixed number of the entity's own ordinary shares it would not affect a user's assessment of whether the entity will be able to meet its requirements to transfer economic resources as and when they fall due because the entity has the unconditional right to avoid transferring economic resources by choosing to settle with a fixed number of shares.

8.21 Attempting to consider economic incentives in the analysis may raise more questions than it answers. A broad range of facts and circumstances could affect an entity's decision to exercise the liability settlement option instead of the

103 This is also referred to in paragraph BC12 of IFRIC 2. The Committee observed '...that a history of redemptions may create a reasonable expectation that all future requests will be honoured. However, holders of many equity instruments have a reasonable expectation that an entity will continue a past practice of making payments. For example, an entity may have made dividend payments on preference shares for decades. Failure to make those payments would expose the entity to significant economic costs, including damage to the value of its ordinary shares. Nevertheless, as outlined in IAS 32 paragraph AG26, a holder's expectations about dividends do not cause a preferred share to be classified as a financial liability.'

104 The Board has also developed presentation and disclosure requirements that would require entities to provide information about claims with alternative settlement outcomes. This includes requirements to attribute amounts within equity to classes of equity other than ordinary shares.

equity settlement option. Therefore, a number of follow-on questions arise if economic incentives are to be considered in identifying a financial liability, including:

(a) how significant does an economic incentive need to be for the entity to be economically compelled to transfer economic resources? And, therefore, what is the effect on classification of that threshold?

(b) that market changes will result in the extent of the economic incentive changing from period to period. Therefore, should the assessment of economic compulsion be performed only when classifying the claim at initial recognition, or would the assessment need to be performed continuously to take into consideration changing facts and circumstances?

(c) whether effects on the entity's other economic resources (such as a change of control provision), or claims (such as additional interest on other debt or covenant breaches), or other business factors should influence an entity's decision to exercise a liability settlement option. Should the assessment of economic compulsion consider economic consequences beyond those of the alternatives in the contract and if so, should changes in those circumstances be considered subsequently?

(d) should the assessment be limited to the current economic consequences at the assessment date (ie an 'intrinsic value' assessment)? Alternatively, should the possible future economic consequences from a possible future settlement be considered in the assessment as well? If so, what future scenarios should be assessed? Options that are subject to risk are typically always *potentially* favourable in the future.

8.22 However, the Board observed that sometimes the entity's stated right to settle a financial instrument by delivering a fixed number of ordinary shares is 'structurally out-of-the-money' (ie always 'out-of-the-money', or always unfavourable). This means it is always favourable for the entity to pay cash or another financial asset or to deliver a variable number of its own shares for an amount independent of the entity's available economic resources, or otherwise settle it in a way that would meet the definition of a financial liability under the Board's preferred approach. That is, the fair value of the liability settlement outcome is always less than the fair value of the equity settlement outcome.

8.23 IAS 32 includes some requirements to help assess whether a financial instrument establishes an obligation that would meet the definition of a financial liability indirectly through its terms and conditions. Paragraph 20 of IAS 32 states that:

> Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

8.24 In the Board's preliminary view, the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained. The Board noted that retaining these requirements reduces structuring opportunities to achieve desired outcomes when classifying financial instruments, in circumstances in which the contractual terms make exercising a certain option always favourable. By focusing on the contractual terms of financial instruments, the requirements in paragraph 20 of IAS 32 do not conflict with the general principle in this section of excluding economic incentives when classifying a financial instrument. However, they would need to be updated to reflect the features that result in liability classification applying the Board's preferred approach.

8.25 For example, consider a financial instrument that contains an obligation to pay cash equal to the fair value of a specified number of own shares (say X number of shares), but grants the entity a right to settle the instrument by physically delivering a different specified number of shares that is greater than X. Because the value of the equity settlement outcome is always greater than the value of the liability settlement outcome, the entity would always settle in cash. Applying the Board's preliminary view set out in paragraph 8.24, such a financial instrument would be classified as a financial liability.

Summary of preliminary views and questions for respondents

8.26 In the Board's preliminary view, economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument. Thus, under the Board's preferred approach, classification would be based on the rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract. This is consistent with the current approach in paragraph 20 of IAS 32.

Question 10
Do you agree with the Board's preliminary view that: (a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument? (b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained? Why, or why not?

Relationship between contracts and law

8.27 Assets and liabilities that are not contractual, for example rights and obligations that arise from statutory requirements imposed by government, are not financial liabilities or financial assets (for example, income taxes). Paragraph AG12 of IAS 32 states that:

> Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 12 *Income Taxes*. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

8.28 However, the Board is aware of questions about the effect of law on the rights and obligations of an existing contract (other than just their enforceability). The question is whether classification of a contract as a financial liability or an equity instrument should be based solely on the contractual terms or whether classification should also consider the law, regulation or any other legal instrument issued by an authority in a particular jurisdiction that might affect the rights and obligations set out in a contract.

8.29 Two transactions that demonstrate the challenges include:

(a) bonds that are contingently convertible to ordinary shares as a result of legal or regulatory requirements. Questions have been raised about whether laws that impose contingent conversion features on particular types of claims issued by an entity should be considered in classifying such instruments as financial liabilities or equity instruments. Paragraph B4.1.13 of IFRS 9 includes an example (Instrument E) illustrating contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. In that example, the effect of the regulation that introduces different contractual cash flows is not considered when assessing whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

(b) mandatory purchases of non-controlling interests that arise as a result of legal or regulatory requirements for acquisitions (mandatory tender offers or MTOs). The Committee received a submission regarding whether a liability should be recognised for the MTO at the date the acquirer obtains control of the acquiree. A small majority of Committee members expressed the view that a liability should be recognised for the MTO in a manner that is consistent with IAS 32 at the date that the acquirer obtains control of the acquiree. Other Committee members expressed the view that an MTO is not within the scope of IAS 32 (because they are non-contractual) or IAS 37 (because they are executory) and that a liability should, therefore, not be recognised.

8.30 Classification based on an assessment of contractual terms consistent with IFRS 9 would ensure consistent consideration of contingent convertible bonds that are affected by law for both the holder (as a financial asset) and the issuer (as a financial liability or an equity instrument). However, doing so would result in, for example, the obligations that arise in MTOs, which have similar consequences as those that arise from written put options, not being considered for the purpose of classification because they are beyond the scope of IAS 32. Other IFRS Standards might have specific guidance for issues that arise when an entity accounts for rights and obligations arising from law (such as IAS 37). However, the Board did not design other IFRS Standards to address the classification of liabilities and equity.

8.31 Alternatively, if the treatment of rights and obligations that arise from law were considered as equivalents of contractual terms under IAS 32 then MTOs might be accounted for consistently with written put options. However, such a fundamental change to the scope of IAS 32 and IFRS 9 to include rights and obligations that arise from law could have consequences beyond the distinction between liabilities and equity. In particular, it would extend the scope of the financial instruments literature in general to encompass rights and obligations arising outside contracts. This would likely have consequences beyond those in paragraph 8.29 that the Board is aware of, and for transactions beyond the scope of the FICE project. Those consequences would give rise to additional challenges that will need to be resolved, including challenges related to the recognition, derecognition and reclassification requirements that are specific to the effect of law and regulation,[105] which are beyond the scope of this project.

Summary of preliminary view and questions for respondents

8.32 The consequences to an entity of the rights and obligations of any financial instrument are the same regardless of whether those rights and obligations arise from a contract or from the law. Therefore, the comparability and usefulness of financial statements would be increased if an entity accounted for similar consequences in the same way. However, there are many assets and liabilities that share similar characteristics or consequences. Nevertheless, different IFRS Standards apply different requirements and the Board has decided on the scope of each IFRS Standard that specifies the accounting for the transactions within its scope.

8.33 The IFRS requirements to account for financial instruments have been designed around the concept of a contract. This includes the recognition, derecognition, classification and measurement requirements. The Board has not designed these requirements to account for rights and obligations arising from law.

8.34 IFRIC 2 does refer to relevant local laws and regulations in effect at the date of classification. However, the Board noted that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice, therefore it does not think that it should reconsider that interpretation, nor apply the analysis in that interpretation more broadly.

8.35 In developing IFRS 9, the Board acknowledged that, as a result of legislation, some governments or other authorities have the power in particular circumstances to impose losses on the holders of some financial instruments. The Board has already decided in IFRS 9 that when an entity assesses the classification of a contingent convertible financial asset it should limit the analysis to the terms and conditions in the contract. The Board noted that IFRS 9 requires the holder to analyse the *contractual terms* of a financial asset to determine whether the asset gives rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. In other words, the holder would not include the payments that arise only as a result of the government or other authority's legislative power as cash flows in its analysis. That is because that power and the related payments are not covered by the contractual terms of the financial instrument.[106]

8.36 In the Board's preliminary view, an entity would apply the Board's preferred approach to the contractual terms of a financial instrument consistently with

105 For example, the requirements in IAS 32 are based on the assumption that transactions occur based on agreement between parties to a contract, whereas law and regulation can be changed unilaterally by an authority by without agreement from the counterparties.

106 See paragraph BC4.191 of Basis for Conclusions on IFRS 9.

IAS 32 and IFRS 9. The Board will consider whether it should take any action to address the accounting for mandatory tender offers, including potential disclosure requirements, following its analysis of responses to this Discussion Paper.

Question 11
The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

Appendix A—Alternative approaches to classification and presentation

A1 The Board considered the following alternative approaches to the Board's preferred approach:

(a) Approach A—classification based only on whether there is a contractual obligation to transfer economic resources at a specified time other than at liquidation (paragraph A4).

(b) Approach B—classification based only on whether the obligation is for an amount independent of the entity's economic resources (paragraph A5).

A2 The overall analysis in this Discussion Paper would remain similar between all three approaches, including in many cases its application to derivative financial instruments. The difference between the approaches is how the primary distinctions identified in Section 2 (see paragraphs 2.32–2.42) are depicted through a combination of classification and presentation. The same distinctions as those made in the Board's preferred approach are required to provide relevant information for users of financial statements to make the assessments identified in Section 2. However, the approaches differ in how they affect the structure of the statement of financial position and the statement of profit or loss.

A3 For each approach, we summarise the difference between it and the Board's preferred approach. This Discussion Paper illustrates the classification and presentation consequences of all three approaches in Appendix C.

Approach A

A4 Approach A captures the following features through classification and presentation:

Classification

(a) Approach A would classify claims as liabilities if (and only if) the entity has an obligation to transfer economic resources at a specified time other than at liquidation, regardless of the amount of the obligation.

(b) Approach A would not classify as liabilities claims that the entity can settle by transferring other equity claims, nor claims for which the entity has the unconditional right to defer payment until liquidation, regardless of how the amount of the obligation is determined.

(c) Applying Approach A to derivative financial instruments using the same unit of account as the Board'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.

(d) The compound instrument and redemption obligation requirements would still apply in the Approach A. However, the liability leg would include only obligations to transfer cash and other financial instruments.

(e) Approach A might continue to need the puttable exception in IAS 32, since it is possible for all the claims against the entity to meet the definition of a liability.

Presentation

(a) Approach A would distinguish between liabilities that are for an amount independent of the entity's available economic resources and those that are not. The requirements would be the same as those required for liabilities applying the Board's preferred approach (see Section 5), in order to help a user make assessments of balance-sheet solvency and returns.

(b) Approach A would distinguish between equity claims that are for an amount independent of the entity's available economic resources and those that are not. The requirements would be different to those required for equity claims under the Board's preferred approach. In particular, not only would the entity need to provide more information about classes of equity other than ordinary shares, it also would have to present prominently on the face of the financial statements the effect of equity instruments that promise a specified return in order to help a user make assessments of balance-sheet solvency and returns. This is because Approach A would not consider the amount of the claim for classification.

Approach B

A5 Approach B would capture the following features through classification and presentation:

Classification

(a) 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.

(b) Approach B would not classify as liabilities claims that depend on the available economic resources of the entity, even if the entity is required to settle the claim by transferring economic resources at a specified time other than at liquidation.

(c) Applying Approach B to derivative financial instruments using the same unit of account as the Board's preferred approach 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.

(d) The compound instrument and redemption obligation requirements would still apply in Approach B. However, the liability leg would include only obligations for an amount independent of the entity's available economic resources.

(e) Depending on how it would be applied to financial instruments, Approach B might not need the puttable exception in IAS 32, because there would always be a claim that depends on the available economic resources of the entity.

Presentation

(a) Approach B would distinguish between liabilities that require the transfer of economic resources at a specified time other than at liquidation and those that do not. The requirements would be the same as those required for liabilities applying the Board's preferred approach (see Section 5), in order to help a user make assessments of funding liquidity and cash flows.

(b) Approach B would distinguish between equity claims that require the transfer of cash or another financial asset at a specified time other than at liquidation and those that do not. The requirements would be different to those required for equity claims applying the Board's preferred approach. In particular, not only would the entity need to provide more information about classes of equity other than ordinary shares, it also would have to present prominently the effect of instruments that require the transfer of resources in order to help a user make assessments of funding liquidity and cash flows. This is because Approach B would not consider the timing of required resource transfers for classification.

Appendix B—Implications for the *Conceptual Framework* and for other IFRS Standards

The *Conceptual Framework for Financial Reporting*

B1 The effects of the distinction between liabilities and equity are fundamental aspects of accounting that can be traced back to definitions of the elements in the *Conceptual Framework*.

B2 The Board added the FICE project to its research agenda in 2012 in response to feedback it received on its *2011 Agenda Consultation*. That feedback included requests for improvements to IAS 32, to the *Conceptual Framework* or both. Consistent with the Board's statement in its *2012 Agenda Consultation* Feedback Statement, the Board began discussing some of the challenges related to distinguishing between liabilities and equity in its Conceptual Framework project.

B3 In the Conceptual Framework project, the Board decided that the *Conceptual Framework* should continue to make a binary distinction between liabilities and equity. The Board considered suggestions either to increase the number of elements representing claims or to define claims without making a distinction. However, the Board observed that:[107]

(a) the recognition and measurement processes will result in the carrying amount of at least one claim being calculated as a residual, that is, as a result of the recognition and measurement of the entity's assets and other claims; and

(b) information about additional classes of liabilities and equity could be provided even if there are only two classes of claims defined as elements of financial statements.

B4 In March 2018, the Board issued the revised *Conceptual Framework*, which includes a revised definition of a liability and new supporting guidance. The changes to the definition of a liability were not intended to address challenges relating to the application of that definition to distinguish liabilities from equity. Hence, the new *Conceptual Framework* definition of a liability is not used to distinguish liabilities from equity in this Discussion Paper.

B5 The scope of the FICE project is focused on financial instruments and its aim is to investigate, and suggest solutions to, the specific challenges of distinguishing financial liabilities from equity instruments when applying IAS 32. If the Board ultimately decides to implement the preliminary views in this Discussion Paper, the Board might consider possible implications for the *Conceptual Framework*.

B6 The Board has acknowledged that one possible outcome of the research is a recommendation to add a project to amend the *Conceptual Framework* in relation to distinguishing between liabilities and equity. Nevertheless, the Board expects

107 For further details, see paragraphs BC4.90–BC4.91 of the *Basis for Conclusions on the Conceptual Framework for Financial Reporting*.

that none of the potential changes arising from this Discussion Paper will result in changes to the supporting guidance in paragraphs 4.28–4.35 of the *Conceptual Framework*. That guidance was not designed to help to distinguish liabilities from equity.[108] Any decision to add a project to amend the *Conceptual Framework* would be made only after considering feedback on the preliminary views in this Discussion Paper and would be subject to the Board's due process.

B7 IAS 32 is one of the IFRS Standards that includes requirements for the classification of claims as liabilities or equity. The other IFRS Standard that deals with similar classification issues is IFRS 2.

B8 At present, the distinction between liabilities and equity in IFRS 2 is consistent with the *Conceptual Framework*. If the Board does ultimately decide to add a project to propose changes to the *Conceptual Framework* to be consistent with the preliminary views in this Discussion Paper, it might need to consider the implications for a future revision to IFRS 2. Any decision to add a project on IFRS 2 to its agenda would be subject to the Board's due process.

Other IFRS Standards and Board projects

B9 Some other IFRS Standards contain requirements that depend on the requirements in IAS 32. Hence, the outcomes of this research project could have implications for those IFRS Standards. Affected IFRS Standards might include:

(a) other financial instruments standards and interpretations, including IFRS 9 *Financial Instruments*;

(b) standards on presentation and disclosure of financial performance, including IAS 33 *Earnings per Share*; and

(c) business combinations and consolidation standards, including IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements*.

B10 When relevant, this Discussion Paper includes a brief discussion of possible consequences for other IFRS Standards. The Board 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.

B11 The Board is also considering particular aspects of financial reporting in other projects that overlap with the matters it is considering as part of this project. The Board will consider those matters on an ongoing basis. These projects include:

(a) the Principles of Disclosure project, which is considering presentation and disclosure requirements across a broad range of IFRS Standards; and

(b) the Primary Financial Statements project, which is considering the structure of the statement of financial position and the statement of financial performance.

B12 Further information about all of the Board's projects is available on our website: https://www.ifrs.org/projects/.

108 See paragraph BC4.92 of the *Basis for Conclusions on the Conceptual Framework for Financial Reporting*.

Appendix C—Brief summary of classification outcomes applying various approaches

Claim	Approach A	Approach B	Board's preferred approach	IAS 32	2018 CF
Simple bonds	Liability				
Ordinary shares	Equity				
Shares redeemable for their fair value[(a)]	Liability	Equity	Liability	Liability	Liability
Irredeemable cumulative preference shares	Equity	Liability	Liability	Equity	Equity
Obligation to deliver a variable number of shares equal to a fixed amount of cash	Equity	Liability	Liability	Liability	Equity

(a) Assumes that the shares redeemable for their fair value do not meet the puttable exception in IAS 32.

Appendix D—Comparison of the Board's preferred approach and IAS 32

Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Simple bonds	Liability classified with income or expense presented in profit or loss *(See Section 3—Obligation to transfer cash or another financial asset at a specified time other than at liquidation and obligation for an amount independent of the entity's available economic resources)*	Liability classified with income or expense presented in profit or loss
Ordinary shares	Equity *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation and no obligation for an amount independent of the entity's available economic resources)*	Equity
Shares redeemable for their fair value (assume they do not meet the puttable exception in IAS 32)	Liability classified with income or expense resulting from changes in fair value presented separately in OCI *(See Section 3—Obligation to transfer cash or another financial asset at a specified time other than at liquidation, but no obligation for an amount independent of the entity's available economic resources and Section 6)*	Liability classified with income or expense presented in profit or loss
Shares redeemable for their fair value (assume they meet the puttable exception)	Equity, carrying amount is not updated for subsequent changes in the amount of cash required to be transferred (but additional disclosure in IAS 1) *(See Section 3—The puttable exception might continue to be required under the Board's preferred approach)*	Equity, carrying amount is not updated for subsequent changes in the amount of cash required to be transferred (but additional disclosure in IAS 1)

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Claim	Board's preferred approach[a]	IAS 32[a]
Irredeemable cumulative preference shares	Liability classified with income or expense presented in profit or loss *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation, but an obligation for an amount independent of the entity's available economic resources)*	Equity
Irredeemable non-cumulative preference shares	Equity with attribution of total comprehensive income to this class of equity consistent with IAS 33 *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation and no obligation for an amount independent of the entity's available economic resources)*	Equity
Obligation to deliver a variable number of shares equal to a fixed amount of cash	Liability classified with income or expense presented in profit or loss *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation, but an obligation for an amount independent of the entity's available economic resources)*	Liability classified with income or expense presented in profit or loss
Compound instruments with non-derivative components (see Section 3)		
Obligation to pay a fixed amount of cash in four years' time and to pay discretionary dividends equal to any dividends paid on ordinary shares for four years	Liability component = obligation to pay a fixed amount of cash in four years' time *(Similar to ordinary bond—accounted for in accordance with IFRS 9)*	Liability component = obligation to pay a fixed amount of cash in four years' time
	Equity component = discretionary dividend payments for four years. Measured as a residual on initial recognition *(Similar to ordinary shares—measured as residual)*	Equity component = discretionary dividend payments for four years. Measured as a residual on initial recognition

continued...

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<table>
<tr><th>Claim</th><th>Board's preferred approach[a]</th><th>IAS 32[a]</th></tr>
<tr><td rowspan="2">Irredeemable non-cumulative preference shares to pay discretionary dividends with an obligation to pay a fixed amount at liquidation</td><td>Liability component = obligation to pay a fixed amount of cash at liquidation

(However, present value will be negligible on a going-concern basis. See paragraph 3.24)</td><td>No liability component</td></tr>
<tr><td>Equity component = discretionary dividend payments. Measured as a residual on initial recognition.

(Similar to irredeemable non-cumulative preference shares)</td><td>Equity in its entirety</td></tr>
<tr><td colspan="3">Derivatives (see Section 4)</td></tr>
<tr><td colspan="3">Forward contract, or written option, to:
(a) receive fixed amount of cash (in functional currency); and
(b) deliver variable number of ordinary shares, indexed to the value of the gold index.</td></tr>
<tr><td>Gross physically settled (exchange cash and shares) and net-share settled</td><td>Liability classified with income or expense presented in profit or loss

(See Section 4—neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, but net amount of derivative affected by a variable independent of the entity's available economic resources)</td><td>Liability classified with income or expense presented in profit or loss</td></tr>
<tr><td>Net-cash settled</td><td>Liability classified with income or expense presented in profit or loss

(See Section 4—obligation to transfer cash or another financial asset, or right to receive cash for the net amount, and net amount of derivative affected by a variable independent of the entity's available economic resources)</td><td>Liability classified with income or expense presented in profit or loss</td></tr>
<tr><td colspan="3">Forward contract, or written option, to:
(a) receive fixed amount of cash (in functional currency); and
(b) deliver fixed number of ordinary shares.</td></tr>
</table>

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Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Gross physically settled (exchange cash and shares)	Equity (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 4— 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
Net-share settled	Equity (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 4—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)*	Liability classified with changes reported in profit or loss
Net-cash settled	Liability classified with income or expense resulting from changes in fair value presented separately in OCI *(See Section 4—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)*	Liability classified with changes reported in profit or loss

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Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Gross physically settled (exchange cash and shares) forward contract, or written option, to: (a) receive a fixed amount of cash in a foreign currency; and (b) deliver fixed number of ordinary shares	Liability classified with income or expense resulting from changes in fair value presented separately in OCI if the contract meets the specific criteria *(See Section 4—neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, but net amount of derivative affected by a variable independent of the entity's available economic resources)* *(See Section 6—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)*	Liability, unless it meets the foreign currency rights issue exception, in which case it is classified as equity
Gross physically settled (exchange liability and shares) forward contract, or written option, to: (a) extinguish an existing liability for the transfer of a fixed amount of cash in the entity's functional currency; and (b) deliver fixed number of ordinary shares.	Equity (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 4—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

continued...

...continued

Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Compound instruments with derivative components (see Section 5)		
Bond to transfer a fixed amount of cash in four years' time, that is convertible to a fixed number of ordinary shares at the option of the bondholder	Liability component = obligation to pay a fixed amount of cash in four years' time *(Similar to ordinary bond—accounted for in accordance with IFRS 9)*	Liability component = obligation to transfer fixed amount of cash in four years' time (classified consistent with an ordinary bond)
	Equity component = obligation to convert the bond to a fixed number of ordinary shares at the option of the holder. Measured as a residual on initial recognition *(Similar to gross physically settled, ie exchange liability and shares, written option to receive/extinguish/convert an existing liability for the transfer of a fixed amount of cash and deliver fixed number of ordinary shares—measured as residual.)*	Equity component = obligation to convert the bond to a fixed number of ordinary shares at the option of the holder. Measured as a residual on initial recognition
Bond to transfer a fixed amount of cash in four years' time, that is convertible to a fixed number of ordinary shares at the option of the issuing entity	Equity in its entirety (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 5—no obligation to transfer cash or another financial asset at a specified time other than at liquidation and no obligation for an amount independent of the entity's available economic resources)*	Equity in its entirety

continued...

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Claim	Board's preferred approach[(a)]	IAS 32[(a)]
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	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 *(See Section 4—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)* *(See Section 6—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)*	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, or to designate the entire financial instrument as at fair value through profit or loss
	No equity component	No equity component

continued...

...continued

Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Redemption obligations (see Section 5)		
Written option to: (a) receive/extinguish/convert a fixed number of ordinary shares; and (b) deliver a fixed amount of cash in four years	Liability component = obligation to pay a fixed amount of cash in four years' time *(Similar to ordinary bond—accounted for in accordance with IFRS 9)*	Recognise present value of redemption amount (ie obligation to pay a fixed amount of cash in four years' time) as a financial liability and reclassify from equity
	Equity component = 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 *(Similar to gross physically settled, ie exchange liability and shares, written option to receive/extinguish/convert an existing liability for the transfer of a fixed amount of cash and deliver fixed number of ordinary shares)*	

(a) If a financial instrument is classified as a financial liability and is designated as at fair value through profit or loss, the effect of changes in the liability's credit risk is presented in other comprehensive income in accordance with IFRS 9.

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EXTERNAL REPORTING BOARD

Te Kāwai Ārahi Pūrongo Mōwaho

Policy Approach to Developing the Suite of PBE Standards

September 2013

Approved by the XRB Board for application by the New Zealand Accounting Standards Board from 1 October 2013

202203.1

External Reporting Board
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Preface

1. In May 2013, the New Zealand Accounting Standards Board (NZASB) issued the PBE Standards – a new suite of standards for Tier 1 and Tier 2 public benefit entities. That initial set of standards, developed in accordance with the External Reporting Board's (XRB Board's) Accounting Standards Framework, can be regarded as the "foundation suite" of PBE Standards. It is expected that the foundation suite will be enhanced and developed over time.

2. This Policy Approach paper has been developed by the XRB Board and the NZASB to assist the NZASB in making consistent decisions when developing the suite of PBE Standards i.e. when considering enhancements and developments to the suite of PBE Standards in the future.

3. While primarily based on International Public Sector Accounting Standards, the foundation suite of PBE Standards was developed using a range of source standards: International Public Sector Accounting Standards, selected NZ IFRSs and domestic standards developed within New Zealand. Developments are likely to arise from each of these sources as changes are made to the international standards and as issues specific to New Zealand emerge.

4. Without a policy such as this, it would be possible for significant fluctuations in the NZASB's approach to developing the suite of PBE Standards to emerge over time. This Policy Approach paper therefore provides constituents with some certainty about the likely future direction of the PBE Standards suite, and provides a basis for assessing proposals for changes to the PBE Standards as they are issued by the NZASB. It also assists constituents to understand the likely implications of future changes to the PBE Standards suite for public benefit entities (PBE) groups containing for-profit entities (commonly referred to as "mixed groups").

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Summary

The Development Principle

In accordance with the Accounting Standards Framework, the primary purpose of developing the suite of PBE Standards is to better meet the needs of the PBE user groups (as a whole). In considering whether to initiate a development, the NZASB shall consider the following factors:

(a) Whether the potential development will lead to higher quality financial reporting by public sector PBEs and not-for-profit entities, including public sector PBE groups and not-for-profit groups, than would be the case if the development was not made; and

(b) Whether the benefits of a potential development will outweigh the costs, considering as a minimum:

   (i) *relevance to the PBE sector as a whole*: for example, where the potential development arises from the issue of a new or amended IFRS, whether the type and incidence of the affected transactions in the PBE sector are similar to the type and incidence of the transactions addressed in the change to the NZ IFRS;

   (ii) *relevance to the not-for-profit or public sector sub-sectors*: whether there are specific user needs in either of the sub-sectors, noting that IPSAS are developed to meet the needs of users of the financial reports of public sector entities;

   (iii) *coherence*: the impact on the entire suite of PBE Standards (e.g. can the change be adopted without destroying the coherence of the suite);

   (iv) *the impact on mixed groups*; and

(c) In the case of a potential development arising from the issue of a new or amended IFRS, the IPSASB's likely response to the change (e.g. whether the IPSASB is developing an IPSAS on the topic).

Application of the Development Principle

The paper includes a series of rebuttable presumptions in applying the development principle:

(a) The NZASB will adopt a new or amended IPSAS.

(b) The NZASB will not include an NZ IFRS that the IASB has issued on a new topic in the suite of PBE Standards unless the IPSASB addresses the issue.

(c) In considering a change to an NZ IFRS that relates to a topic for which there is an existing PBE standard based on an IPSAS, the NZASB shall consider the factors in the development principle in determining whether to initiate a development of the PBE Standards. Particular emphasis in this case needs to be placed on the IPSASB's likely response to the change.

(d) The NZASB will not incorporate minor amendments to NZ IFRS into the equivalent PBE Standard in advance of the IPSASB considering the change.

1. Introduction

1. This paper addresses the approach to developing and enhancing the suite of PBE Standards, now that the transition suite for public sector PBEs is completed. References to PBEs in this paper include references to all PBEs: public sector PBEs and not-for-profit entities, and public sector PBE groups and not-for-profit groups.

2. Triggers for possible changes to the standards are likely to come from three sources:

   (a) the IPSASB issuing a new IPSAS or a change to an existing IPSAS (section 4.1);

   (b) the IASB issuing a new IFRS or a change to an existing IFRS (section 4.2); and

   (c) domestic developments within New Zealand, including both exogenous events such as changes to the legislative framework and endogenous events where the NZASB considers that developments are warranted (section 4.3).

3. This paper considers the implications of the Accounting Standards Framework for developing the suite of PBE Standards and identifies an approach to be taken for each of the triggers for possible changes to PBE Standards.

2. Basis for Development of PBE Standards

4. The multi-standards approach in the Accounting Standards Framework is designed to better meet the needs of users of the financial statements of PBEs. In its decision to base the development of standards for Tier 1 and Tier 2 entities on IPSAS, the XRB Board decided the following:

> 149. The XRB therefore proposes that a set of PBE Accounting Standards (PAS) be developed and that they use IPSAS as their base. PAS would modify IPSAS for any recognition, measurement or disclosure matters considered inappropriate in the New Zealand context at this time. Such modifications would only be made where the IPSAS requirement in question would have a material impact on the financial position or performance being reported, and that impact would adversely detract from the financial statements' usefulness to users. Based on work to date, the number of modifications is expected to be relatively few.
>
> 150. The XRB also proposes that PAS include other relevant standards (including domestic standards) appropriate for New Zealand and/or to address topics not covered in IPSAS.
>
> 151. Thirdly, the XRB proposes PAS be modified to make them relevant, applicable and understandable to not-for-profit sector preparers and users. This is necessary because IPSASB has developed IPSAS for public sector entities. Some modification is desirable to enhance their usefulness in the not-for-profit context.
>
> (Accounting Standards Framework, paragraphs 149 – 151)

5. This paper uses the term 'development' to encompass any change to the suite of PBE Standards.

6. In considering the appropriateness of potential developments of the suite of PBE Standards, it is necessary to consider these developments in the context of the Accounting Standards Framework, including the impact of any developments on the quality of the financial reporting arising from those standards and the trade-off between the benefits of improvements in the quality of the resulting financial reports and the associated costs.

2.1 Quality of Financial Reporting

7. The suite of PBE Standards is designed to meet users' needs by providing high quality financial reporting by PBEs. It follows that any development of PBE Standards should aim to improve the quality of financial reporting. The quality of financial reporting relies on meeting the needs of users of PBE general purpose financial reports (including financial statements), while endeavouring to ensure that the costs arising from a development do not outweigh the benefits.

8. In this context, high quality financial reporting is assessed by reference to the conceptual framework for PBEs (as it applies from time to time), with primary emphasis on the objective of financial reporting and then the qualitative characteristics. A standard is more likely to lead to higher quality financial reporting if it adheres closely to the conceptual framework.

9. The categories of users of financial statements of PBEs and for-profit entities are different. The IASB's emerging Conceptual Framework identifies users of IFRS as

suppliers of resources to the entity, and notes that the decisions that they make are related to providing resources to the entity.[1]

10. In contrast, the IPSASB considers that the objective of financial reporting is to serve a wider group of users, being resource providers and service recipients and their representatives. The IPSASB notes that information is needed for both accountability and decision-making purposes[2].

11. A development of the suite of PBE Standards will improve the quality of financial reports prepared in compliance with PBE Standards if it improves the accounting for specific transactions by better meeting the objective of financial reporting and the associated qualitative characteristics of financial reporting.

12. Further, high quality financial reporting depends on consistent treatment of similar transactions. For example, it would usually be inappropriate to require different measurement for similar liabilities in similar circumstances. As a result, any development of PBE Standards (including the conceptual framework for PBEs) should ensure that the suite is maintained as a coherent whole.

13. It follows that any developments should ensure that the needs of users are better met than they were prior to the development. Alternatively, the cost-benefit test (see next section) may be met where the needs of users are equally as well served, with a consequent benefit in some other way such as a reduction in the costs of preparing the financial statements.

2.2 Costs and Benefits

14. In considering a potential development of the suite of PBE Standards, the primary purpose and benefit is to improve the information provided to users of PBE financial statements.

15. Benefits need to be considered in relation to the suite of standards as a whole, in addition to the implications for a specific area of financial reporting. The benefit of aligning the PBE Standards with NZ IFRS to the extent possible is that this will reduce differences between the financial statements of PBEs and for-profit entities. This benefit is particularly relevant to entities that are members of mixed groups[3] and users of PBE financial statements whose familiarity with financial statements arises from experience in the for-profit sector. However, for other preparers that are not part of a mixed group, there may be additional preparation costs as a result of changes in accounting standards that might not otherwise arise.

16. The PBE Standards are largely based on IPSAS in accordance with the Accounting Standards Framework and, therefore, careful consideration is required before making any change to a PBE standard based on an IPSAS in circumstances other than as a consequence of the IPSASB issuing a new or amended IPSAS (as

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1 New Zealand Equivalent to the IASB *Conceptual Framework for Financial Reporting 2010*, paragraph OB2.

2 IPSASB, *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, January 2013, paragraphs 2.1–2.4.

3 For the purposes of this paper, a mixed group is a PBE group that includes at least one material for-profit subsidiary where that for-profit subsidiary applies accounting policies that differ from those of the mixed group and that may need to be adjusted under the consolidation standards.

discussed further below in paragraph 28). In addition, the benefit of using IPSAS to the extent possible is that IPSAS are a suite of standards that comprise a coherent package. It also reduces standard-setting costs as the IPSASB documents are readily available for application in New Zealand with little additional work. Reducing the time spent on setting the base standards releases resources for working with the international standard setters and for necessary domestic projects.

17. In developing a coherent suite of PBE Standards, it will generally be relatively low cost to add additional guidance for all PBEs, or for sub-groups of PBEs such as not-for-profit entities. However, it is expected that recognition and measurement requirements will be common to all PBEs. Further, using recognition and measurement requirements developed from a number of sources creates the potential for inconsistencies within the suite of PBE Standards, such as applying different measurement requirements to similar liabilities. Care should be taken to minimise the impact of such inconsistencies, if they cannot be eliminated.

18. At times, there is a tension between reducing the costs borne by preparers within mixed groups – that is the elimination of differences between PBE Standards and NZ IFRS that are not sector-specific – and improving the suite of PBE Standards taken as a whole. This policy takes the view that reducing the costs on preparers within mixed groups should be considered to the extent that these costs can be reduced whilst meeting the needs of the wider range of users of financial statements of public sector PBEs and not-for profit entities (including public sector and not-for-profit groups) through a complete and coherent suite of PBE Standards.

3. The Development Principle

19. In accordance with the Accounting Standards Framework, the primary purpose of developing the suite of PBE Standards is to better meet the needs of PBE user groups (as a whole). In considering whether to initiate a development, the NZASB shall consider the following factors:

(a) Whether the potential development will lead to higher quality financial reporting by public sector PBEs and not-for-profit entities, including public sector PBE groups and not-for-profit groups, than would be the case if the development was not made; and

(b) Whether the benefits of a potential development will outweigh the costs, considering as a minimum:

(i) *relevance to the PBE sector as a whole:* for example, where the potential development arises from the issue of a new or amended IFRS, whether the type and incidence of the affected transactions in the PBE sector are similar to the type and incidence of the transactions addressed in the change to the NZ IFRS;

(ii) *relevance to the not-for-profit or public sector sub-sectors:* whether there are specific user needs in either of the sub-sectors, noting that IPSAS are developed to meet the needs of users of the financial reports of public sector entities;

(iii) *coherence:* the impact on the entire suite of PBE Standards (e.g. can the change be adopted without destroying the coherence of the suite);

(iv) *the impact on mixed groups*; and

(c) In the case of a potential development arising from the issue of a new or amended IFRS, the IPSASB's likely response to the change (e.g. whether the IPSASB is developing an IPSAS on the topic).

20. The NZASB will need to exercise its judgement in balancing the factors in the development principle because, in many cases, there will need to be a trade-off between these factors. This policy provides a basis for making such a trade-off decision: it cannot replace the application of judgement by the NZASB with a series of bright-line rules.

4. Application of the Development Principle

21. The following sections are designed to assist in the application of the factors in the development principle. They consider, in turn, potential developments of the suite of PBE Standards that might arise from developments in IPSAS and NZ IFRS as well as addressing issues that might arise within New Zealand. Although this paper treats each of these developments separately, it is likely that specific developments will need to be considered from a number of perspectives. For example, the NZASB may have planned to continue to update PBE IAS 34 *Interim Financial Reporting* in line with developments of NZ IAS 34 *Interim Financial Reporting* to retain consistent interim reporting across all sectors (section 4.2). However, if the IPSASB were to issue a standard addressing interim reporting, this new IPSAS would be considered as a development resulting from an enhancement to IPSAS (section 4.1).

4.1 New or Amended IPSAS

22. There is a rebuttable presumption that the NZASB will adopt a new or amended IPSAS. It is expected that such changes will lead to higher quality financial reporting by PBEs in New Zealand and the factors in the development principle are presumed to be met.

23. This rebuttable presumption is based on the expectation that the IPSASB has considered the needs of the wide range of users of public sector financial statements in developing and enhancing the suite of IPSAS.

24. Depending on the circumstances, it may be appropriate to amend a recently issued or newly amended IPSAS in the process of adoption in New Zealand. Examples of possible amendments include:

    (a) improving the quality of the IPSAS in the New Zealand context by, for example, adding guidance to enable not-for-profit entities and public sector PBEs to apply the standard consistently or adding guidance to assist not-for-profit entities in applying the standard, given that the standard has been developed for application by public sector PBEs;

    (b) amendments necessary to maintain the coherence of the suite of PBE Standards;

    (c) excluding options that are not relevant in the New Zealand context; or

    (d) amending the scope of an IPSAS if the IPSAS conflicts with a legislative requirement, or a legislative requirement addresses the same issue for public sector entities. However, in these circumstances, it may be appropriate to adopt the IPSAS for not-for-profit entities.

4.2 New or Amended NZ IFRS

25. New or amended NZ IFRS will require the NZASB to consider whether to initiate a development of the PBE standards in the following circumstances:[4]

    (a) an IFRS that the IPSASB has used as the basis for an IPSAS is changed;

    (b) the IASB issues an IFRS on a new topic; and

    (c) there is a change to an NZ IFRS that has been used as the basis for a PBE Standard[5].

4.2.1 An IFRS that the IPSASB has used as the basis for an IPSAS is changed

26. As noted earlier, the PBE Standards are primarily based on IPSAS. In turn, many IPSAS are primarily based on IFRS. Examples of such standards are PBE IPSAS 16 *Investment Property* and PBE IPSAS 17 *Property, Plant and Equipment*, which are based on IAS 40 *Investment Property* and IAS 16 *Property, Plant and Equipment*, respectively. Accordingly, there are likely to be many instances in which a new or amended NZ IFRS relates to a topic covered by an existing IPSAS standard that has been incorporated into the PBE standards.

27. **In considering a change to an NZ IFRS that relates to a topic for which there is an existing PBE standard based on an IPSAS, the NZASB shall consider the factors in the development principle in determining whether to initiate a development of the PBE Standards. Particular emphasis in this case needs to be placed on the IPSASB's likely response to the change.**

28. Given the presumption in paragraph 22 that any standard issued by the IPSASB will be included in the PBE Standards, there are considerable potential costs and risks associated with "getting ahead of the IPSASB". Therefore, the NZASB needs to decide whether to develop a PBE standard ahead of the IPSASB or to wait for the IPSASB's response. If the issue is already on the IPSASB's active work plan, the NZASB would normally wait for the IPSASB to complete its work, unless the NZASB is of the view that there is an urgent need for action in New Zealand or the NZASB is of the view that the IPSAS is unlikely to be appropriate in the New Zealand context.

29. **Furthermore, in the case of minor amendments to an NZ IFRS, there is a rebuttable presumption that the change should not be incorporated into the equivalent PBE Standard in advance of the IPSASB considering the change.** This is because minor amendments are less likely to meet the cost-benefit test, particularly when the potential costs and risks associated with getting ahead of the IPSASB are taken into account.

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[4] An amendment to an NZ IFRS can fall into more than one of the above categories, for example, an NZ IFRS on a new topic might also result in changes to other NZ IFRS that fall into category (a) and/or (c).

[5] The NZ IFRS applying to PBEs were "frozen" in 2011, pending the establishment of the XRB and the anticipated development of PBE Standards. The "frozen" NZ IFRS that the NZASB has included in the PBE Standards are PBE IFRS 3 *Business Combinations*, PBE IFRS 4 *Insurance Contracts*, PBE IFRS 5 *Non-current Assets Held For Sale and Discontinued Operations*, PBE IAS 12 *Income Taxes* and PBE IAS 34 *Interim Financial Reporting*, together with NZ IFRIC 12 *Service Concession Arrangements* and NZ-SIC 29 *Service Concession Arrangements: Disclosures* (which are the basis for PBE FRS 45 *Service Concession Arrangements: Operator*).

30. Where there is a major change to an IFRS for which there is an existing IPSAS and where the IPSASB is unlikely to address the change in an acceptable time frame, the NZASB could either develop a domestic modification to the PBE Standard or assist the IPSASB to develop an IPSAS. Options for assisting the IPSASB include offering to provide staff resources for the IPSASB or partnering with the IPSASB to update a specific IPSAS in the light of the major change. It may be more effective to assist the IPSASB because any uncertainties about the IPSASB's approach to the issue will be resolved sooner rather than later. However, the level of effort required to develop an IPSAS based on an IFRS for international use is likely to be significantly higher than developing a PBE Standard based on an IFRS or its equivalent NZ IFRS for use in New Zealand. The IPSASB's due process, multi-constituency reach and less regular meetings leads to a standards development process for the IPSASB that is more time consuming and complex.

4.2.2 The IASB issues an IFRS on a new topic

31. An example of a new topic is where the IASB is considering issuing a standard on rate-regulated activities.

32. There is a rebuttable presumption that the NZASB will not include an NZ IFRS that the IASB has issued on a new topic in the suite of PBE Standards unless the IPSASB addresses the issue.

33. As noted in paragraph 35, some NZ IFRS were included in the suite of PBE Standards to maintain current practice until the IPSASB addresses the related issues. This rationale does not apply to an NZ IFRS on a new topic. Also, given the PBE standards are primarily based on IPSAS in accordance with the Accounting Standards Framework, adding further PBE standards based on NZ IFRS is unlikely to be consistent with the objectives of that Framework.

34. In considering whether to rebut the presumption, the NZASB should consider whether the new standard both leads to a major improvement in the quality of financial reporting and fills a gap in the suite of PBE Standards (as distinct from a gap in NZ IFRS). This is unlikely to arise.

4.2.3 An NZ IFRS that the NZASB has included in the PBE Standards is changed

35. The NZASB has included selected "frozen" NZ IFRS in the suite of PBE Standards (see footnote 5) in order to maintain current practice until the IPSASB addresses the related issues.

36. In considering a change to an NZ IFRS that is included in the suite of PBE Standards, the NZASB shall consider the factors in the development principle in determining whether to initiate a development of the PBE Standards.

37. However, in situations where there is no equivalent IPSAS on the topic and the IPSASB is not expected to create such a standard in the foreseeable future, the IPSASB's likely response to the change would be less relevant. This will impact on the overall assessment of the costs and benefits of including the NZ IFRS development in the PBE standards. This is because the potential problems

associated with “getting ahead of the IPSASB” (as discussed in paragraph 28 above) are less likely to arise.

38. An implication of this policy is that those PBE Standards based on a “frozen” NZ IFRS (see footnote 5) may need to be updated to align with the current equivalent NZ IFRS.

4.3 Domestic Developments

39. Domestic developments include developing standards to meet specific requirements in New Zealand.

40. The suite of PBE Standards contains standards directly addressing issues relevant to New Zealand, including PBE FRS 42 *Prospective Financial Statements* and PBE FRS 43 *Summary Financial Statements*. Further domestic standards may be developed where a need arises when an issue of importance in New Zealand is not addressed in a standard issued by the IPSASB (section 4.1) or the IASB (section 4.2).

41. In determining whether to initiate the development of a domestic standard for inclusion in the PBE suite, the NZASB will consider the factors in the development principle. Assuming the NZASB determines that the development of a domestic standard would improve the quality of financial reporting by PBEs, the NZASB will first consider whether there is an international pronouncement addressing the relevant issue that is applicable in the New Zealand context.

42. The Accounting Standards Framework presumes that New Zealand will be a standards-taker rather than a standards-maker whenever possible, for a range of reasons, including:

(a) the quality derived by an international due process;

(b) the prospect of international comparability; and

(c) the limited resources available for the domestic development of standards.

43. It follows that the NZASB will develop domestic standards or guidance that result in a material improvement in information available to users of financial statements when:

(a) there is no other source of material available internationally; or

(b) the available international guidance is not targeted specifically towards addressing New Zealand issues.

2018 AFAANZ Conference

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Saturday, 30 June 2018

8:00-18:00	☑ **Accounting Education Special Interest Group (SIG5)** (Crystal I)
8:00-16:00	☑ **Behavioural Finance Special Interest Group (SIG7)** (Gallery 3)
9:00-16:00	☑ **11th Accounting History Special Interest Group Symposium (SIG2)** (Gallery 1)
9:00-15:30	☑ **Accounting Standards Special Interest Group (SIG3)** (Gallery 4)
18:00-21:30	☑ **Management Accounting Special Interest Group (SIG8)** (Gallery 4)

Sunday, 1 July 2018

8:30-13:00	☑ **Auditing and Assurance Special Interest Group (SIG1)** (Gallery 1)
9:00-13:00	☑ **Qualitative Research in Accounting Network Interest Group (SIG4)** (Gallery 4)
9:00-12:00	☑ **Womens Mentoring Program** (Gallery 3)
12:00-14:30	☑ **HoD Meeting** (Crystal I)
13:00-19:00	☑ **Exhibitions Open** (Great I)
13:00-17:00	☑ **Registration** (Great Room Prefunction)
14:30-14:45	☑ **President's Welcome - Chris van Staden and Millicent Chang** (Great IV)
14:45-16:00	☑ **Plenary Session 1** (Great IV)
16:00-16:30	☑ **Afternoon Tea** (Great I)
16:30-17:30	☑ **Panel Discussion - CPA and CAANZ** (Great IV)
17:30-18:30	☑ **First time AFAANZ Conference Attendees Meeting, Sponsored by CAANZ** (Crystal I)
18:30-19:30	☑ **Welcome Reception, Sponsored by CPA Australia** (Great I)

Monday, 2 July 2018

7:30-9:00 ☑ **Breakfast Panel - "50th Anniversary of Ball and Brown (1968)"** (Great IV)

8:30-18:30 ☑ **Exihibitions Open** (Great I)

9:00-10:30 **CONCURRENT SESSIONS 1 - WITH DISCUSSANTS**

Auditing	Corporate Finance	Corporate Finance	Corporate Governance	Corporate Social Responsbility	Financial Accounting	Interdisciplinary	International Accounting	Public Sector / N for Profit
Crystal II	Great III	Gallery 1	Crystal I	Gallery 4	Great II	Gallery 3	The Greys Room	Gallery 2
☐ **Audit Fees 1** *Session Chair: Michael Turner, The University of Queensland* *The Effect of Audit Industry Structure Change on Audit Pricing: Evidence from China* Zixuan Li; Steven Cahan *Discussant: Paul Coram, The University of Adelaide* *Audit Office's Capacity, Opportunity Costs and Audit Pricing* Chun-Chan Yu; Hua-Wei Huang; TsingZai Wu *Discussant: Eunice Khoo, UNSW Sydney* *PCAOB Inspections and Audit Fees: An Analysis of the First Three Inspection Rounds of Small Audit Firms* Ann Vanstraelen; Lei Zou *Discussant: Christine Contessotto, Deakin*	☐ **Corporate Governance** *Session Chair: Dewan Rahman, University of Queensland* *Effect of CEO Successors' Board Experience on Firm Performance and Value* Helen Choy; Hanyong Chung *Discussant: Helen Lu, The University of Auckland* *Government's Say-on-pay Policy and Corporate Risking Taking: Evidence from China* Haiyan Jiang; Kun Su; Gary Tian *Discussant: Chelsea Liu, The University of Adelaide* *Raising Capital for the Family Firm: Whence the Advantage?* Dong Xiang; Yuming Zhang; Andrew Worthington *Discussant: Sarah Osborne,*	☐ **Equity Offerings 1** *Session Chair: Sazali Abidin, Lincoln University* *Why do So Few Firms Go Public on Mondays?* Abu Chowdhury; Mir Zaman *Discussant: Dixin Wu, Research School of Accounting, The Australian National University* *The Impact of Regulation on the Seasoned Equity Offering Decision* Adrian Melia; Paul Docherty *Discussant: Hoa Luong, Curtin University* *Does the Pre-IPO innovation affect the firms' Long-term performance? -- Evidence from China* Lu Zhou; Mehdi Sadeghi *Discussant: Jin Lv, Australian National University*	☐ **Managerial Effects** *Session Chair: Janice Hollindale, Bond University* *Performance Measures in CEO Annual Incentive Plans: New Evidence from the Compensation Discussion and Analysis* Orla Lenihan; Niamh M. Brennan *Discussant: Paul Mather, La Trobe University* *Performance Informativeness and CEO Turnover Upon Differing Industry Conditions* Lin Li; Peter Lam; Justin Law; Wilson Tong *Discussant: Thu Phuong Truong, Victoria University of Wellington* *Managerial Perception of Market Competition and Acquisitions* Kyle Peterson;	☐ **Corporate Social Responsbility 1** *Session Chair: Binh Bui, Victoria University of Wellington* *Corporate Social Responsibility Reporting and Investment: Evidence from Acquisitions* Kun WANG; yue WU *Discussant: ELVIA R SHAUKI, University of South Australia* *Accountability for workplace safety in the Bangladesh ready-made garment industry* Suraiyah Akbar; Craig Deegan *Discussant: Pei-Chi Kelly Hsiao, The University of Auckland* *Corporate Irresponsibility: The Price of Environmental Violations* Gladys Lee; Cameron Truong; Xinning	☐ **Disclosure** *Session Chair: Leye Li, UNSW Sydney* *Towards international accounting standards for human capital based disclosures: The value relevance of employee costs in the Australian mining industry.* Ananda Samudhram; Errol Stewart; Eu-Gene Siew; Jothee Sinnakkannu *Discussant: Lyndie Bayne, UWA* *Mandatory CFO Compensation Disclosure and CFO Performance* Dichu Bao; Lixin (Nancy) Su; Yong Zhang *Discussant: Jongwon Park, Monash University* *Exploring the comparability of non-financial performance measures in annual reports*	☐ **Interdisciplinary** *Session Chair: Nagaratnam Jeyasreedharan, Tasmanian School of Business and Economics, University of Tasmania* *Carbon Risk and Cost of Debt: Evidence from Natural Experiments* Justin Hung Nguyen; Noor Houqe; Bohui Zhang *Discussant: Thomas McInish, University of Memphis* *Does Brand Equity Diminish Earnings Management and Accounting Irregularities?* Fariz Huseynov; Ghada Ismail; Pankaj Jain; Thomas McInish *Discussant: christine helliar, University of South Australia* *Drought and Farm Intensification: Insights from New Zealand Dairy Farmers* Alissa Johnston; Rosalind Whiting; Ivan Diaz-Rainey	☐ **International Accounting 1** *Session Chair: Arshad Ali, University of Malakand* *Ownership Structures, Firm Value and Related Party Transactions: Evidence from GCC Firms* Ahmed Al-Hadi; Baban Eulaiwi; Grantley Taylor; Saurav Dutta *Discussant: Tien C. Nguyen, Auckland University of Technology* *VALUE RELEVANCE OF GOODWILL UNDER IMPAIRMENT AND AMORTIZATION REGIMES – THE ROLE OF COUNTRY-LEVEL INSTITUTIONS* Tien C. Nguyen; Asheq Rahman; Humayun Kabir *Discussant: Sorin Daniliuc, ANU* *EITI Implementation Experience and*	☐ **Public Sector / Not for Profit 1** *Session Chair: Janet Lee, The Australian National University* *Compromised steering and accountability the case of urban water management Ghana* Matthew Egan; Gloria Agyemang *Discussant: Antonius Sumarwan, School of Accountancy, Queensland University of Technology* *Credit Union Accountability A multi-case exploration of member-base social enterprises in lightly regulat context, Indonesia* Antonius Sumarwan; Belinda Luke; Craig Furneau *Discussant: Professor Zahirul Hoque*

University	*QUT*		Nam Tran *Discussant: Sue Wright, University of Newcastle*	Xiao *Discussant: Janice Loftus, University of Adelaide*	Lyndie Bayne; Marvin Wee; Ann Tarca *Discussant: Chuan Yu, UNSW Sydney*	*Discussant: Julie Harrison, University of Auckland*	*Perceived Control of Corruption* Olayinka Moses; Noor Houqe; Tony vanZijl *Discussant: Edmund Keung, National University of Singapore*	*La Trobe University* *Auditors' Propensity and Consistency in Issuing Going-Concern Modified Audit Opinions for Charitable Organisations* Yitang (Jenny) Yang; Roger Simnett; Elizabeth Carson *Discussant: Matthew Egan The University of Sydney*

10:30-16:30 ☑ **Research Interactive Sessions** (Great I)

Concept of Corporate Social Responsibility, Governance and Regulation – An Explorative Study of Starbucks
Manchuna Shanmuganathan

Real/Accruals Earnings Management and Analysts Forecast Prperties
Nigar Sultana; Harjinder Singh; Imran Haider; Tham Yuet Hong

THE AUSTRALIAN SKILLED MIGRATION POLICY: WHAT'S THE PROBLEM REPRESENTED TO BE?
Hock Thye Chan

Earnings Quality and the Clean Surplus
Javed Mahmood; Roger Willett; Paul Shantapriyan; Radzi Jidin

UNCHANGING ELEMENT IN A CHANGING WORLD? WOMEN IN ACCOUNTING ACADEMY
Camilla Soueneta Nascimento Nganga; William Martins de Gouveia; Silvia Pereira de Castro Casa Nova

Self-disclosure and closeness in HDR student-supervisor relationship
Amrinder Khosa; Steven Burch; Carla Wilkin

Fair values and audit fees: Evidence from Australian real estate industry
Pinprapa Sangchan; Ahsan Habib; Borhan Bhuiyan ; Haiyan Jiang

10:30-11:00 ☑ **Morning Tea Break** (Great I)

11:00-12:30 ☑ **Plenary Session 2** (Great IV)

12:30-13:20 ☑ **Lunch** (Great I)

13:20-14:20 **CONCURRENT SESSIONS 2 – WITHOUT DISCUSSANTS / PANEL DISCUSSION**

	Auditing	Corporate Finance	Corporate Governance	Corporate Social Responsibility	Education	Finance	Management Accounting
Great II	Crystal II	The Greys Room	Crystal I	Gallery 4	Great III	Gallery 1	Gallery 3
☐ **AASB Academic Advisory Panel Update** *Session Chair: Christine Helliar, University of*	☐ **Audit Fees 2** *Session Chair: Chun-Chan Yu, National Cheng*	☐ **Finance 1** *Session Chair: Lu Zhou, Macquarie University* *Pre-IPO media*	☐ **Board Diversity** *Session Chair: Paul Mather, La Trobe University*	☐ **Corporate Social Responsbility 2** *Session Chair:*	☐ **Technology / Self-Learning** *Session Chair: Nicola J. Beatson,*	☐ **Banking Related Issues 1** *Session Chair: Romalani Leofo,*	☐ **Emerging Management Control Systems** *Session Chair:*

South Australia	Kung University *How do Auditors Respond to Low Annual Report Readability?* Belen Blanco; Paul Coram; Sandip Dhole; Pamela Kent *READABILITY, TONE AND AUDIT FEES: SOME AUSTRALIAN EVIDENCE* Vincent Bicudo de Castro; Ferdinand Gul; Mohammad Muttakin; Dessalegn Mihret *Can an Audit Kill Two Birds with One Stone? Internal Control Audit Failure Rates and Audit Costs for Integrated vs. Non-integrated Audits: Evidence from China* Josh Gunn; Chan Li; Lin Liao; Shan Zhou	*coverage and after-market liquidity* Dixin Wu; Ka Wai (Stanley) Choi; Wanyun Li *Accessing Capital Markets during the World Cup in Football* Sturla Fjesme; Jin Lv; Chander Shekhar *ASIC Announcements - An Event Study* Lee Hall; Dean Earea; Adrian Gepp; Geoff Harris; Simone Kelly; Bruce Vanstone	*Foreign nationals on the board of directors of Russian public companies: Are they gate-keepers or a lobbying mechanism?* Oksana Kim *Does Board Turnover Enhance Firm Performance? A Contingency Approach* Kevin Koh; Wei Qiang; Yen H. Tong; Sze Sze Wong *Women on boards, firm risk and profitability nexus: Are women risk-averse or risk moderators?* Muhammad Nadeem; Tahir Suleman; Ammad Ahmed	Leanne Morrison, RMIT *Corporate Social Responsibility: The Myopic Barometer?* David K. Ding; Christo Ferrira; Udomsak Wongchoti *Corporate Social Responsibility (CSR) Performance, Earnings Quality and Cost of Equity* Sudipta Bose; Chuan Yu *Do CSR Performance Measures Help Reduce Performance Misattribution* Bo Qin; Lu Yang	University of Otago *Questioning the apparent lack of focus in accounting education on student self-questioning* Greg van Mourik; Ian Mitchell *Expanding Intelligent Tutoring Systems Design in Accounting Education: Investigating the use of a Constraint-Based Tutor for Capital Investment Decision-Making* Nick McGuigan; Antonija Mitrovic; Thomas Kern; Samantha Sin *The impact of free Wi-Fi in an academic setting on the academic performance of students in accounting courses: How it is utilised during class time.* Alena Golyagina; Michael Kend	National University of Samoa *Financial Relations among Private Sector and Monetary Financial Institutions: The ECM Approach* Renáta Pitoňáková *Loan Terms, Single Banking Relationship and Competition in China's Banking Market* Wei Yin; Kent Matthews *Supply Chain Counterparties' Managerial Ability Uncertainty and Corporate Bond Yield Spreads* Tsung-Kang Chen	Rebecca Tan, Th Australian National University *How founders' organizational blueprints influence the emergence of management control systems in early stage firm* Chris Akroyd; Ralph Kober *The Constructio of Comfort in Sc Numbers; The Case of a Public Private Partnership* Paul Andon; Jan Baxter; Wai Fon Chua *Walking the Tightrope: The Role of Management Control System in Balancing Social and Economic Imperatives in t Early Stages of Social Enterpris Life Cycle* Aldonio Ferreira; Maleen Gong; Ralph Kober; Lixian Zhou

14:30-16:00

CONCURRENT SESSIONS 3 – WITH DISCUSSANTS

Accounting History / Critical Perspectives	Auditing	Ball and Brown (1968)	Corporate Finance	Education	Finance	Financial Accounting	Management Accounting	Taxation
Gallery 2	**Crystal II**	**Great II**	**The Greys Room**	**Great III**	**Gallery 1**	**Crystal I**	**Gallery 3**	**Gallery 4**
☐ **Accounting History / Critical Perspective** *Session Chair: Muhammad Bilal Farooq, Auckland University of*	☐ **Audit Quality 1** *Session Chair: Juliana Ng, The Australian National University*	☐ **Special Session** *Session Chair: Marvin Wee, The Australian National*	☐ **Gender and Finance** *Session Chair: Kai Wai Hui, The University of Hong Kong* *Are Women*	☐ **Challenging Disruption** *Session Chair: Trevor Wilmshurst, TSBE,*	☐ **Anomalies / Behavioural Finance** *Session Chair: Abu Chowdhury, Stockholm University* *Social recognition and*	☐ **Financial Accounting** *Session Chair: Zhenghang Zhu, The Australian National University*	☐ **MCS - Design and Use** *Session Chair: Brian Burfitt, UNSW*	☐ **Taxatio** *Session Chai Grantley Taylor, Curti University* *Financial Statement*

Technology Accounting professionalization, the state and dialectics of transnational capitalism: the case of Iran Dessalegn Mihret; Soheila Mirshekary; Ali Yaftian *Discussant: Timothy Wang, THE UNIVERSITY OF SYDNEY* Early Funeral Insurance: The Unintended Consequences of Calculating Death Sandra VAN DER LAAN; Lee MOERMAN *Discussant: Dessalegn Mihret, Deakin University* Biodiversity accounting and reporting: A structured literature review Annika Schneider; Grant Samkin *Discussant: Giulia Leoni, RMIT University*	The Impact of Audit Committee Members' Reputation Incentives on Monitoring the Financial Reporting Process Eunice Khoo; Youngdeok Lim; Gary Monroe *Discussant: Zixuan Li, The University of Auckland* Benefits and Costs of the Enhanced Auditor's Report: Early evidence from Australia Yuzhen Wei; Neil Fargher; Elizabeth Carson *Discussant: David Hay, University of Auckland* The Impact of Corporate Reputation on the Timeliness of External Audit and Earnings Announcement Eunice Khoo; Youngdeok Lim; Gary Monroe *Discussant: Neil Fargher, The Australian National University*	University How efficient is the market for earnings information? Evidence from analysts' updating process Stephen Taylor; Alex Tong *Discussant: David Lont, University of Otago* Acquisition-year earnings and operating cash flow as measures of firm performance Jian Liang *Discussant: Richard Morris, UNSW Sydney* Use of Accrual Accounting Based Firm Fundamentals Information in Varying Levels of Investor Protection and Different Types of Financing (Equity or Debt Financing) Adnan Ahmad; Asheq Rahman; Mohay Khattak	Greener? Corporate Gender Diversity and Environmental Lawsuits Chelsea Liu *Discussant: Andrew Worthington, Griffith University* Board Gender Diversity and Acquisition Choices Syed Shams; Abeyratna Gunasekarage; Mehdi Khedmati *Discussant: Helen Choy, Drexel University* Female and R2 Saba Sehrish; David Ding; Nuttawat Visaltanachoti *Discussant: Abeyratna Gunasekarage, Monash University*	Univesity of Tasmania The Disruptive Changing Accounting University Environment: How Accounting Academics have been gazumped. Warrick Long; Lisa Barnes; Tony Williams; Maria Northcote *Discussant: Nick McGuigan, Monash University* Large lectures in the technological interactivity era: Value added or time waster? James Wakefield; Jonathan Tyler *Discussant: Carolyn Fowler, Victoria University of Wellington* Facing Failure Nicola J. Beatson; David A. G. Berg; Jeffrey K. Smith *Discussant: Paul de Lange, Curtin Business School*	investor overconfidence Bastian Breitmayer; Matthias Pelster *Discussant: Roger Colbeck, University of Tasmania* The Correlation Structure of Anomaly Strategies Paul Geertsema; Helen Lu *Discussant: Helen Roberts, University of Otago* Investor characteristics and trading activity under different market conditions Joey Yang; Marvin Wee; Daniel Richards *Discussant: Simone Kelly, Bond Business School*	The Role of Accounting Rules in Mitigating Managerial Myopia: The Case of Investment in Software Development and R&D Tami Dinh; Baljit K. Sidhu; Chuan Yu *Discussant: Kim Mear, Massey University* IFRS Adoption and Seasoned Equity Offering Underperformance Solomon Opare; Noor Houqe; Tony vanZijl *Discussant: Dichu Bao, Hong Kong Polytechnic University* Measuring Innovation Around the World Ping-Sheng Koh; David Reeb; Elvira Sojli; Wing Wah Tham *Discussant: Ava Wu, The University of Sydney*	Sydney Management control systems and managerial attention Rachael Lewis; David Brown; Nicole Sutton *Discussant: Ralph Kober, Monash University* Enabling control in a radically decentralized company Winnie O'Grady *Discussant: Jane Baxter, UNSW Sydney* The Influences of Internal Transparency and Global Transparency in an Enabling and Effective Technology-Structured Management Control System for New Product Development Angela Liew *Discussant: Ken Bates, Victoria University of Wellington*	Readability and Tax Aggressivene Christof Beuselinck; Belen Blanco; Sandip Dhole; Gerald Lobo *Discussant: Elizabeth Morton, RMI University* TAX DISCLOSURE LOST IN TRANSLATIO Elizabeth Morton *Discussant: Leah Meng , Curtin University* Corporate social responsibility corporate governance and tax have utilization: Empirical evidence fro Chinese firm Leah Meng ; Grantley Taylor; Alista Brown ; Ahmed Al-Hadi *Discussant: Sandip Dhole Monash University*

		Discussant: Mark Wilson, The Australian National University						

16:00-16:30 ☑ **Afternoon Tea** (Great I)

16:30-18:00 ☑ **Panel Discussion: "Practice Panel"** (Great IV)
Session Chair: Tony van Zijl, Victoria University of Wellington

18:00-19:00 ☑ **Networking Hour** (Great Room Prefunction)

Tuesday, 3 July 2018

8:30-18:30 ☑ **Exihibitions Open** (Great I)

8:30-9:30 **CONCURRENT SESSIONS 4 – FORUM**

Auditing	Corporate Governance	Corporate Social Responsibility	Education	Finance	Financial Accounting	Interdisciplinary	Management Accounting
Crystal II	**Crystal I**	**Gallery 4**	**Great III**	**Gallery 1**	**Great II**	**Gallery 3**	**The Greys Room**
☐ **Audit Fees 3** *Session Chair: Sarowar Hossain, UNSW Sydney* *Do Partners with Large Prestigious Audit Clients Earn Fee Premiums?* Stuart Taylor *The Volatility of Fair Value Measurement Inputs and Audit Fees in the U.S. Banking Industry* Feier Shang; Balijt K. Sidhu; Chuan Yu *Audit Pricing and Price Discrimination by Big 4 Auditors* Hooi Ying Ng; Per Christen Tronnes; Leon Wong *What Drives Differences in Audit Pricing Across the Globe?* Brigitte Eierle; Sven Hartlieb; David Hay; Lasse Niemi; Hannu Ojala	☐ **Board Composition** *Session Chair: Ling Mei Cong, RMIT University* *Gender Diverse Boards and Nomination Committees* Sama Kamal; Harjinder Singh; Nigar Sultana *The impact of board composition and ownership on strategic change* Ihssan Samara; Prof. Sunil Sahadev *Financial Expertise on the Audit Committee and Its Impact on Real Earnings Management* Husam Aldamen; Janice Hollindale; Jennifer Ziegelmayer *Does Board Gender Diversity Affect Corporate Cash Holdings?* Muhammad Atif; Benjamin Liu; Allen Huang	☐ **Carbon Performance and CSR Reporting** *Session Chair: Daniela Juric, Monash University* *Corporate social responsibility: Innovative reporting reflecting practice and performance* Tricia Ong; Hadrian Djajadikerta *Investigating Integrated Reporting and Corporate Social Responsibility Disclosures in New Zealand* Alex Randell; Mary Low *Diversity of US Boards and Carbon Disclosure: Evidence from the Carbon Disclosure Project Reports* Pallab Kumar Biswas; Larelle (Ellie) Chapple *Is culture a barrier or stimulus for corporate carbon*	☐ **Education Forum 1** *Session Chair: Michael Kend, RMIT University* *What? You want me to write?!* Keith Howson; Lisa Barnes; Warrick Long *Should industry direct constructive alignment in university teaching? A study of the accounting profession* Connie Vitale; Dorothea Bowyer *The persistent accounting stereotype: Why is it so resistant to change?* Paul Wells *Generic skills in accounting education: Perspectives of Saudi final year students* Mohammed Ali Al Mallak; Lin Mei Tan; Fawzi Laswad	☐ **Banking Related Issues 2** *Session Chair: Rui Ma, Massey University* *Consumption pattern, financial literacy and financial well-being: the course of retirement* Rui Xue; Adrian Gepp; Terry O'Neill; Steven Stern; Bruce Vanstone *Foreign Remittance and Financial Development in Sri Lanka: A Dynamic Modelling Approach* Niroshani Anuruddika Kumari Parahara Withanalage ; Nada Kulendran; Kumi Heenetigala *Ex-post Government Interventions & Banking Stability* Dulani Jayasuriya Daluwathumullagamage; Sumit Agarwal *Addressing the declining ICFS puzzle: Explanation of the access to bank lines of credit* Na Tan; Liang Chang; Yushu Zhu	☐ **Performance Measurement** *Session Chair: Hedy Huang, Massey University* *Accounting-based Regulations, Guanxi Orientation, and Fair Value Opinion Shopping in China: An Institutional Anomie Theory Perspective* June CAO *Assessing analysts' performance in forecasting GAAP and non-GAAP earnings* Serena Robino *Why do firm-year financial statement numbers conform to Benford's Law?* Noleen Yin; Neil Fargher *Non-GAAP Reporting in Australia and CEO Age* Imran Haider; Saurav Dutta; Nigar Sultana; Harjinder Singh	☐ **CSR / Interdisciplinary** *Session Chair: Xinning Xiao, Monash University* *The role of Corporate Social Responsibility on Earnings Management: Evidence from Asia-Pacific countries* Salmin Mostafa; Wee Ching Pok; Philip Palmer *PLAY THE GAME WHERE IT MATTERS: FIRMS' RANKINGS, CARBON DISCLOSURE AND PERFORMANCE* Binh Bui *The effect of carbon performance on the cost of equity of firms regulated under the EU ETS* Yimeng Chen; Janice Loftus; Grant Richardson	☐ **Accounting Behavioural Effects** *Session Chair: Umesh Sharma, University of Waikato* *Modes of Constitution: An Essay on Accounting Performativity* Lichen Yu; Christian Huber *A contingency-based investigation of customer accounting: The Australasian bank case.* Ken Bates; Carolyn Fowler; Ian Eggleton *Statistical Tests for Accounting Systems* Stijn Masschelein; Frank Moers *A qualitative study on the Vicious Cycle of Internal Audit in Iran* Bita Mashayekhi; Farzaneh Jalali

		performance? Le Luo; Qingliang Tang					

9:40-10:40

CONCURRENT SESSIONS 5 - WITHOUT DISCUSSANTS / PANEL DISCUSSION

	Accounting History / Critical Perspectives	Auditing	Corporate Governance	Education	Finance	Financial Accounting	Interdisciplinary	International Accounting
Great II	**Gallery 2**	**Crystal II**	**Crystal I**	**Great III**	**Gallery 1**	**Gallery 4**	**Gallery 3**	**The Greys Room**
☐ **Meet with the Editors** *Session Chair: Robert Faff, University of Queensland*	☐ **Accounting History/Critical Perspective** *Session Chair: Sandra VAN DER LAAN, University of Sydney* *Understanding how the competition between the ICAP and the ACCA and its impact on the Pakistani accounting profession* Muhammad Bilal Farooq *Challenging platform accountability in the sharing economy: the case of Airbnb* Giulia Leoni; Lee Parker *Faithful representation as an 'objective mirage': a Saussurean analysis of accounting and its participation in the credit crisis* Timothy Ganghua Wang; John Roberts	☐ **Audit Quality 2** *Session Chair: Feier Shang, University of Melbourne* *Do multiple links between CEOs, audit committees and audit partner affect audit fees and audit quality?* Sarowar Hossain; Gary Monroe; Gopal Krishnan *Home Country Characteristics and Private Firm Demand for Audit Quality* Shireenjit Johl; Peter Carey; Christine Contessotto *Audit Partner Gender Diversity and Audit Quality* Bin Srinidhi; Zhifeng Yang; Karen Zhang	☐ **Corporate Governance** *Session Chair: Tejshree Kala, The Australian National University* *Can Organizational Identity Mitigate the CEO Horizon Problem?* Margaret Abernethy; Like Jiang; Flora Kuang *Information and Communication Technology (ICT), Corporate Governance, and Firm Performance: An International Study* Noor Houqe; Binh Bui *Directors Network and Accruals Quality in Malaysia* Effiezal Aswadi Abdul Wahab; Janice How; Mohammad Faizal Jamaluddin; Peter Verhoeven	☐ **Global Trends** *Session Chair: Greg van Mourik, Monash University* *Undergraduate accounting students instructional preferences in Australia and Zimbabwe: A comparative study* Seedwell T. M. Sithole; Indra Abeysekera *What is your flavour? Matchmaking for accounting graduates* Sue Malthus; Carolyn Fowler; Carolyn Cordery *Professional Accounting Body Affiliation in a Developing Country: The Case of Membership Attraction in Vietnam* Frederique Bouilheres; Paul De lange; Gelnnda Scully	☐ **CSR** *Session Chair: Imran Haider, Curtin University* *Does compliance with Green Bond Principles bring any benefit to make G20's "Green economy plan" a reality?* Madurika Nanayakkara; Sisira Colombage *Return Performance of Ethical Stocks and Sin Stocks in Asia-Pacific* Sazali Abidin; JD Van Heerden; Carol Cheong; Linh Ho *TRANSPARENCY AND CRASH RISK: AN EMPIRICAL INVESTIGATION INTO THE US BANKS* Romalani Leofo; Shams Pathan; Mamiza Haq	☐ **Corporate Finance and Investing** *Session Chair: Ao Li, the Australian National University* *Management earnings forecasts and corporate bond financing of Chinese listed firms* Kun(Tracy) Wang ; Zhenghang Zhu *Priced Firm-Specic Risk and Accounting Information* david johnstone *Managerial Litigation Risk and Corporate Investment Efficiency: Evidence from Derivative Lawsuits* Leye Li; Gary S. Monroe; Jeff Coulton	☐ **Profession and Practice** *Session Chair: Rijadh Djatu Winardi, Universitas Gadjah Mada* *Linked ecologies as predator, niche construction as prey: the Italian Accounting Profession* christine helliar; Veneziani Monica; claudio teodori; Rocca Laura; louise crawford *The constraining effect of incomplete contracts on the public reporting of waste management data* Heinrich Oosthuizen; Roger Willett; Trevor Wilmshurst; Belinda Williams *Indigenous community connections*	☐ **International Accounting 2** *Session Chair: Tien C. Nguyen, Auckland University of Technology* *EARNINGS MANAGEMENT IN PRIVATE VIS-À-VIS PUBLIC EUROPEAN FIRMS* Jingwen Yang; Aziz Jaafar; Lynn Hodgkinson *The adaption of IFRS and their Implications for Alternative Investment Market: Qualitative Evidence from UK* Arshad Ali; Saeed Akbar; Phillip Ormrod *Interim Reporting Frequency and the Mispricing of Accruals* Shou-Min Tsao; Hsueh-Tien Lu; Edmund Keung

							and Aboriginal enterprise development in Australia Sarath Ukwatte Jalathge; Pavithra Siriwardhane; Prem Yapa	

10:40-16:00 ☑ **Research Interactive Sessions** (Great I)

Can firms live with unrealistic performance targets intentionally?
Syrus Islam

The Implementation of Accrual Accounting: A Lesson Learned of Basic Requirement Model at Local Governments in Indonesia
Deddi Nordiawan; Ayuningtyas Hertianti; Vidiya Arinanda

A Public View at All-inclusive Governance in Ghana's Oil Sector
Dr Emmanuel Tetteh Asare; Prof Bruce Burton; Theresa Dunne

The influence of parent-PMS on subsidiaries' decision-making: The perspectives of using process of parent-PMS and subsidiaries external embeddedness
Yudai Onitsuka

How do MNEs shift profits out of Indonesia?
Arnaldo Purba; Alfred Tran

The Association between Environmental Management Accounting Practices and Improving Environmental and Economic Performance: Evidence from Australian Cotton Farming
Shamim TASHAKOR; Ranjith Appuhami; Rahat Munir

Understanding accounting manipulation: A review of the contrasting features of finance-economics and social-psychology theories
Md Kazi Saidul Islam

10:40-11:10 ☑ **Morning Tea Break** (Great I)

11:10-12:40 ☑ **Plenary Session 3** (Great IV)

12:40-13:20 ☑ **Lunch** (Great I)

13:20-14:20 **CONCURRENT SESSIONS 6 - WITHOUT DISCUSSANTS**

Auditing	Ball and Brown (1968)	Corporate Governance	Corporate Social Responsibility	Education	Finance	Financial Accounting	Management Accounting	Public Sector / Not for Profit
Crystal II	Great II	Crystal I	Gallery 4	Great III	Gallery 1	The Greys Room	Gallery 3	Gallery 2
☐ **Audit Report** *Session Chair: Lei Zou, UNSW* *Assessing the Impact of the New Auditor's Report* Hong (Alice) Li; David Hay; David Lau *Risks of Material Misstatement, Materiality Level, and Client Firm*	☐ **Special Session** *Session Chair: Marvin Wee, The Australian National University* *Order Backlog Disclosure before Seasoned Equity Offerings* Szu-fan Chen; Zhihong Chen *Earnings Co-*	☐ **Ownership Effects 2** *Session Chair: Nigar Sultana, Curtin University* *Does Institutional Ownership Improve Firm Investment Efficiency?* Yue Cao; Yizhe Dong; Yu Lu;	☐ **Integrated and CSR Reporting 1** *Session Chair: Sudipta Bose, The University of Newcastle* *A Textual Analysis of U.S. Corporate Social Responsibility Reports* Gordon	☐ **Questioning What We Know** *Session Chair: Thomas Kern, The Accountability Institute* *Using cognitive load theory compliant instructional resources to enhance*	☐ **Finance 2** *Session Chair: Rui Xue, Bond University* *Variables influencing an individual's decision to establish an SMSF* Roger Colbeck; William Maguire *The impacts of symbiotic relationships on*	☐ **Corporate Decision Making** *Session Chair: June Cao, Macquarie University* *Related party transactions and the cost of debt: Evidence from China* Ahsan Habib; Hedy Huang; Jing Jia	☐ **Cost Accounting** *Session Chair: Angela Liew, University of Auckland* *Litigation Risk and Cost Behavior: Evidence from Derivative Lawsuits* Leye Li; Gary S. Monroe; Jeff Coulton	☐ **Public Sector / Not for Profit 2** *Session Chair: Janet Lee, The Australian National University* *Strategic versus calculative practices at a university* Dr Esin Ozdil; Professor Zahirul Hoque

	Characteristics: Evidence from the U.K. Yaqoub Alduraywish; Reza Monem; Pran Boolaky *Key Audit Matters Disclosure: A case study of negative consequences* Ray McNamara; Simone Kelly McNamara; Jestin Mathews	*Movements and the Informativeness of Earnings* Andrew Jackson; Chao Li; Richard Morris *Components of other comprehensive income and analyst forecasting behaviour* Neal Arthur; Victoria Clout; Tina Huynh; Meishan Mai	Diandian Ma *Flights-to-control: Time variation in the value of a vote* Paul Docherty; Steve Easton; Sean Pinder *Exit as governance: Qualified foreign institutional investor, state control, and stock price crash risk* Feng Xie; Jing Chi; Jing Liao	Richardson; Peter M. Clarkson; Albert Tsang *Sustainability Reporting* Eranga Weerakonda Arachchige ; Ruwan Wijesinghe *Climate Change Risk Reporting: A Discourse Analysis* Leanne Morrison; Jayanthi Kumarasiri ; Nava Subramaniam	*learning: students perceptions and preferences* Rina Datt; Seedwell T.M. Sithole *The Effect of Using Whiteboard Animation in Teaching Introductory Accounting Concepts* Tim Hasso *The extent to which university accounting education provide a foundation for exercising professional scepticism? – Views from auditors* Gina Xu; Gayle Morris	*Micro, Small and Medium Enterprises' performance: The mediating effects of interfirm relationships and business-bank relations* Ploypailin Kijkasiwat; Stuart Locke; Nirosha Hewa Wellalage	*The Influence of Conflict Risk on Investment Efficiency for Multinational Enterprises* Ao Li *The Effect of CFO Expertise on SEC Comment Letters* Jongwon Park; Soo Young Kwon; Jee-Hae Lim	*Corporate Strategy, Cost Stickiness and Analyst Forecasts* Minzhi (Cathy) Wu; Mark Wilson *Accounting for value in kind (VIK) sponsorship resources: a sporting organisation plays the VIK game.* Brian Burfitt; Jane Baxter; Jan Mouritsen	*Using Structuration Theory to Analyse the Budgeting Process for Iranian Universities* Farzaneh Jalali Aliabadi; Graham Gal

14:30-15:30	**CONCURRENT SESSIONS 7 – FORUM**							
	Auditing	**Corporate Governance**	**Corporate Social Responsibility**	**Education**	**Finance**	**Finance**	**Financial Accounting**	**Interdisciplinary**
	Crystal II	**Crystal I**	**Gallery 4**	**Great III**	**Gallery 1**	**Gallery 3**	**Great II**	**The Greys Room**
	☐ **Other Audit Issues** *Session Chair: Vincent Bicudo de Castro, Deakin University* *Audit Partner Busyness and Earnings Conservatism* Abhijeet Singh; Harjinder Singh *Audit Committee ownership and audit report lag: Evidence from Australia* Ahsan Habib; Md. Borhan Uddin Bhuiyan; Mabel D' Costa	☐ **Monitoring** *Session Chair: Niamh M. Brennan, University College Dublin* *Media Coverage and Investment Efficiency* Thu Huong Nguyen; Muhammad Jahangir Ali; Balasingham Balachandran; Huu Nhan Duong *Independent*	☐ **Corporate Social Responsbility 3** *Session Chair: Sumit Lodhia, University of South Australia* *Examining ship recycling-related disclosure practices of the global shipping industry* Craig Deegan; Suraiyah Akbar; Moriom Ferdousi	☐ **Education Forum 2** *Session Chair: Sue Malthus, Nelson Marlborough Institute of Technology* *Leadership in teams: Perspectives on the Ability, Willingness and Readiness of Australian Master of Professional Accounting*	☐ **Investments** *Session Chair: Joey Yang, University of Western Australia* *Market Volatility, Liquidity Shocks, and Stock Returns: Worldwide Evidence* Rui Ma; Hamish Anderson; Ben Marshall *Market liquidity*	☐ **Managerial Effects** *Session Chair: Adrian Melia, University of Newcastle* *New CEO Earnings Baths Pre- and Post-Sarbanes-Oxley* Helen Lu; Paul Geertsema; David Lont *Evidence of strategic news tone dispersion effects around*	☐ **Earnings Attributes** *Session Chair: Noleen Yin, ANU* *Are financial reports useful? The views of New Zealand public versus private users* Dimu Ehalaiye; Fawzi Laswad; Nives Botica Redmanyne; Warwick Stent; Lei Cai *Other*	☐ **Interdisciplinary Forum** *Session Chair: Rosalind Whiting, University of Otago* *Entropic Efficiency of Currency Markets* Nagaratnam Jeyasreedharan *Financial DEA modelling in accounting research* Julie Harrison; Li Chen; Yilin He; Frederick Ng; Paul Rouse

<table>
<tr>
<td>Audit Quality in New Zealand – Early Evidence from the Regulator
Elizabeth Rainsbury
Going Concern Audit Opinions: Are They Good News for Corporate Insiders?
Sandra Ho; Allan Hodgson; Zhengling Xiong
Are auditor disclosed materiality thresholds informative of firms' earnings quality? – Evidence from the revised ISA 700 audit report
Beng Wee Goh; Jimmy Lee; Dan Li; Na Li</td>
<td>Director Expectations Gap and Hindsight Bias
Mitch Bryce; Jahangir Ali; Paul Mather
Multiple Directorships and Board Meeting Attendance: The Moderating Role of Ownership
Bilal Latif; wim Voordeckers; Frank Lambrechts; Walter Hendriks
Government intervention in hostile takeover – the case of Vanke
Jing Gao; Ling Mei Cong; Wei Cai
Financial versus non-financial information for default prediction: Evidence from Sri Lanka and the USA
JM Ruwani Fernando; Leon Li; Greg Hou</td>
<td>ESG RISK MANAGEMENT IN MSCI WORLD COMPANIES: THE INFLUENCE OF INSTITUTIONAL INVESTORS
Natalia Semenova; Lars Hassel
It's Your Funeral: An Investigation of Pricing in the Funeral Industry in Australia
Sandra VAN DER LAAN; Lee MOERMAN; Tina Huynh; Colin Wong
CORPORATE SOCIAL RESPONSIBILITY STRATEGY, MANAGEMENT CONTROL SYSTEMS AND COMPANY PERFORMANCE
TITI SUHARTATI; ELVIA R SHAUKI; CHAERUL D DJAKMAN</td>
<td>students.
Heinrich Oosthuizen; Paul de Lange; Trevor Wilmshurst
Ubuntu, a way to look at cooperative learning
Karin Barac; Marina Kirstein; Rolien Kunz
Cultural identity in the transnational classroom: The student perspective
Meredith Tharapos</td>
<td>and funding liquidity: A comparative analysis between China and the United States
Xiaoxing Liu; Jiaxin Xu
Analyst Book Value Forecasts
Kai Wai Hui; Alfred Zhu Liu; Schneible Jr, Richard ; Guochang Zhang
Volatility Management in Carry Trade
Xihui Wang; Xing Han; Helen Roberts</td>
<td>opportunistic insider purchases
Dewan Rahman; Barry Oliver; Robert Faff
CEO Age and Analysts Forecast Properties
Harjinder Singh; Nigar Sultana; Imran Haider</td>
<td>Comprehensive Income Disclosures, Earnings Management, Corporate Governance and Firm Performance in China
YAN WANG; Yuan George Shan
Financial Distress, Internal Control and Earnings Management: Evidence from China
Yuanhui Li; Xiao Li; Erwei Xiang; Hadrian Geri Djajadikerta</td>
<td>Institutionalised Corruption in Indonesian Public Budgeting and Procurement
Rijadh Djatu Winardi
Measuring Intellectual Capital Efficiency of Information Technology Firms
Sriranga Vishnu</td>
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15:30-16:00 ☑ **Afternoon Tea** (Great I)

16:00-17:30 **CONCURRENT SESSIONS 8 – WITH DISCUSSANTS**

<table>
<tr><th>Auditing</th><th>Corporate Finance</th><th>Corporate Governance</th><th>Corporate Social Responsibility</th><th>Education</th><th>Finance</th><th>Financial Accounting</th><th>Financial Accounting</th><th>Management Accounting</th></tr>
<tr><th>Crystal II</th><th>Gallery 1</th><th>Crystal I</th><th>Gallery 4</th><th>Great III</th><th>Gallery 2</th><th>Great II</th><th>The Greys Room</th><th>Gallery 3</th></tr>
<tr>
<td>☐ Behavioural Audit
Session Chair: Leon Wong, UNSW Sydney
The Effect of</td>
<td>☐ Mergers & Acquisitions
Session Chair: Sorin Daniliuc, The Australian National</td>
<td>☐ Ownership Effects 1
Session Chair: Paul Docherty, Monash</td>
<td>☐ Integrated and CSR Reporting 2
Session Chair: Suraiyah Akbar, RMIT</td>
<td>☐ Contemporary Professional Skills
Session Chair: Seedwell T.M. Sithole, University</td>
<td>☐ Banking
Session Chair: Niroshani Anuruddika Kumari Parahara</td>
<td>☐ Accounting Policies
Session Chair: Serena Robino, The</td>
<td>☐ Financial Analysts/Earnings attributes
Session Chair: Ananda Samudhram, Monash University Malaysia
Evidence of a Positive</td>
<td>☐ MCS and Strategy
Session Chair: Rachael Lewis, UNSW Sydney
Effecting strategic change:</td>
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CSR Assurance and Combined Assurance on Investor Valuation Judgments Hien Hoang; Roger Simnett *Discussant: Harjinder Singh, Curtin University* *The Impact of Professional Skepticism and Anti-Retaliation Protection on Accountants' Whistle-Blowing Intention* Sarah Fu; Turner Michael; Monroe Gary *Discussant: Roger Simnett, UNSW Sydney* *The Effect of the Type of Accounting Standards and the Strength of the Regulation on Auditor's Evidence Demands* June CAO; Paul J. Coram *Discussant: Noel Harding, UNSW*	*University* *Takeover premium and bidder performance in relation to market optimism and CEO relative compensation: evidence from the Australian market* Hoa Luong; John Evans; Lien Duong *Discussant: Eden Quxian Zhang, Monash University* *The Asymmetric Private Information Mask: A Comparative Analysis of Private Equity Bids and Tender/Merger Offers* Sarah Osborne *Discussant: Haiyan Jiang, University of Waikato* *Why Do Distressed Firms Acquire?* Eden Quxian Zhang *Discussant: Saba Sehrish, Massey University, New Zealand*	*University* *Agreement and disagreement between shareholders and directors about corporate governance: What we learn about director primacy* Christofer Adrian; Sue Wright *Discussant: Peter Lam, University of Technology Sydney* *Do Institutional Owners Deter Earnings Management? A Meta-Analysis* Martin Mutschmann; Tim Hasso *Discussant: Feng Xie, Massey University* *The Wall Street Rule and its impact on board monitoring* Brandon Chen; Lien Duong; Thu Phuong Truong *Discussant: Nam Tran, University of Melbourne*	*University* *The Determinants of Voluntary Integrated Reporting* Pei-Chi Kelly Hsiao; Charl de Villiers; Tom Scott *Discussant: Shan Zhou, THE UNIVERSITY OF SYDNEY* *Corporate Governance, Integrated Reporting and the Use of Credibility-Enhancing Mechanisms on Integrated Reports* Ruizhe Wang; Shan Zhou; Timothy Wang *Discussant: Craig Deegan, RMIT University* *The ART of Accountability: Reporting of success rates by Assisted Reproductive Technology providers in Australia* Daniela Juric; Shannon Sidaway; Craig Deegan *Discussant: Mary Low, University of Waikato*	*of Tasmania* *Re-Considering 'Presage' in Accounting Education: A Fertile Research Area for Accounting Education* Nick McGuigan *Discussant: Jonathan Tyler, University of Technology Sydney* *Assurance of Learning - Achieving the Teamwork Criteria in Accounting Leaning Standards: A Case Study in Accounting* Heinrich Oosthuizen; Paul de Lange; Trevor Wilmshurst *Discussant: Lisa Barnes, Avondale College of Higher Education* *A cross-institutional phenomenographic study of accounting students' experiences of group work* Bernadette SMITH *Discussant: Paul Wells, Auckland University of Technology*	*Withanalage , Victoria University* *The Value Relevance of Regulatory Capital Components* Martien Lubberink; Roger Willett *Discussant: Mike Qinghao Mao, Deakin University* *Organizational Form, Business Strategies and the Demise of Demutualized Building Societies in the UK* Radha Shiwakoti; Abdullah Iqbal; Warwick Funnell *Discussant: Paul Geertsema, The University of Auckland* *Do Lower Returns on Bank Stocks Suggest Lower Cost of Capital? An Explanation for the Low Risk Anomaly and the Loan Growth Effect* Mike Qinghao Mao; K.C. John Wei *Discussant:*	*University of Western Australia* *The Value Relevance of Segment Reporting to Private Equity Investors for Target Acquisition Decisions: An Australian Analysis* Jacqueline Birt; Michael Kend ; Mahesh Joshi ; Maryam Safari *Discussant: Victoria Clout, UNSW Sydney* *The Influence of External Control on Comparative Conditional Conservatism in Australian Private and Public Companies under IFRS* Arthur Stenzel; Richard Morris *Discussant: Ping-Sheng Koh, ESSEC Business School* *Value Relevance of Deferred Tax Under IFRS* Kim Mear; Michael	*Trend in Positive Quarterly Earnings Surprises over the Past Two Decades* Paul Griffin; David Lont *Discussant: David Johnstone, University of Wollongong* *Political Corruption and Corporate Earnings Management* Huai Zhang; Jin Zhang *Discussant: Erwei Xiang, Edith Cowan University* *Composite Measures of Analyst Expertise, Earnings Quality and Forecast Bias* Ava Wu; Mark Wilson *Discussant: Andrew Jackson, UNSW Sydney*	*Management accounting and control systems in a telecommunications organisation* Umesh Sharma; Stewart Lawrence; Alan Lowe *Discussant: Cheng Hsu Lee, National Cheng Kung University* *Accountability, Distance-Repair, and Public-Private Partnerships: The Case of an Australian Prison* Paul Andon; Jane Baxter; Linda English *Discussant: Winnie O'Grady, University of Auckland* *Family Firm and Tax Aggressiveness in Taiwan: The Moderating Role of Corporate Opacity* Cheng Hsu Lee; Sudipta Bose *Discussant: Stijn Masschelein, University of Western Australia*

					Martien Lubberink, VUW - Wellington	Bradbury; Jill Hooks *Discussant: Maryam Safari, RMIT University*		

19:30-20:00 ☑ **Pre-dinner Drinks** (Great Room Prefunction)

20:00-23:45 ☑ **Conference Dinner / Dance and Awards Ceremony** (Great IV)

Create My Program

CIGAR 2018 Workshop: Sessions program

30 minutes per paper (15 minutes presentation + 5 min discussant + 10 minutes general audience)

5 July 2018, Thursday (*presenting author (s)*)

11:30 -13:00 Concurrent sessions		
Session 1: Transparency and Accountability, Lecture Room 54, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Eugenio Anessi Pessina		
Authors	Paper title	Discussant
Dorothea Greiling, Birgit Grüb, Andreas Glöckner	Financial accounting for European Public Private Partnership - Transparent disclosure of or possibility for concealing public debts?	Marco Bisogno
Beatriz Cuadrado-Ballesteros, *Marco Bisogno*, Francesca Citro	Explaining budget transparency through political institutions characteristics	Gianluca Zanellato
Adriana Tiron-Tudor, *Gianluca Zanellato*	Compliance Evolution Toward the International Integrated Reporting Framework: The case study of European Financial Institution Public and Private Organization in Contrast	Dorothea Greiling
Session 2: Auditing, Lecture Room 51, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Tjerk Budding		
Authors	Paper title	Discussant
Khalil Abushamsieh, Antonio M. Lopez-Hernandez, David Ortiz-Rodriguez	Accountability and Transparency in Arabian Organisations of Supreme Auditing Institutions	Luis Filipe Cracel Viana
David Hay, *Carolyn Cordery*	Evidence about the value of public sector audit to stakeholders	Khalil Abushamsieh
Luis Filipe Cracel Viana, Jose Antonio Moreira, Paulo Alves	Court of Auditors and Public Private Partnerships: The Portuguese Experience	Carolyn Cordery

5 July 2018, Thursday (*presenting author (s)*)

14:00 -15:30 Concurrent sessions		
Session 1: PSA in Emerging Economies (EEs), Lecture Room 54, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Dorothea Greiling		
Authors	Paper title	Discussant
Evgenii Aleksandrov, *Anatoli Bourmistrov, Giuseppe Grossi*	Performance budgeting and institutional work as a 'creative distraction' of accountability relations in a municipality	Qi Zhang
Qi Zhang, Yao Zheng	Disclosure for promotion: provincial leaders' political decisions of final accounts disclosure in China	Anatoli Bourmistrov
Session 2: Financial Management, Lecture Room 51, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Gorana Roje		
Authors	Paper title	Discussant
Nuno Ribeiro, Susana Jorge, Sonia Nogueira, Maria Antonia Jesus	A new approach to determinant factors of local government debt: Structural equations analysis	Eugenio Anessi Pessina
Christoph Schuler, Sandro Fuchs	Does the theory of change deliver new insights how to overcome the limits of PFM reforms?	Maria Antonia Jesus
Eugenio Anessi Pessina, Elena Cantu	Accounting for accountability or for recentralisation?	Sandro Fuchs

5 July 2018, Thursday (*presenting author (s)*)

16:00 -17:30 Concurrent sessions		
Session 1: Management accounting, Lecture Room 51, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Maja Letica		
Authors	Paper title	Discussant
Ivana Dražić Lutilsky, Tatjana Jovanović, Maja Letica	Analysis of internal reporting system in hospitals - Case study for Croatia, Slovenia and Bosnia and Herzegovina	Jelena Jurić
Martina Dragija Kostić, *Tatjana Jovanović, Jelena Jurić*	Cost management at higher education institution - Case of Bosnia and Herzegovina, Croatia and Slovenia	Ivana Dražić Lutilsky
Session 2: Performance information and Budgeting, Lecture Room 54, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Giuseppe Grossi		
Authors	Paper title	Discussant
Ricardo Lopes Cardoso, André Carlos Busanelli de Aquino, Rafael de Lacerda Moreira	A battle between the dominant budgetary logic and the competing financial reports logic: challenges to the implementation of accrual accounting by public sector accountants	Karina Kenk
Karina Kenk, Toomas Haldma	The use of performance information in the framework of mergers of local governments	Ricardo Lopes Cardoso

6 July 2018, Friday (presenting author (s))

9:00 -10:30 Concurrent sessions		
Session 1: Accounting and asset management, Lecture Room 51, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Johan Christiaens		
Authors	Paper title	Discussant
Lucia Biondi, Fabio Giulio Grandis, *Giorgia Mattei*, Fabrizio Mocavini	Financial reporting for heritage assets. Towards an International public sector accounting standard?	Nives Botica Redmayne
Dimu Ehalaiye, *Nives Botica Redmayne,* Fawzi Laswad	Does accounting information contribute to better understanding of public asset management? The case of local government infrastructural assets.	Gorana Roje
Gorana Roje, Nives Botica Redmayne	On the Management and Financial Reporting for State Assets - a comparative analysis between Croatia and New Zealand	Giorgia Mattei
Session 2: Accounting and Budgeting, Lecture Room 54, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Sandra Cohen		
Authors	Paper title	Discussant
Vesna Vašiček, *Jelena Poljašević,* Tatjana Jovanović	Dual reporting and approaches to accounting and budgeting basis adjustment - Cross country comparison	Giovanna Dabbicco
Giovanna Dabbicco, Giorgia Mattei	The reconciliation of budgets and accounts: A comparative study of Italy and the UK	José Manuel Vela-Bargues
Isabel Brusca Alijarde, Rosa María Dasí González, Amparo Gimeno Ruiz, Vicente Montesinos Julve, *José Manuel Vela-Bargues*	The role of National Accounting and Governmental Financial Statistics to measure financial sustainability and the integration of accounting systems	Jelena Poljašević

6 July 2018, Friday (presenting author (s))

11:00 -12:30 Concurrent sessions		
Session 1: Accounting and reporting practices, Lecture Room 51, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Andreas Bergmann		
Authors	Paper title	Discussant
Berit Adam, Isabel Brusca, *Eugenio Caperchione*, Jens Heiling (EY), *Susana Jorge,* Francesca Manes Rossi	Are higher education institutions in Europe preparing professionals in public sector accounting? A comparative analysis	Verica Budimir
Verica Budimir, Ivana Dražić Lutilsky, Davor Vašiček	Usage of performance indicators in Croatian higher education institutions	Renaldo Marques
Renaldo Marques, Patrícia Gomes, Maria José Fernandes	Heritage assets - The case of the certification of the construction of a traditional musical instrument in a public entity	Eugenio Caperchione
Session 2: PSA in Emerging Economies (EEs), Lecture Room 54, Center for Graduate Study Programmes (ground floor EAST)		
Session Chair: Chamara Kuruppu		
Authors	Paper title	Discussant
Chamara Kuruppu, Pawan Adhikari, Oleksandr Maksymchuk	Participatory Budgeting in a Ukrainian Municipality: What has happened in the process of diffusing participatory budgeting?	Indra Bastian
Indra Bastian, Surya Hadi Purnama	Leadership in the Follow-Up of Audit Findings: Case Study of River Basin Organization of Serayu Opak, Indonesia	Anamaria Dan
Adriana Tiron-Tudor, Tudor Oprisor, *Anamaria Dan*	Disclosure requirements in the municipal bonds markets	Chamara Kuruppu