IFRS NEWSLETTER
FINANCIAL INSTRUMENTS

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KPMG
cutting through complexity

"The IASB has made welcome progress in outlining plans to move forward its two ongoing financial instruments projects. However, the complexity of the topics means that there is a lot of work to do."

Chris Spall
KPMG's global IFRS financial instruments leader

The future of IFRS financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB's discussions in May 2015 on its financial instruments projects.

Significant progress was made at the IASB's May meeting, with the Board discussing the future direction of its projects on macro hedge accounting and financial instruments with characteristics of equity.

Highlights

Macro hedge accounting

- The project's first step will be to identify the information needs of constituents, before considering recognition and measurement requirements.
- It will prioritise dynamic interest rate risk management.
- An 'expert advisory panel' will be formed at a later stage in the project.

Financial instruments with characteristics of equity

- The Board discussed the conceptual and application challenges in distinguishing between liabilities and equity.
- Initially, the project will identify the characteristics of claims that create these challenges.
- It will then explore the possible solutions, which may involve amending IAS 32 *Financial Instruments: Presentation* or the definitions of a liability or equity.

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TWO PROJECTS SET IN MOTION

The story so far …

Macro hedge accounting

Although current IFRS – specifically, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* – provides models for macro hedge accounting, these contain restrictions that limit companies' ability to reflect some common dynamic risk management (DRM) activities; moreover, some of these models deal specifically with interest rate risk management rather than other types of risk. Without an accounting model that reflects the broader use of DRM activities, some have asserted that it can be difficult to faithfully represent these activities in financial statements.

In response to these issues, in April 2014 the IASB published its discussion paper *DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the DP) as the first due process document for the project. The DP puts forward an outline of one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which companies' managed exposures are identified and revalued for changes in the managed risk. As the project involves fundamental accounting questions and is not simply a modification to current hedge accounting models, the IASB did not proceed straight to issuing an exposure draft. Our publication New on the Horizon: Accounting for dynamic risk management activities provides a detailed analysis of the proposals.

Financial instruments with characteristics of equity

IAS 32 includes requirements for the classification of financial instruments between liabilities and equity. These binary classification requirements result in significant practice issues when applied to many financial instruments with characteristics of equity – other than, for example, typical non-redeemable common shares that pay discretionary dividends. In the past, the IFRS Interpretations Committee has received several queries in this area and in some cases was unable to reach a conclusion. The Committee referred some of these issues to the IASB, because the perceived issue required consideration of fundamental concepts in IFRS.

The Board issued a discussion paper *Financial Instruments with Characteristics of Equity* in 2008. However, due to capacity issues the Board could not issue an exposure draft on the topic and the project was halted. Since then, the Board has discussed some of the challenges as part of its project on the *Conceptual Framework for Financial Reporting*.

In October 2014, the Board resumed the project on financial instruments with characteristics of equity, deciding to split the project into two work streams – classification, and presentation and disclosures. The Board noted that the project may also result in amendments to the definitions of liabilities and equity in the Conceptual Framework. It did not formally revisit the project until May 2015.

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MACRO HEDGING: RESTARTING THE PROJECT

The Board agreed on the future direction of its macro hedging project.

What's the issue?

Respondents to the April 2014 DP broadly supported the macro hedging project, although several acknowledged that aligning financial reporting and DRM activities would be challenging.

Despite this general support, the Board identified significant diversity in views on the project's objectives. Many felt that the objectives were unclear, and different stakeholder groups seemed to have different views on what those objectives should be.

Preparers wanted to address accounting mismatches …

Based on the feedback received, preparers did not consider the transparent representation of DRM activities in the financial statements to be a priority for this project.

Instead, they seemed to support a project whose objective is to address accounting mismatches. Given the diversity of companies' DRM activities and techniques, it would be extremely challenging to develop a single accounting approach.

They also suggested that the PRA would be one mechanism, along with fair value and cash flow hedge accounting and the fair value option, to provide entities with the flexibility to best reflect their DRM activities.

… while users supported greater transparency of DRM activities …

Users broadly supported the project and the concept of the PRA. They considered it to be a step towards better alignment of financial reporting and DRM activities, based on the assertion that current IFRS does not provide sufficient information for DRM activities. Net interest income is a critical element for users in understanding a bank's performance, and, in their feedback, users noted that they need to consider both what is hedged and what is unhedged in order to see a complete picture of DRM activities.

However, there was no consensus as to:

- *where* the information about DRM activities should be shown – i.e. profit or loss, other comprehensive income or disclosures in the notes to the financial statements; or
- *how* the information should be shown – i.e. would disclosures be adequate without recognition and measurement of the PRA?

… and regulators had mixed views

Regulators' responses reflected a mixture of the views expressed by preparers and users, as outlined above. As such, they suggested that a balance should be struck between conflicting considerations.

The project's first step will be to identify the information needs of constituents, before considering recognition and measurement requirements.

What did the staff recommend?

The staff noted that:

- users have highlighted a lack of clarity in the information currently provided for DRM activities in the financial statements; and
- preparers feel that current disclosure requirements under IFRS 7 *Financial Instruments: Disclosures* do not necessarily reflect DRM activities.

Given that there was less diversity in respondents' feedback on these points, and given their importance, the staff recommended that the Board first identify these information needs and then consider the recognition and measurement requirements in order to arrive at a consistent set of proposals to address those needs. This would give the Board greater flexibility in considering how best to address the diversity in views in other areas.

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The Board will prioritise dynamic interest rate risk management.

In addition, the staff recommended that the Board:

- prioritise dynamic interest rate risk management and consider other risks at a later stage; and
- form an 'expert advisory panel' at a later stage, to assist the Board in its deliberations.

What did the IASB decide?

The Board agreed with the staff recommendations. Some Board members emphasised the following points.

- This is not a 'disclosure-only' project. It cannot be completed without considering the recognition and measurement requirements – e.g. disclosure of a core demand deposit cannot be made without considering how to measure it.
- Once the project's analysis of interest rate risk has been completed, the Board may discuss its application to other risks.
- The Board should not move too quickly in setting up an expert advisory panel, as the broad range of input received on the DP needs to be narrowed down. The Board should clarify what qualifications panel members would require, and what issues the panel would discuss.

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FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY: PROJECT STARTS IN EARNEST

Initially, the project will identify the characteristics of claims that create challenges in distinguishing between liabilities and equity. It will then explore the possible solutions, which may involve amending IAS 32 or the definitions of a liability or equity.

A binary classification model raises fundamental questions about how to account for certain characteristics of claims.

What's the issue?

The classification of financial instruments as liabilities or equity has a significant impact on their balance sheet presentation, on their measurement, and on how they affect an entity's financial performance.

However, the increasing complexity of financial instruments is making it difficult to distinguish between liabilities and equity.

What challenges did the staff identify?

The staff suggested that the challenges should be divided into two areas – conceptual and application – a distinction that will be helpful in determining the scope of the project. Addressing the *conceptual* challenges might require an amendment to IAS 32 and/or the Conceptual Framework, but addressing the application challenges in IAS 32 might only require an amendment to IAS 32.

The staff also considered the issues that different user groups, jurisdictions and entities might face.

Conceptual challenges

There are challenges relating to the rationale for distinguishing between liabilities and equity, and also the approach used in making that distinction. The staff perceive that these challenges arise because of the interaction between:

- the economic nature of claims against the entity; and
- the polarised financial reporting effects of classifying claims as liabilities or equity.

Financial innovation and growing investor needs have resulted in various types of contracts that include features (or characteristics) that distribute the amount, timing and uncertainty of cash inflows to the entity in different ways amongst the different claims against the entity.

Meanwhile, distinguishing between liabilities and equity leads to the following key differences in financial reporting.

	Liabilities	Equity
Financial position	Different presentation on the balance sheet.	
Measurement	Subject to specific subsequent measurement requirements – e.g. amortised cost or fair value.	Generally reflects the changes in total assets and total liabilities.
Financial performance	Changes in the carrying amount of liabilities – i.e. income and expense – are included in an entity's financial performance.	Changes in equity are *not* included in an entity's financial performance.
Disclosures/ presentation	Different categories and disclosure requirements apply.	Generally treated as a large homogeneous class, disregarding important differences between different classes of equity instruments.

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The staff used the following example transcations to demonstrate the conceptual challenges.

Transaction	Conceptual challenges
Put options written on non-controlling interests (NCI puts)	**What's the issue?** Sometimes, these transactions require the entity to repurchase shares in a subsidiary in exchange for cash, at the option of the counterparty (the NCI shareholder). In this example, the quantity of cash to be transferred is equal to the fair value of the underlying shares, and the option is exercisable on demand by the holder in perpetuity. The obligation to transfer cash is similar to that for a bond. However, the amount of cash to be transferred equals the value of the underlying share – so the return (and the risk of that return) on NCI puts is similar to that for ordinary shares. **What's the conceptual challenge?** If the NCI puts were classified as liabilities, then they would be measured in a similar way to a bond liability, and any related income or expense would be included in profit or loss. This would be inconsistent with the accounting for ordinary shares and the returns on them – i.e. returns on ordinary shares do not affect profit or loss. Conversely, if the obligation on NCI puts were classified as equity, then they would be accounted for in a similar way to ordinary shares. However, this would be inconsistent with: • the way an obligation to transfer cash – i.e. a financial liability – is measured; and • the accounting for any income or expense on that obligation – i.e. the returns on a liability are included in profit or loss.
Contingently convertible bonds	**What's the issue?** Sometimes, these instruments pay discretionary interest at the option of the entity and mandatorily convert to a variable number of the entity's own shares if the entity breaches its Tier 1 capital ratio. The value of shares delivered on conversion is equal to the face value of the claim. These instruments lack any obligation to transfer cash before liquidation of the entity, a feature that is similar to ordinary shares. However, they promise a return that is independent of the entity's performance – i.e. a fixed amount of currency – and are therefore similar to zero-coupon bonds (financial liabilities). **What's the conceptual challenge?** Classifying the obligation to transfer a variable number of shares as equity would be similar to the accounting for ordinary shares and the returns on them. However, this would be inconsistent with: • the way a financial liability is measured; and • the accounting for any income or expense on such an instrument. Conversely, if the instruments are classified as liabilities, then they would be measured in a similar way to a bond liability, and any related income or expense would be included in profit or loss. This would, however, be inconsistent with the accounting for ordinary shares and the returns on them.

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The staff argued that a binary classification between liabilities and equity cannot convey all of the similarities and differences between the transactions described above, and that it is therefore necessary to rethink these classification requirements.

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IAS 32 defines equity as a residual interest in an entity's net assets – i.e. its assets minus its liabilities. The notion of a residual interest can be thought of as having two aspects:

1. an equity-like return for the holder that reflects a variable interest in an entity's assets that remains after more senior or fixed claims have been satisfied; and
2. the absence of a contractual obligation for an entity to pay cash or other assets to the holder (except in a liquidation of the entity, and assuming that the holder cannot force liquidation).

Consistent with the staff's observations, conceptual challenges arise when an instrument has characteristics of both liabilities and equity – e.g. one, but not both, of these aspects is present.

The IASB has previously amended IAS 32 to allow certain puttable instruments that represent a residual variable interest to be classified as equity, even though they include an obligation to pay cash and therefore do not satisfy IAS 32's definition of equity. Effectively, Aspect 1 is present but not Aspect 2.

IAS 32's model generally focuses more on Aspect 2 in identifying equity instruments – e.g. a preference share with fixed but discretionary returns is classified as equity.

However, an obligation to deliver a variable number of shares is treated as a liability under IAS 32 – because although there is no actual obligation to pay cash, the entity is considered to be using its own shares as currency, and the returns to the holder are not necessarily consistent with those envisaged in Aspect 1. Also, under IAS 32, if a compound instrument has distinct equity and liability components, then they are classified and accounted for separately – e.g. some convertible debt instruments.

The application challenges generally relate to consistency, completeness and clarity of the IAS 32 requirements.

Application challenges

Applying the IAS 32 requirements to particular types of financial instruments can lead to challenges. These generally relate to the consistency, completeness and clarity of the IAS 32 requirements, and the appropriateness of any cost/benefit trade-offs, practical expedients and exceptions.

Some of the main application challenges that the staff identified include the following.

- Applying the fixed-for-fixed condition to derivatives on own equity (in particular, for foreign currency convertible bonds).
- Applying the requirement to recognise a 'gross' liability for derivatives that include an obligation for the entity to purchase its own equity instruments – e.g. NCI puts.
- The need to consider features introduced through statutory requirements (or regulatory overlays) in making the distinction. In some cases, it can also be difficult to distinguish a contractual obligation from a statutory obligation – e.g. mandatory tender offers, or some contingent convertible bonds where the conversion feature is introduced by regulations.
- Effects of features that are contingent on events beyond the control of the entity and the counterparty, and distinguishing events that are within the control of the issuer from those that are beyond its control – for example:
  - NCI puts where the share is puttable if the holder dies; and
  - contingent convertible bonds whose conversion is contingent on the entity's regulatory capital position or a regulator's actions.
- The lack of guidance on how to account for transactions within equity.

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- The lack of guidance on classifying discretionary payments made on instruments that are wholly classified as liabilities.

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In our experience, the main areas in which applying IAS 32 has proved problematic are:

- the role of 'economic compulsion' and 'substance' in the classification of financial instruments, which is restricted to consideration of the contractual terms of an instrument;
- the interaction of statutory requirements with the contractual terms;
- contingent settlement terms, including application of the 'not genuine' concept;
- the 'fixed-for-fixed' principle – i.e. a fixed amount of cash in return for a fixed number of equity instruments – for contracts that will be settled in the issuer's own equity instruments;
- the gross presentation and measurement of a financial liability arising from an obligation to repurchase own equity instruments; and
- the requirements on derivative contracts with settlement options.

Chapter 7.3 of KPMG's Insights into IFRS 11th edition 2014/2015 offers extensive guidance on IAS 32's classification requirements.

Different user groups, jurisdictions and entities are affected differently by these issues.

User-specific issues

The staff noted that users of the financial statements will be the stakeholder group most affected by issues relating to the distinction between liabilities and equity. However, different users will have different perspectives.

User	Needs
Investors (or potential investors)	Investors generally need information in the financial statements that will help them assess: • the prospects for future net cash inflows to the entity; and • the return they expect from investing in debt or equity instruments. Any features that affect future cash flows are relevant to the investor's assessment of those cash flows. Therefore, those features and their effects need to be faithfully represented in the financial statements. Reducing the various types of claims, with their range of similarities and differences, to a binary distinction does not faithfully represent all of those similarities and differences. This can lead to users making errors when estimating the cost of capital and the expected return on investments.
Regulators	Regulators are interested in how an entity's financial position and performance are represented, and their interaction with regulatory reporting and other requirements.
Preparers	Preparers want to represent their capital structure as faithfully as possible, with minimal complexity and limiting the costs of applying the accounting requirements.
Auditors	Auditors are interested in the auditability of the requirements, robustness of the distinction, and the complexity and cost of applying the accounting requirements.

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The information in which investors are interested may depend on the nature of the investments they hold. For example, holders of ordinary shares will generally have a keen interest in how returns on other classes of shares with preferential claims are determined – since those claims will reduce the amounts available for distribution on ordinary shares. The allocation of returns between these classes may be of less interest to holders of debt instruments, because their claims rank above those of equity holders; however, creditors will be interested in the extent of an issuer's ability to make distributions to equity holders that reduce the resources remaining within the entity that are available to satisfy those creditors' claims.

Jurisdiction-specific issues

Different capital structures have evolved over time in different jurisdictions, and particular regulatory or legal structures may be more common in one jurisdiction than another. For example:

- the issues could be pervasive to takeover transactions in jurisdictions where mandatory tender offers on acquisition of a controlling interest are common regulatory requirements;
- the effects could be acute for some entities in certain jurisdictions where it is common (although not a legal requirement) for significant NCI shareholders to be offered a put option on their shares on an acquisition; and
- entities in developing economies often issue foreign currency convertible bonds to access more developed foreign capital markets.

Entity-specific issues

The staff noted that many different types of entities might be affected, because of the wide variety of financial instruments being issued and the fundamental nature of the distinction between liabilities and equity – for example:

- financial institutions are transacting in different types of 'bail-in' instruments following the introduction of new capital rules by banking regulators; and
- non-financial corporates issue 'hybrid' securities for various reasons, including capital management, tax, and investor demands for higher yields.

The staff recommended that the Board identify and discuss which characteristics of claims could be relevant in making the distinction between liabilities and equity.

What did the staff recommend?

The staff recommended that the starting point should be to identify which characteristics of claims are relevant when distinguishing between liabilities and equity. They believed that identifying the characteristics would also help in assessing whether any potential subclasses are needed within liabilities and within equity, to provide useful information to the users of financial statements.

Although the distinction between liabilities and equity is a significant issue for certain types of instruments, the staff noted that for most claims classification has not presented challenges. Therefore, the staff urged caution in identifying a potential solution to any challenges identified, to ensure that it avoids unnecessary changes and does not introduce unintended consequences.

Addressing the conceptual challenges

The staff recommended that the Board discuss which characteristics of claims are relevant to the distinction, and the information needs of users in making their assessments. They also suggested that the Board consider the need to develop a definition of – and recognition, measurement and presentation requirements for – equity.

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Addressing the application challenges

The staff recommended that the Board consider challenges in accounting for derivatives on own equity, and how IAS 32 deals with those challenges – in particular, the 'fixed-for-fixed' condition and obligations in derivatives to redeem own equity instruments.

They also suggested that the Board discuss the IAS 32 requirements that deal with:

- the interaction of contractual rights and obligations with regulatory and legal overlays;
- substance over form;
- contingencies and conditionality; and
- the recognition, derecognition and reclassification of equity instruments (and components), including on settlement, conversion, expiration, modification and other events.

What did the IASB discuss?

The Board did not make any decisions during this meeting. However, individual Board members agreed with the staff's analysis of the main challenges in distinguishing between liabilities and equity under IAS 32, and with the proposed approach to address these challenges as part of the project.

During the discussion, one Board member suggested that the project should consider introducing a third category – e.g. a hybrid or mezzanine category – for financial instruments with characteristics of both liabilities and equity. This suggestion received a mixed response from the other Board members. Some agreed with the suggestion, but many believed that the project's scope should be restricted to identifying possible solutions – mainly through presentation and disclosures – within the confines of the binary distinction under the Conceptual Framework.

One Board member emphasised that careful consideration would be needed when considering potential subclasses of equity, because the elements of equity are generally subject to legal and regulatory requirements in different jurisdictions.

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A new third category – as suggested by one Board member – would require changes to the Conceptual Framework, which currently recognises a binary distinction between liabilities and equity. US GAAP currently has an additional classification whereby certain instruments – e.g. an equity share that is puttable at the option of the holder – are presented as 'temporary equity', which is between total liabilities and equity. For more details, see Chapter 7.3 of KPMG's IFRS compared to US GAAP.

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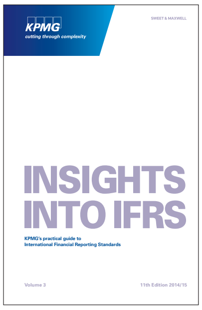
Insights into IFRS: Volume 3 – IFRS 9 (2014)



Builds on previous publications to bring you our first complete work of interpretative guidance based on IFRS 9 (2014).

April 2015

First Impressions: IFRS 9 *Financial Instruments*

Provides our detailed analysis on the complete version of IFRS 9 *Financial Instruments*.

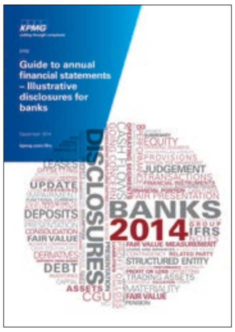
September 2014

IFRS Newsletter: IFRS 9 Impairment – Issue 1

Highlights the discussions of the IFRS Transition Group for Impairment of Financial Instruments on the impairment requirements of IFRS 9.

April 2015

Guide to annual financial statements – Illustrative disclosures for banks



Illustrates one possible format for financial statements based on a fictitious bank and helps to identify which disclosures may be required.

December 2014

IFRS Newsletter: Revenue – Issue 13

Examines the latest developments on the new revenue standard.

March 2015

IFRS Newsletter: Insurance – Issue 44

Summarises the IASB's recent discussions on the insurance contracts project.

March 2015

IFRS Newsletter: Leases – Issue 17

Highlights the recent discussions of the IASB and the FASB on their lease accounting proposals published in 2013.

March 2015

Breaking News

Brings you the latest need-to-know information on international standards in the accounting, audit and regulatory space.

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