IFRS NEWSLETTER
FINANCIAL INSTRUMENTS

Issue 25, July 2015

cutting through complexity

"The likely end-point for mandatory adoption of IFRS 9's new general hedging model remains some years away given the Board's plan to issue a second discussion paper on macro hedging."

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 July 2015 on its financial instruments projects.

Highlights

Accounting for dynamic risk management – Macro hedging

- The IASB plans to publish a second discussion paper before issuing an exposure draft.
- The Board approved the staff's proposed scope and approach for identifying the information needs of constituents.
- This may include information about risk exposures of entities that do not undertake dynamic risk management activities.

Financial instruments with characteristics of equity

- The Board discussed the various assessments that users might make using information in the statements of financial position and performance.
- It identified the features of claims that are relevant to those assessments.

PROGRESS ON BOTH FINANCIAL INSTRUMENTS PROJECTS

The story so far …

Accounting for dynamic risk management – Macro hedging

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 entities' 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 2014 DP) as the first due process document for the project. The 2014 DP puts forward an outline of one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which entities' 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 (ED). 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 *Financial Instruments: Presentation* 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 DP *Financial Instruments with Characteristics of Equity* in 2008. However, due to capacity issues the Board could not issue an ED 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*[1].

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, when it discussed the conceptual and application challenges in distinguishing between liabilities and equity.

In June 2015, the Board identified features that are relevant in measuring claims and in distinguishing between liabilities and equity. It noted that a feature is relevant if it has the potential to affect the prospects for future cash flows and said that it would analyse the relevance of these features for assessments that users might make as a next step in the project.

1. The IASB recently published the ED *Conceptual Framework for Financial Reporting* (ED/2015/3). References to the Conceptual Framework in this newsletter are references to the existing *Conceptual Framework for Financial Reporting*.

ACCOUNTING FOR DYNAMIC RISK MANAGEMENT – MACRO HEDGING

The Board plans to publish a second discussion paper before issuing an exposure draft.

Due process

What's the issue?

Respondents to the 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 respondents felt that the objectives were unclear, and different stakeholder groups seemed to have different views on what those objectives should be.

Based on these comments and feedback, it may not be appropriate to move on to an ED of a proposed standard without further research and consultation.

What did the staff recommend?

The staff recommended that:

- the project should remain as a research project instead of being transferred to the IASB's standards agenda; and
- the Board should publish a second DP before issuing an ED.

The staff believed that the benefits of publishing a second DP would include:

- more effective consultation with stakeholders to explore the different views in greater detail and ensure that the proposals in the subsequent ED are more widely supported;
- greater flexibility in considering how best to address the diversity in views;
- the possibility that new accounting approaches which more faithfully represent DRM activities might emerge in redeliberations;
- a clearer understanding of the proposed accounting model and how it reflects the financial effects of DRM activities on interest rate risk;
- better opportunities for field testing various approaches; and
- reduced risk of significant changes to the model proposed in the subsequent ED, since the principles and their operability will have been more thoroughly tested.

However, the staff recommended that the Board keep open the possibility of moving directly to an ED if a solution emerges that addresses the disclosure, recognition and measurement issues.

What did the IASB discuss?

Some Board members mentioned the difficulties associated with identifying solutions to the issues raised by stakeholders – in particular, the comparability between entities that do and do not undertake DRM activities – which indicated that being able to move directly towards an ED was unlikely.

What did the IASB decide?

The Board agreed with the staff recommendations.

KPMG Insight

The Board's tentative decision to undertake extensive and fundamental further research with the aim of progressing towards a second DP – rather than feeling able to move more swiftly towards an ED of a new standard – indicates that completion of the project is likely to be a number of years into the future.

Currently, IFRS 9 contains a new general hedge accounting model but the IASB has allowed entities to choose to continue to apply the hedge accounting requirements of IAS 39 rather than adopt that new model. The Board has stated that this choice is intended to run until the project on accounting for macro hedging is completed – therefore, it seems that the longer it takes to complete the project on accounting for macro hedging, the longer entities may continue to choose to apply IAS 39's hedge accounting requirements. For more information, see Section 12.2 in our First Impressions: IFRS 9 (2013) – Hedge accounting and transition.

The Board approved the staff's proposed scope and approach for identifying the information needs of constituents.

This may include information about risk exposures of entities that do not undertake dynamic risk management activities.

Identifying the information needs of constituents

What's the issue?

During its May 2015 meeting, the Board decided to identify the information needs of constituents as a first step in continuing the project.

In the July meeting, the staff sought feedback from the Board on the approach to be taken. The staff focused on the following questions.

- What does 'useful information' mean?
- Whose information needs are being identified?
- Why do they need this information?
- What sources will the staff use?

What approach do the staff plan to take?

What does 'useful information' mean?

The staff identified the qualitative characteristics of useful information described in the Conceptual Framework – that it has to be 'relevant' and provide a 'faithful representation'. The Conceptual Framework goes on to state that the usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. The staff also noted that the process for identifying the useful information should consider the benefits and costs of reporting that information.

Based on the feedback received on the 2014 DP, the staff stated the following views on the analysis to be performed.

Feedback on the 2014 DP	Staff views	Reasons for the staff views, and further considerations
Concern over comparability between entities that dynamically manage interest rate risk and those that do not	The project should also consider any useful information on entities that do not undertake DRM activities but are exposed to interest rate risk – rather than only focusing on the information needs for DRM activities.	• If the project only focuses on the information needs for DRM activities, then entities that do not undertake DRM activities but have material net risk exposures would be outside the scope of the project. In this case, entities that undertake DRM activities could be seen as riskier than entities that do not. • 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.

Feedback on the 2014 DP	Staff views	Reasons for the staff views, and further considerations
Significant diversity in views on the project's objectives between users and preparers	One way of solving this issue is to concentrate the analysis on the main features of DRM activities.	• Constituents' needs and concerns should be analysed in detail against the qualitative characteristics in the Conceptual Framework – e.g. whether information arising from behaviouralisation[2] provides a relevant and faithful representation, and any concerns over this information.

Whose information needs are being identified?

The staff identified that the information needs of users and preparers are the main focus, and made the following observations.

Users	The staff will mainly focus on information that is useful to existing and potential investors, lenders and other creditors.
Preparers	The representation of DRM activities and the information arising from this representation in the financial statements is a key area of interest.

Although regulators have a significant interest in this project, the staff do not think it is important to specifically address their information needs because the regulators can require entities to provide information directly to them.

Why do they need this information?

Feedback received on the 2014 DP identified that:

- users consider that a closer alignment of financial reporting and DRM activities would provide useful information; and
- preparers think that financial reporting would improve if they were able to convey information about their DRM activities in a direct manner.

The staff noted that proxy hedging[3] is a clear example in which the information provided to users currently does not reflect what entities do, and for which both users and preparers would prefer more useful information.

The staff also noted that constituents need information on DRM activities for the following reasons.

- Existing IFRS does not always represent DRM activities, because it deals with one-to-one hedging relationships between the hedged item and the hedging instrument.
- It helps promote better understanding of management's decisions – e.g. if an entity decides to intentionally leave net open risk positions unhedged, this information may be useful to users so that they can better understand and assess the entity's risk exposures and the rationale for management's corresponding decisions.
- It allows users to assess the impact of DRM activities on net interest income (NII). In other words, NII before and after DRM activities, and derivatives disaggregated by use – i.e. DRM activities and trading – would provide useful information to users.

2. This allows entities to focus on the expected cash flow profile, rather than on the contractual lives of the exposures.
3. Proxy hedging takes place when an entity hedges an item, but then designates another item for accounting purposes.

What sources will the staff use?

As well as performing a further review of the feedback received on the 2014 DP, the staff plan to review various other sources – e.g. financial statements and regulatory information – to identify information needs.

What did the IASB discuss?

Some Board members referred to the key issues in the feedback being about whether the project should be about hedge accounting or about disclosure of risk management. It was noted that users may be interested in disclosures about whether an entity carries out DRM activities and – whether it does or not – the entity's risk exposures. One Board member referred to two related problems in addition to DRM activities: the limitations of cost-based reporting of, for example, net interest margin; and reporting hedges of future net income, including associated accounting mismatches.

The staff responded that there were a number of interlinked problems; after identifying the relevant information needs, they hoped to separate issues according to the problems they posed, with the aim being to find different solutions to different problems, rather than trying to find a single solution to several different problems.

What did the IASB decide?

The Board agreed with:

- the staff's proposed scope – namely that the project should also consider useful information on entities that do not undertake DRM activities but are exposed to interest rate risk, rather than focus only on the information needs for DRM activities; and
- the staff's proposed approach for identifying the information needs of constituents.

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Users make various assessments using different parts of the financial statements, based on their information needs.

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.

Now that the Board has identified features of claims that it believes are relevant to distinguishing between liabilities and equity, the next important step is to map those features to the various assessments users might make using information in the statement of financial position and the statement of financial performance. Some of these assessments are mentioned in the Conceptual Framework.

General-purpose financial statements provide information about a reporting entity's financial position – i.e. its economic resources and the claims against it. They also provide information about the effects of transactions and other events that change the entity's economic resources and claims. Users make various assessments using different parts of the financial statements. These assessments are relevant to distinguishing between liabilities and equity.

The staff described the types of assessments that users might make, and the features that are relevant to them.

What did the staff recommend?

The Board previously identified the following features that are relevant in *measuring* claims – namely, the:

- type of economic resource required to settle the claim;
- timing of the transfer of economic resources required to settle the claim;
- amount or quantity of economic resources required to settle the claim;
- priority of the claim relative to other claims; and
- conditions or contingencies attached to the claim.

The staff therefore identified the assessments that users make based on information in the statement of financial position and statement of financial performance, and described the features that are relevant to those assessments. To illustrate the consequences of distinctions between claims, the staff used the same examples of instruments that were used at the June 2015 meeting. We have reproduced the table explaining these examples below, for ease of reference.

Type of claim	Explanation
Ordinary bonds	The entity has an obligation to transfer an amount of cash, equal to an amount specified in a particular currency, at a specified time before liquidation and senior to all other claims.
Shares redeemable for their fair value	The entity has an obligation to settle the claim with cash, at fair value, at a specified time before liquidation or on demand of the holder. However, like ordinary shares (see below), they do not specify the amount of economic resources and claims that the entity needs to pay – i.e. the fair value of the shares reflects the total amount of recognised and unrecognised economic resources and other claims.

Type of claim	Explanation
Share-settled bonds	These claims do not require the entity to settle the claim using economic resources – i.e. the entity uses a variable number of its own ordinary shares of an equal value to the amount specified instead of cash. Although these claims are not required to be settled with economic resources before liquidation of the entity, conversion to a claim with different features is required before liquidation. However, like ordinary bonds, they specify the amount or rate of change in amount that the entity requires to settle the claims.
Cumulative preference shares	These claims are not required to be settled before liquidation of the entity. However, like ordinary bonds, they specify the amount or rate of change in amount that the entity requires to settle the claims.
Ordinary shares	The entity has no obligation other than the obligation to transfer at liquidation a share of whatever type, and amount, of economic resources remain under the entity's control after meeting all other claims.

Assessments of financial position

The Conceptual Framework explains that financial statements provide information about an entity's financial position – i.e. its economic resources and the claims against it. This information helps users assess the reporting entity's:

- financial strengths and weaknesses;
- liquidity and solvency; and
- needs for financing and ability to obtain financing.

The staff identified two possible types of assessment of financial position that users might make.

Assessment A	The extent to which the entity is expected to have the economic resources required to meet its obligations as and when they fall due.
Assessment B	The extent to which the entity has sufficient economic resources to satisfy the total claims against it at a point in time.

The following table outlines these assessments, their relevant features and the distinctions between claims. It also illustrates how these distinctions apply to the example instruments.

Relevant features	Potential implications for classification	How this applies to the example instruments
Assessment A		
• Timing of transfer of economic resources • Type of economic resources required to be transferred • Amount (or quantity) of economic resources required to be transferred	• If the claim contains an obligation to transfer economic resources at a specified time prior to liquidation, then the amount and type of economic resources to be transferred is relevant and the claim should be classified as a financial liability. • If the claim is only settled at the time of liquidation, then other features are not relevant and the claim should be classified as equity. • Within liabilities, additional sub-classifications may include a distinction between claims that require different types of economic resources, or that require settlement at different times prior to liquidation.	• Ordinary bonds and shares redeemable at fair value are classified as financial liabilities because the entity is obliged to transfer economic resources on redemption prior to liquidation. • Ordinary shares and cumulative preference shares are classified as equity because the entity is not obliged to transfer any economic resources prior to liquidation. • Share-settled bonds are classified as equity if the entity has the ability to issue the required number of shares, because the entity is not obliged to transfer any economic resources prior to liquidation. However, if the entity does not have the ability to issue the shares and is required to purchase existing shares to transfer to the holder, then the claim is classified as a financial liability because the entity will be obliged to transfer economic resources prior to liquidation.
Assessment B		
• Amount (or quantity) of economic resources required to be transferred • Priority (or seniority/rank) of the claim relative to other claims	• If the specified amount of the claim is independent of the availability of the entity's actual economic resources, then the priority of the claim on liquidation will also be relevant and the claim should be classified as a financial liability. • If the specified amount of the claim depends on the availability of the entity's actual economic resources, then other features are not relevant and the claim should be classified as equity. • Within liabilities, additional sub-classifications may include a distinction between claims that have different levels of priority on liquidation, or that specify different levels of variability in the specified amount.	• Ordinary bonds, share-settled bonds and cumulative preference shares are classified as financial liabilities because the claims specify an amount that is independent of the entity's economic resources. • Ordinary shares and shares redeemable at fair value are classified as equity because the amount of the claim is dependent on the availability of the entity's actual economic resources.

To summarise, the example instruments would be classified as follows under the two assessments.

Instrument	Assessment A	Assessment B
Ordinary bonds	Financial liability	Financial liability
Shares redeemable for their fair value	Financial liability	Equity
Share-settled bonds	Equity/Financial liability	Financial liability
Cumulative preference shares	Equity	Financial liability
Ordinary shares	Equity	Equity

Assessments of financial performance

The Conceptual Framework explains that financial statements provide information about the effects of transactions and other events that change the entity's economic resources and claims. To assess the prospects for future cash flows from the entity, users need to be able to distinguish between changes in the entity's economic resources and claims that result from:

- the entity's financial performance; and
- other events or transactions, such as issuing debt or equity instruments.

Information about financial performance helps users to understand the return that the entity has produced on its economic resources.

The staff have identified two potential types of assessment of financial performance that users might make.

Assessment X	The components of changes in economic resources, other than changes resulting from contributions from issuing claims or distributions from settling claims.
Assessment Y	A comparison of the returns on the entity's economic resources to the promised returns of the entity's claims.

Assessment X helps in assessing the entity's past and future ability to generate net cash inflows through its operations, rather than by obtaining additional resources directly from investors and creditors. Information about changes in the entity's economic resources are based on IFRS requirements that deal with the accounting for an entity's assets and are unaffected by claims or their features.

To the extent that the obligations imposed by claims require an entity to change its economic resources, those changes are reflected as and when they occur, in accordance with the recognition and measurement requirements for those economic resources. (For this reason, Assessment X has not been included in the table below.)

The following table outlines Assessment Y only.

Relevant features	Potential implications for classification	How this applies to the example instruments
Assessment Y		
• Amount (or quantity) of economic resources required to be transferred • Priority (or seniority/rank) of the claim relative to other claims	• If the claim specifies an amount that is independent of the actual returns on the entity's economic resources, and therefore specifies a promised return, then there might be a difference between the returns that the entity has actually produced on its economic resources and the returns that it is obliged to produce to meet its claims. How this difference is distributed amongst the claims depends on their relative priority on liquidation. The claim should be classified as a financial liability, and changes in these claims will be treated as income or expense. • If the claim specifies an amount that is dependent on the actual returns on the entity's economic resources and on higher-priority claims, then no further information is required, other than information about the performance of the entity's economic resources. The claim should be classified as equity. An increase in assets will be reflected as income or returns attributable to equity claims, and a decrease will be reflected as expense or losses attributable to equity claims. Changes in measuring the equity claims will not be treated as income or expense. • Changes in claims classified as liabilities will be shown within the same total. Changes in claims classified as equity will also be shown within the same total. However, additional sub-classifications may include a distinction between claims that have different levels of priority on liquidation, or that specify different levels of variability in the specified amount.	• Ordinary bonds, share-settled bonds and cumulative preference shares are classified as financial liabilities because the claims specify a promised return that is independent of the actual return on the entity's economic resources. • Ordinary shares and shares redeemable at fair value are classified as equity because the claims specify a return that is dependent on the actual return on the entity's economic resources and higher-priority claims.

KPMG Insight

For some types of financial instrument, a user's preferred classification of it as financial liability or equity would differ depending on the type of assessment that the user seeks to make based on information in the financial statements. Different users with different information needs might therefore prefer different classifications of the same instrument.

This presents a challenge to the Board in ultimately having to choose a single classification model that would be applied consistently – and indicates how additional disclosures about relevant features are a likely ingredient of any proposals for change.

The Board generally agreed with the staff's analysis.

What did the IASB discuss?

The Board did not make any decisions during this meeting. However, Board members generally agreed with the analyses of assessments presented by the staff and the features of claims that are relevant to these assessments.

During the discussion, one Board member requested that the staff test the assertion that some features are more relevant than others when conditionality is introduced into the analysis.

The Board members also briefly discussed whether the measurement of claims should be updated, either to show an increase in claims or to reflect fair value – and if so, whether the changes should be *recognised* (and where) or whether they should merely be *disclosed*. As more exotic financial instruments with additional features are created, disclosure of how these additional features change the value of the instruments becomes more important to users.

YOU MAY ALSO BE INTERESTED TO READ …

Visit KPMG's Global IFRS Institute at kpmg.com/ifrs to access KPMG's most recent publications on the IASB's major projects and other activities.

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*.

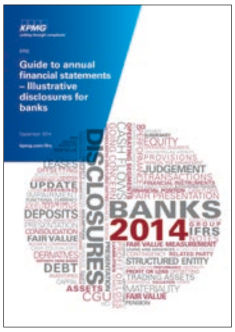
September 2014

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 47

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

July 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.

KPMG CONTACTS

Americas
Michael Hall
T: +1 212 872 5665
E: mhhall@kpmg.com

Tracy Benard
T: +1 212 872 6073
E: tbenard@kpmg.com

Asia-Pacific
Reinhard Klemmer
T: +65 6213 2333
E: rklemmer2@kpmg.com.sg

Tamami Okawa
T: +81 3 3548 5107
E: Tamami.Okawa@jp.kpmg.com

Europe, Middle East and Africa
Colin Martin
T: +44 20 7311 5184
E: colin.martin@kpmg.co.uk

Venkataramanan Vishwanath
T: +91 22 3090 1944
E: vv@kpmg.com

Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication: Hiroaki Hori and Angie Ah Kun.

We would also like to thank the following reviewers for their input: Mark Northan and Chris Spall.

KPMG International Standards Group is part of KPMG IFRG Limited.

Publication name: *IFRS Newsletter: Financial Instruments*

Publication number: Issue 25

Publication date: July 2015

kpmg.com/ifrs

***IFRS Newsletter: Financial Instruments* is KPMG's update on the IASB's financial instruments project.**

If you would like further information on any of the matters discussed in this Newsletter, please talk to your usual local KPMG contact or call any of KPMG firms' offices.