



cutting through complexity

“Although IAS 32 works well for many instruments, the staff's analysis has highlighted inconsistencies that arise when using it to distinguish liabilities from equity. **”**

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 September 2015 on its project on financial instruments with characteristics of equity.

The IASB has continued its discussions on financial instruments with characteristics of equity, having previously identified features of claims that are relevant in distinguishing between liabilities and equity, and in making other related assessments of financial information.

Highlights

At its September meeting, the Board focused on the classification of non-derivatives. It:

- discussed the extent to which the requirements in IAS 32 *Financial Instruments: Presentation* capture the features that users need to make their assessments; and
- considered three possible classification approaches.

Classification of derivatives will be considered at a future meeting.

The Board also decided to consult on a package of temporary measures to address concerns about implementing IFRS 9 *Financial Instruments* before the forthcoming insurance contracts standard comes into effect. This will be discussed in Issue 48 of our [IFRS Newsletter: Insurance](#) (scheduled for publication in early October).

The macro hedge accounting project was not discussed during the September meeting.

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY – RELEVANT FEATURES

The story so far ...

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 discussion paper (DP) *Financial Instruments with Characteristics of Equity* in 2008. However, due to capacity issues the Board could not issue an exposure draft (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.

In July 2015, the Board analysed the relevance of these features for assessments that users might make using information in the statements of financial position and performance.

The relevant features of claims that users need to make their assessments should be considered in light of existing requirements in IAS 32.

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.

To date, the Board has identified features of claims that it believes are relevant to distinguishing between liabilities and equity, and has mapped those features to the various assessments users might make using information in the statement of financial position and the statement of financial performance.

The next important step is to determine the extent to which the existing definitions and other related requirements in IAS 32 capture the features needed to make those assessments. To move the project forward, possible classification approaches need to be developed.

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*.

What was the basis for this month's discussions?

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 Board has also identified the assessments that users make based on information in the statement of financial position (Assessments A and B) and statement of financial performance (Assessments X and Y), and described the features that are relevant to those assessments.

Relevant features of assessments as identified by the Board

Assessment	Description	Relevant features
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.	<ul style="list-style-type: none">• Timing of transfer of economic resources.• Type of economic resources required to be transferred.• Amount (or quantity) of economic resources required to be transferred.
B	The extent to which the entity has sufficient economic resources to satisfy the total claims against it at a point in time, and how any potential shortfall will be distributed amongst claims.	<ul style="list-style-type: none">• Amount (or quantity) of economic resources required to be transferred.• Priority (or seniority/rank) of the claim relative to other claims.
X	The returns that an entity has produced on its economic resources.	<ul style="list-style-type: none">• No relevant features as such – changes in the timing of settlement and the type of economic resources required to settle claims may have implications for the entity's economic resources, but will be recognised as they occur under the requirements for the entity's assets.²
Y	The extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it, and how any potential shortfall in returns will be distributed amongst claims.	<ul style="list-style-type: none">• Amount (or quantity) of economic resources required to be transferred.• Priority (or seniority/rank) of the claim relative to other claims.

2. These features may be relevant to assess physical flows – e.g. contributions and distributions – for which information is provided elsewhere, such as in the statement of cash flows.

To illustrate the consequences of distinguishing between claims, the staff used the same examples of instruments that were used at the June and July 2015 meetings. 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.
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. 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.

The staff discussed the extent to which the requirements in IAS 32 capture the features that users need to make their assessments.

What did the staff discuss?

Analysis of existing IAS 32 requirements

The staff identified that IAS 32 has two main principles for classifying non-derivative³ financial instruments as financial liabilities:

- obligations to deliver cash or another financial asset (if the transfer is required before liquidation); and
- obligations to deliver a variable number of equity instruments.

3. The staff's analysis will be expanded to derivatives at a future meeting.

The following table maps the relevant features used in the assessments to the corresponding requirements under IAS 32.

IAS 32 requirement	Relevant feature	IAS 32 application	Relevant assessment
Obligation to deliver <i>cash or another financial asset</i> before liquidation	Type of economic resources required to be transferred.	<ul style="list-style-type: none"> Used as the basis for sub-classifications of different liabilities. Requirement to transfer cash or another financial asset is what makes the claim a <i>financial</i> (as opposed to non-financial) liability. 	N/A
Obligation to deliver cash or another financial asset <i>before liquidation</i>	Timing of transfer of economic resources.	<ul style="list-style-type: none"> Relevant for distinguishing liabilities and equity. Claims that require a transfer of economic resources before liquidation are classified as liabilities. 	Assessment A
Obligation to deliver a variable number of shares	Amount required to be transferred.	<ul style="list-style-type: none"> Relevant for distinguishing liabilities and equity. Claims that require the entity to transfer a variable number of equity instruments for a specified amount are classified as liabilities. Obligation to use own equity instruments as currency represents an obligation for a specified amount independent of the entity's economic resources, rather than a specified equity interest. 	Assessments B and Y

However, IAS 32 also specifies an exception to the definition of a liability for some puttable financial instruments ('the puttables exception'). This exception results in some obligations to transfer economic resources before liquidation being classified as equity instead of liabilities. Qualifying criteria include the requirements that these instruments:

- represent the most subordinate claim on liquidation of an entity; and
- oblige an entity to deliver a pro rata share of its net assets to the holders on liquidation.

IAS 32 requirement	Relevant feature
Most subordinate claim on liquidation	Priority (or seniority/rank) of the claim relative to other claims.
Pro rata share of the entity's net assets	Amount (or quantity) of economic resources required to be transferred.

The staff highlighted that inconsistencies arise from using IAS 32 to distinguish liabilities from equity.

The staff outlined three possible approaches for classification.

Based on their analysis, the staff noted that – apart from the puttables exception – IAS 32 does not distinguish between:

- claims that require the transfer of economic resources, before liquidation, of an amount that *is* independent of the entity's economic resources – e.g. ordinary bonds; and
- other claims that require the transfer of economic resources, before liquidation, of an amount that *is not* independent of the entity's economic resources – e.g. shares redeemable for their fair value that are not the most residual claim.

In addition – apart from the limited case where a claim settled by delivery of a variable number of own equity instruments for a specified amount are classified as liabilities – IAS 32 does not consistently distinguish between:

- claims that require the transfer of economic resources, at liquidation, of an amount that *is* independent of the entity's economic resources – e.g. cumulative preference shares; and
- other claims that require the transfer of economic resources, at liquidation, of an amount that *is not* independent of the entity's economic resources – e.g. ordinary shares.

Possible classification approaches

The staff outlined three possible approaches for classification that they intend to develop further as the project progresses.

Title	Explanation
Approach Alpha	Focuses the distinction between liabilities and equity on features that are relevant for Assessment A.
Approach Beta	Focuses the distinction between liabilities and equity on features that are relevant for Assessments B and Y.
Approach Gamma	Focuses the distinction between liabilities and equity on features that are relevant for Assessments A, B and Y.

These approaches could result in changes to the existing definitions in IAS 32, the Conceptual Framework or both. Additional subclasses within liabilities or within equity may be required, to help make the identified assessments. Some approaches may still require an exception for puttable instruments.

The following table provides an overview of the three potential approaches outlined by the staff and highlights the features used in distinguishing liabilities from equity. It also illustrates how these distinctions apply to the example instruments.

Relevant assessment	Relevant features to distinguish between liabilities and equity	Impact on classification
Approach Alpha		
Assessment A	<p>Timing of required settlement.</p> <p>When applying this approach to the example instruments:</p> <ul style="list-style-type: none"> share-settled debt is not settled using economic resources before liquidation and would be classified as equity; and cumulative preference shares do not require the transfer of economic resources before liquidation and would be classified as equity. 	<p>Classify as liabilities obligations to transfer economic resources before liquidation. All other claims would be classified as equity.</p>
Approach Beta		
Assessments B and Y	<p>Amount of economic resources required to settle the claim.</p> <p>When applying this approach to the example instruments:</p> <ul style="list-style-type: none"> shares redeemable at their fair value would be classified as equity; and cumulative preference shares require the transfer of economic resource of an amount independent of the entity's economic resources and would be classified as liabilities. 	<p>Classify as liabilities obligations to transfer an amount of economic resource independent of the entity's economic resources. All other claims would be classified as equity.</p>
Approach Gamma		
Assessments A, B and Y	<p>Timing of required settlement and amount of economic resources required to settle the claim.</p>	<p>Classify as liabilities obligations to transfer:</p> <ul style="list-style-type: none"> economic resources before liquidation; or an amount of economic resource independent of the entity's economic resources. <p>All other claims would be classified as equity. Therefore, claims should only be classified as equity if:</p> <ul style="list-style-type: none"> the transfer of economic resources is required only at liquidation; and the amount of those resources is not independent of the entity's economic resources.

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The staff emphasised that, in an approach for which the timing of the required settlement is the relevant feature, liability classification applies *only* if there is an obligation to transfer economic resources before liquidation.

However, in some cases an entity's liquidation date is predetermined. Alternatively, the holder of an instrument may sometimes have the right to force liquidation. In such cases, classification as a financial liability may be required if the exception for obligations arising on liquidation in paragraphs 16C–D of IAS 32 is not applicable.

Financial liability classification under IAS 32 may also apply to:

- liquidation rights held by the instrument holder that become exercisable on the occurrence of an event that is not within the control of the entity – e.g. a change in control; and
- liquidation rights held by preference shareholders as a class rather than included in the individual instrument.

The staff did not discuss whether or how liquidation rights might impact their analysis.

The Board generally agreed with the staff's analysis and commented on the proposed approaches.

What did the IASB discuss?

The Board did not make any decisions during this meeting. However, Board members generally agreed with the staff's analysis of how the existing requirements of IAS 32 capture the features that users need to make their assessments. The analysis highlighted that different types of features are considered differently in making classification decisions under IAS 32.

Some Board members emphasised that (because the classification of the majority of claims has not presented challenges to preparers under IAS 32) the DP should not start from a 'blank sheet of paper' – i.e. the intention should not be to change the classification for most instruments, but rather to address problem areas.

In response, one Board member cautioned that the focus should be on fixing problems for users in evaluating the performance of entities, rather than having just a preparer perspective on challenges – although problems for preparers in applying the model might give rise to diversity in practice that in turn might be a problem for users.

Another Board member pointed out that a stronger basis in sound principles would better prepare the Board for making tough decisions about the implications and outcomes of the project.

It was suggested by another Board member that the staff should further develop the three classification approaches discussed (Alpha, Beta and Gamma), and compare how each:

- addresses current problem areas;
- impacts areas where there are no current problems; and
- demonstrates consistency with the Conceptual Framework ED.

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