



*cutting through complexity*

**“** Derivatives on ‘own equity’ present complex accounting challenges that will continue to haunt the Board’s efforts to renew its approach to equity/liability classification. **”**

**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 October 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 addressed the extent to which the requirements in IAS 32 *Financial Instruments: Presentation* capture features that are relevant for users of financial statements, and considered three possible classification approaches in the context of non-derivatives.

### Highlights

#### **Financial instruments with characteristics of equity**

At its October meeting, the Board focused on the classification of derivatives on ‘own equity’. It discussed:

- the challenges of accounting for them; and
- how the IAS 32 requirements deal with those challenges.

Classification of specific types of instruments such as contingent convertible bonds (CoCos) and put options written on non-controlling interests (NCI puts) will be considered at a future meeting.

The next step for the project will be to further address the conceptual challenges of the ‘fixed-for-fixed’ condition in IAS 32.

#### **Other matters discussed – Insurance and impairment**

The Board continued its discussions 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 49 of our [IFRS Newsletter: Insurance](#) (scheduled for publication at the end of October).

The Board was also provided with a summary of the activities of the Transition Resource Group for Impairment of Financial Instrument ('the ITG') and informed about an issue relating to the measurement of expected credit losses for revolving credit facilities. Read our [web article](#) to find out more.

The macro hedge accounting project was not discussed during the October 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*<sup>1</sup>.

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.

In September 2015, the Board focused on the classification of non-derivatives. It discussed the extent to which the requirements in IAS 32 capture the features that users need to make their assessments. It also considered three possible classification approaches.

Accounting for derivatives on own equity presents challenges in addition to the issues discussed for non-derivatives, because derivatives have other pertinent characteristics.

## What's the issue?

The staff noted that the consistency, completeness and clarity of the accounting requirements for derivatives on own equity are of the utmost importance, but are difficult to achieve due to a number of challenges – including:

- the wide variety of contracts;
- the ease with which similar economic outcomes can be reproduced using different combinations of contracts; and
- the complexity – and in some cases ambiguity – of the terms of these contracts.

Derivative financial instruments contain contractual rights or obligations to exchange the underlying financial assets or financial liabilities with another party. Derivatives can be seen as exchange contracts with two 'legs', with each leg representing one side of the exchange.

The distinguishing characteristic of derivatives on own equity is that:

- one of the underlying financial instruments of the exchange meets the definition of equity (the equity leg); and

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*.

- the other underlying financial instrument could be either a financial asset leg or a financial liability leg – e.g. a forward contract to pay cash in exchange for a specified number of own equity shares.

Changes in the non-equity leg meet the definition of income and expense, while changes in the equity leg do not.

Therefore, regardless of the distinction between liabilities and equity, accounting challenges arise simply because derivatives on own equity combine an underlying instrument that would, on its own, meet the definition of equity with one that would not.

## What was the basis for this month's discussions?

To illustrate the consequences of distinguishing between claims, the staff used the following examples of instruments at the [June](#), [July](#) and [September](#) 2015 meetings. We have reproduced the table explaining these examples below, for ease of reference.

Type of claim	Explanation
<b>Ordinary bonds</b>	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.
<b>Shares redeemable for their fair value</b>	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.
<b>Share-settled bonds</b>	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.
<b>Cumulative preference shares</b>	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.
<b>Ordinary shares</b>	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 Board previously discussed three possible approaches for classification that it intends to develop further as the project progresses. The following table provides an overview of the three 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.

	<b>Approach Alpha</b>	<b>Approach Beta</b>	<b>Approach Gamma</b>
<b>Relevant features to distinguish between liabilities and equity</b>	Timing of the required settlement.	Amount of economic resources required to settle the claim.	Timing of the required settlement and amount of economic resources required to settle the claim.
<b>Application of distinguishing feature</b>	Classify as liabilities obligations to transfer economic resources before liquidation. All other claims would be classified as equity.	Classify as liabilities obligations for an amount independent of the entity's economic resources. All other claims would be classified as equity.	Classify as liabilities obligations: <ul style="list-style-type: none"> <li>to transfer economic resources before liquidation; or</li> <li>for an amount independent of the entity's economic resources.</li> </ul> All other claims would be classified as equity.
<b>Classification of ordinary bonds</b>	Liability	Liability	Liability
<b>Classification of ordinary shares</b>	Equity	Equity	Equity
<b>Classification of shares redeemable for their fair value</b>	Liability	Equity	Liability
<b>Classification of share-settled bonds</b>	Equity	Liability	Liability
<b>Classification of cumulative preference shares</b>	Equity	Liability	Liability

**The staff discussed the challenges of accounting for derivatives on own equity.**

## What did the staff discuss?

### Different types of derivatives on own equity

The staff identified that derivatives on own equity can be distinguished in terms of:

- the underlying exchange;
- conditionality; and
- any features that are relevant to the distinction between liabilities and equity.

### The underlying exchange

There are two basic types of exchange:

- asset/equity exchange – in which a financial asset is received in exchange for delivering own equity, when both items are not existing financial instruments of the entity; and
- liability/equity exchange – in which an existing financial liability or equity instrument is extinguished in exchange for delivering own equity or a financial liability.

### Conditionality

The underlying exchange in a derivative could be either:

- unconditional – e.g. forward contracts; or
- conditional on:
  - events within the control of the counterparty – e.g. written options;
  - events within the control of the entity – e.g. purchased options; or
  - events beyond the control of both parties – e.g. contingent forward contracts.

### Features that are relevant to the distinction between liabilities and equity

The staff focused their analysis on the timing of the required settlement and the amount of economic resources required to settle the claim, in light of the importance of these features to the classification approaches that are being developed.

### Timing of the required settlement

Derivatives typically require settlement before liquidation. The following table shows the classification of derivatives under both Approaches Alpha and Gamma if the distinction between liabilities and equity is based only on the timing of the required settlement.

Settlement method	Timing of transfer of economic resources	Classification
Net in cash or another financial asset – i.e. physical delivery or receipt of a variable amount of cash or other financial assets equal to the net position.	Before liquidation for the entire derivative.	Either a financial asset or a financial liability in its entirety.
Net in own equity – i.e. physical delivery or receipt of a variable number of underlying equity instruments depending on the net position.	No transfer of economic resources required before liquidation.	Equity instrument in its entirety.

Settlement method	Timing of transfer of economic resources	Classification
Gross – i.e. physical delivery or receipt of the underlying equity instrument in exchange for the non-equity instrument.	Before liquidation for one part of the transfer, but not for the other.	Challenging for these approaches, since part of the derivative would be a financial asset or financial liability and the other part would be an equity instrument.

#### ***Amount of economic resources required to settle the claim***

Derivatives can specify the amount of underlying financial instruments to exchange in different ways. These include:

- the exchange of a fixed amount of the underlying financial instruments – e.g. the receipt of a fixed amount of cash or other financial assets in exchange for the delivery of a fixed number of ordinary shares;
- the exchange of a variable amount of one or both of the underlying financial instruments – e.g. the receipt of a fixed amount of cash or other financial assets in exchange for the delivery of a variable number of ordinary shares; and
- the exchange of a variable amount of one of the legs with reference to the value of the other leg – e.g. a contract to exchange a variable amount of cash for a fixed number of ordinary shares where both legs are equal to the value of the ordinary shares.

The following table shows the classification of derivatives under both approaches Beta and Gamma if the distinction between liabilities and equity is based only on whether the amount is independent of the entity's economic resources.

What is exchanged?	Is the amount independent of the entity's economic resources?	How is the derivative classified?
Amounts of underlying financial instruments equal to an amount independent of the entity's economic resources.	Yes – for the entire derivative.	Either a financial asset or a financial liability in its entirety, regardless of whether it requires the transfer of economic resources or not.
Amounts of underlying financial instruments equal to an amount equal to an entity's equity instruments.	No – for the entire derivative.	Equity instrument in its entirety, regardless of whether it requires the transfer of economic resources or not.
One leg of the exchange – An amount independent of the entity's economic resources. Other leg of the exchange – An amount not independent of the entity's economic resources.	Yes – for one part of the entire derivative, but not the other.	Challenging for these approaches, since part of the derivative would be a financial asset or a financial liability and the other part would be an equity instrument.

## KPMG Insight

The staff's analysis highlighted that the accounting for derivatives on own equity that require gross settlement would present challenges for all three approaches – i.e. Alpha, Beta and Gamma – because part of the derivative would be classified as a financial asset or a financial liability and the other part would be classified as an equity instrument.

We note that the agenda paper is not entirely clear when referring to the 'amount' feature of a financial instrument. Approaches Beta and Gamma are described as focusing on the 'amount of economic resources required to settle the claim'. However, when explaining how the approaches would be applied (including to derivatives) the paper refers to whether the amount exchanged is independent of the entity's economic resources, regardless of whether the derivative requires the transfer of economic resources. In other words, 'amount' in this sense seems to refer to the value of the economic resources or equity instruments required to settle the instrument.

The staff noted that different types of derivatives can be distinguished based on their conditionality. However, they did not analyse at this meeting how conditionality features in derivatives would affect the three classification approaches.

The staff briefly outlined the three settlement methods for derivatives. IAS 32 also contains guidance on settlement options when a derivative gives a party a choice over how it is settled – e.g. the issuer or the holder can choose settlement net in cash or by exchanging shares for cash. The staff did not specifically discuss whether or how settlement options might impact their analysis.

**The staff analysed how IAS 32 deals with the challenges of accounting for derivatives on own equity.**

## Relevant requirements of IAS 32

The staff noted that the following requirements are relevant for derivatives on own equity:

- the fixed-for-fixed condition (this applies to asset/equity and liability/equity exchanges); and
- the redemption obligations requirement (this applies to liability/equity exchanges).

### Fixed-for-fixed condition

The fixed-for-fixed condition is part of the definitions of financial instruments in IAS 32. A derivative is only classified as an equity instrument if:

- the fixed-for-fixed condition is met – i.e. exchange of a fixed amount of cash (or another financial asset) in the entity's functional currency for a fixed number of the entity's own equity instruments; and
- the derivative is settled gross.

IAS 32 requires an entity to classify derivatives on own equity in their entirety as either equity or non-equity. The fixed-for-fixed condition is subject to one exception for foreign currency rights issues.

The staff illustrated the challenges and the pros and cons of classification based on the 'fixed-for-fixed' condition, using the example of a simple forward contract to receive cash in exchange for delivering a fixed amount of ordinary shares that is settled gross. The staff explored three variations on this contract:

- Example 1: Fixed-for-fixed
- Example 2: Foreign currency rights issue exception
- Example 3: Not fixed-for-fixed: asset leg variability.

### Example 1: Fixed-for-fixed

An entity enters into a forward contract to receive a fixed amount of cash (100) in exchange for the delivery of a fixed number of ordinary shares. At inception, the shares and the cash are of equal value (100 each) so the contract is initially recognised at zero. The contract is settled gross. Subsequently, the values of each of the legs change as follows.

Scenario	Value of cash receivable	Value of shares deliverable	Net position of contract
<b>A</b>	100	80	20
<b>B</b>	100	120	(20)

Because the fixed-for-fixed condition is met, the entire instrument is classified as equity. The changes shown in both scenarios result only from the change in the value of the shares deliverable (the equity leg) because the asset leg is fixed. These changes and the net position of the contract are not recognised in the financial statements.

### Example 2: Foreign currency rights issue exception

An entity enters into a forward contract to receive a fixed amount of foreign currency – i.e. not the entity's functional currency – in exchange for delivering a fixed number of ordinary shares. The instrument is offered pro rata to all existing holders of the same class of own non-derivative equity instruments and it meets the foreign currency rights issue exception. At inception, the shares and the cash are of equal value (100 each) so the contract is initially recognised at zero. The contract is settled gross. Subsequently, the values of each of the legs change as follows.

Scenario	Value of cash receivable	Value of shares deliverable	Net position of contract
<b>A</b>	120	80	40
<b>B</b>	120	140	(20)
<b>C</b>	80	60	20
<b>D</b>	80	120	(40)

Because the instrument meets the foreign currency rights issue exception, the entire instrument is classified as equity. Changes in the net position of the contract result from changes in the value of the shares deliverable and changes in the functional currency equivalent of the foreign currency cash receivable. However, because the contract is classified as equity, all changes in value and the net position of the contract are not recognised.

### Example 3: Not fixed-for-fixed: asset leg variability

An entity enters into a forward contract to receive a variable amount of cash based on a commodity index in exchange for delivering a fixed number of ordinary shares. At inception, the shares and the cash are of equal value (100 each) so the contract is initially recognised at zero. The contract is settled gross. Subsequently, the values of each of the legs change as follows.

Scenario	Value of cash receivable	Value of shares deliverable	Net position of contract
<b>A</b>	120	80	40
<b>B</b>	120	140	(20)
<b>C</b>	80	60	20
<b>D</b>	80	120	(40)

The entire instrument is classified as either a financial asset or a financial liability because the fixed-for-fixed condition is not met. Changes in the net position of the contract result from changes in:

- the value of the shares deliverable; and
- the amount of cash to be received based on changes in the commodity index.

All resulting changes in value are recognised as income or expense.

Based on these examples, the staff identified the following pros and cons of applying the fixed-for-fixed condition to derivatives on own equity.

<b>Pros</b>	<ul style="list-style-type: none"> <li>Using the fixed-for-fixed condition to classify a derivative in its entirety is a pragmatic approach which avoids the need to componentise a derivative into its underlying legs.</li> <li>Such an approach would work for an instrument that meets the fixed-for-fixed condition, because: <ul style="list-style-type: none"> <li>the only source of changes in the net position of the contract is due to changes in the value of the underlying equity leg; and</li> <li>these changes are not recognised in profit or loss</li> </ul> </li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>If an instrument fails the fixed-for-fixed condition, then classifying the instrument in its entirety results in: <ul style="list-style-type: none"> <li>some contracts with underlying equity instruments being accounted for as financial assets or financial liabilities, with all resulting changes in value reported in profit or loss – including changes in the underlying equity instrument; and</li> <li>some contracts with underlying financial asset instruments being accounted for as equity instruments (if they meet the foreign currency rights issue exception), with changes in the underlying asset leg not being recognised in profit or loss.</li> </ul> </li> <li>An application problem arises, because it is not always clear what the term 'fixed' means in the fixed-for-fixed condition. For example, it could mean 'fixed' in terms of the entity's functional currency or 'fixed' in terms of volume or units of financial assets.</li> </ul>

### **Redemption obligation requirements**

The redemption obligation requirements are derived from the definition of a financial liability, and require an entity to classify any obligation to repurchase its own equity as a financial liability for the present value of the redemption amount. This applies even if the obligation is conditional on the counterparty exercising a right to redeem. The redemption obligation requirements are subject to one exception for puttable instruments and obligations arising on liquidation, which are classified as equity if certain conditions are met.

These requirements and the compound instrument requirements in IAS 32 are related. They result in similar accounting for all contracts that impose an outcome meeting the definition of a financial liability, regardless of the manner in which the contracts are structured.

The staff illustrated the challenges and the pros and cons of applying the redemption obligation requirements using the following examples of simple liability/equity exchanges:

- Example 4: Simple convertible bond
- Example 5: Written put option on own equity
- Example 6: Forward contract to extinguish own equity in exchange for debt.

#### **Example 4: Simple convertible bond**

The entity issues a bond for 100 that requires it to pay to the holder an amount of 110 in cash one year after the issue date. At that date, the holder has the right to elect to receive 100 ordinary shares of the entity instead of the cash payment, but cannot receive both the 110 in cash and the 100 shares. The claim does not have any unconditional payments and is not convertible or redeemable by the counterparty or the entity during the one-year period.

Under IAS 32, the issuer would account for the convertible bond as a compound instrument, and:

- recognise a financial liability for the claim at an initial amount equal to the fair value of the same bond issued without the conversion feature – e.g. 110 discounted to a present value of 95;
- recognise the difference between the fair value of the financial liability and the fair value of the convertible bond at issue date in equity – i.e. residual of 5;
- recognise the accrual over the year of interest expense on the financial liability of 15; and
- at exercise date, either recognise the payment made (110), or reclassify the carrying amount of the financial liability (110) to equity, depending on the holder's election.

### Example 5: Written put option on own equity

The entity issues 100 ordinary shares and a written put option for 100 in cash. One year after the issue date, the counterparty has the right to receive an amount of 110 in cash – in exchange for putting the 100 ordinary shares back to the entity – but cannot receive the cash and retain the shares. The claim does not pay dividends in the intervening period, is not convertible or redeemable by the counterparty or the entity during the one-year period, and does not meet the puttable instruments exception.

Under IAS 32, the issuer would account for the written put option and ordinary shares by:

- recognising the 100 ordinary shares issued in equity;
- recognising a financial liability for the present value of the redemption amount – e.g. 110 discounted to a present value of 95 on the issue date;
- reclassifying the amount recognised for the financial liability from equity;
- continuing to recognise the difference between: (a) the fair value on issue date of the combined 100 ordinary shares and the put option; and (b) the financial liability in equity – i.e. residual of 5;
- accruing interest expense of 15 on the financial liability over the year; and
- at exercise date, either recognising the payment made (110), or reclassifying the carrying amount of the financial liability (110) to equity if the option is not exercised.

Examples 4 and 5 have similar sets of features, even though they are expressed in different ways:

- both are issued for 100 in cash; and
- both give the counterparty the right to choose, one year from issue date, to either:
  - demand payment from the entity of 110; or
  - continue to invest in the entity with rights to 100 ordinary shares.

IAS 32 implicitly takes the view that the instruments should be accounted for in the same way due to their similar features. This is illustrated in the table below, which shows the classification on initial recognition.

	Simple convertible bond	Written put option on own equity
<b>Amount received</b>	100	100
<b>Financial liability</b>	95	95
<b>Equity</b>	5	5

There may be differences between these two instruments, such as additional rights or obligations that should be considered separately – e.g. the convertible bond may require payment of coupons or interest, and the shares that are puttable may have rights to dividends in the intervening period.

### Example 6: Forward contract to extinguish own equity in exchange for debt

The entity issues 100 ordinary shares and a forward contract to repurchase the shares one year later for 110 in cash. The shares are therefore mandatorily redeemed. The entity receives 95 in cash at the issue date for the 100 shares and the forward contract. The claim does not pay dividends in the intervening period, is not convertible or redeemable by the counterparty or the entity during the one-year period, and does not meet the puttable instruments exception.

Under IAS 32, the entity would:

- recognise a financial liability for the present value of the redemption amount – e.g. 110 discounted to a present value of 95; and
- reclassify that amount from equity.

The forward contract is unconditional. This arrangement is accounted for differently to Examples 4 and 5, because the residual value in equity is zero or non-existent.

Based on these examples, the staff identified the following pros and cons of applying the redemption obligation requirements to derivatives on own equity.

<b>Pros</b>	<ul style="list-style-type: none"><li>• The accounting for arrangements with the same economic outcomes is similar.</li></ul>
<b>Cons</b>	<ul style="list-style-type: none"><li>• Classification as financial liability or equity would differ between the three classification approaches being developed if the redemption price is equal to the value of the underlying shares – i.e. if there is an obligation to deliver a variable amount of cash equal to the value of ordinary shares.</li><li>• Application challenges arise due to a lack of consistency, completeness and clarity because the IAS 32 requirements that achieve similar accounting are expressed differently and in different sections of the standard.</li><li>• The redemption obligation requirements are unclear as to the accounting for:<ul style="list-style-type: none"><li>– redemption obligations settled with a variable number of shares without any obligation to pay cash;</li><li>– residual equity components arising from the redemption obligation requirements; and</li><li>– any discretionary payments made during the period.</li></ul></li></ul>

## KPMG Insight

The staff's analysis focused on the fixed-for-fixed condition and the 'redemption obligation' requirements as being relevant for the classification of derivatives on own equity under IAS 32. They noted a number of conceptual and application challenges.

As the staff noted, if a derivative fails the strict fixed-for-fixed condition, then the entire instrument is generally treated as a financial asset or a financial liability.

This creates a 'bright line' approach to classification, with small injections of potential variability into the terms of an instrument having a big effect on the accounting. Also, practitioners have shown ingenuity in accommodating, within the fixed-for-fixed test, anti-dilution clauses that adjust a conversion ratio or exercise price merely to preserve the relative economic interests of derivative holders and existing shareholders.

The staff considered the fixed-for-fixed condition and the redemption obligation requirements in turn, focusing more on classification. However, it is also important to consider how the two interact, and what they mean for measurement and presentation.

A derivative that breaches the fixed-for-fixed condition will generally be measured at its net fair value, with changes in fair value affecting profit or loss. Conversely, a redemption obligation will usually lead to the recognition of an amortised-cost type gross liability for the present value of the redemption price. Also, the presence of a redemption obligation in an own equity derivative will usually trump the fixed-for-fixed analysis. For example, if the fixed-for-fixed condition requires a derivative to be classified as equity (supposedly in its entirety) but the derivative contains a redemption obligation, then a non-derivative liability will be extracted from the arrangement.

Equally, if the fixed-for-fixed condition is breached and the instrument is apparently required to be accounted for as a derivative at fair value through profit or loss, this could effectively be supplanted by the need to recognise a redemption obligation included in the instrument.

**The staff discussed some next steps for the project to address the challenges identified.**

## Potential ways forward

The staff discussed their initial thoughts on how some of the challenges identified in their analysis should be considered. They also said that they would present an analysis for specific types of instruments like CoCos and NCI puts at a future meeting.

### Consequences of the three classification approaches under development

For some derivatives, differences in the distinction between liabilities and equity based on the three approaches might be relevant. Therefore, as these approaches are developed further, consequential changes to the requirements for derivatives will have to be considered. The affected derivatives include those:

- containing an obligation to deliver a variable number of shares;
- settled net in financial assets or the entity's own equity instruments; and
- on own equity with a strike price equal to the fair value of the entity's own equity.

### **Conceptual challenges of the fixed-for-fixed condition**

Taking into account the pros and cons of classifying derivatives using the fixed-for-fixed condition (as described earlier), the staff proposed the following two alternatives to be considered after analysing other types of derivatives.

- Componentise derivatives in finer detail, which would result in a more faithful representation of the underlying instruments. However, taking into account the complexity involved and the wide variety of instruments, the practicability of such an approach would need to be considered.
- Classify all derivatives on own equity as financial assets or financial liabilities, even when they meet the fixed-for-fixed condition. Although more practical, this approach would:
  - result in recognising changes in the underlying equity leg as income or expense; and
  - require a similar change to the classification of non-derivative obligations to issue a fixed number of ordinary shares as financial liabilities.

### **Application challenges of the existing requirements for derivatives on own equity**

The challenges of applying the fixed-for-fixed condition and redemption obligation requirements to derivatives on own equity (as described earlier) will be addressed as the three approaches are developed further.

#### **KPMG Insight**

The staff's analysis suggested that one alternative approach to addressing the challenges of applying the fixed-for-fixed condition could be to componentise derivatives in finer detail. However, this approach might create unit-of-account issues that may not be consistent with the treatment of non-derivatives.

The IFRS Interpretations Committee has previously considered the unit of account for a non-derivative instrument. It noted that a single obligation to deliver a variable number of an entity's own equity instruments is a non-derivative obligation that meets the definition of a financial liability. This instrument cannot then be subdivided into components for the purpose of evaluating whether the instrument contains a component that meets the definition of equity.

**The Board generally agreed with the staff's analysis and commented on the potential ways forward.**

## **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 the challenges of accounting for derivatives on own equity and how the specific IAS 32 requirements (the fixed-for-fixed condition and redemption obligation requirements) deal with these challenges.

One Board member requested further explanation on why the fixed-for-fixed condition results in equity classification.

Another Board member commented that the three classification approaches under development focus on outflows, whereas derivatives also have an inflow leg. As these approaches are developed further, the staff will need to consider this characteristic, as well as other features specific to derivatives.

Some Board members asked the staff not to rule out the approach of componentising derivatives solely on the basis of concerns that it would be too complex to apply in practice.

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## Acknowledgements

We would like to acknowledge the efforts of the principal author of this publication: Angie Ah Kun.

We would also like to thank the following reviewer for their input: Chris Spall.

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Publication name: *IFRS Newsletter: Financial Instruments*

Publication number: Issue 27

Publication date: October 2015

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