

# Financial instruments

## IFRS Newsletter



**“The latest Board discussions have highlighted the need to further explore presentation options as a means to address the shortcomings of a binary classification approach.”**

– Chris Spall  
KPMG’s global IFRS  
financial instruments leader

## Contents

Financial instruments with characteristics of equity	2
Keeping you informed	8
KPMG contacts	10
Acknowledgements	10

## The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in February 2016 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 challenges of accounting for the classification of derivatives on ‘own equity’.

### Highlights

As financial markets have become more sophisticated, the number and complexity of financial instruments has increased. A single distinction between liabilities and equity cannot convey all of the similarities and differences between claims. For this reason, the Board decided that the objective of the project should include exploring potential improvements to presentation and disclosure in addition to improvements to the distinction between liabilities and equity alone.

At its February meeting, the Board discussed:

- using sub-classes of financial liabilities to provide additional information useful to assessing financial performance and financial position;
- using sub-classes within equity to provide additional information about relevant features; and
- claims with conditional alternative settlement outcomes.

The next step for the project will be to develop the proposed approaches further so that the Board can ultimately form a preliminary view on its preferred approach. This is in line with the objective of this research project – which is “to investigate perceived financial reporting challenges with IAS 32 *Financial Instruments: Presentation* and to assess potential ways to improve financial reporting or to remedy an identified deficiency”.

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

# Financial instruments with characteristics of equity

## The story so far ...

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 (DP) *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*<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 (Alpha, Beta and Gamma).

In [October 2015](#), the Board discussed the challenges of classifying and accounting for derivatives on 'own equity' and how IAS 32 addresses these challenges.

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1. The IASB [recently published](#) the exposure draft *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*, unless otherwise stated.

**Sub-classes of liabilities may provide additional information useful to assess financial performance and financial position.**

## Sub-classes of liabilities

### What's the issue?

Approach Gamma classifies as liabilities, obligations:

- to transfer economic resources prior to liquidation; or
- for an amount of economic resources independent of the entity's economic resources.

Certain instruments with both liability and equity features – e.g. shares redeemable at fair value at a specified time before liquidation or on demand – would therefore be classified as financial liabilities. However, changes in the carrying amounts of these instruments depend on residual returns – i.e. are driven by changes in the entity's economic resources and changes in other claims that do promise a return. The staff therefore believed that it would be useful to present separately these changes in the carrying amount from other income and expense.

### What was discussed?

The staff proposed presenting income and expense that depend on a residual return separately in other comprehensive income (OCI). This would prevent the counterintuitive results associated with redemption linked to the performance of an entity and would achieve accounting similar to IFRS 9 *Financial Instruments* for presenting changes in fair value due to own credit risk in OCI for financial liabilities designated at fair value through profit or loss. Further, because the nature of this type of income and expense will not change in the future, the staff believed that reclassifications from OCI to profit or loss in subsequent periods would not be appropriate.

The following table outlines the staff's view on presenting additional sub-classes based on the feature that leads to liability classification under approach Gamma:

	<b>Classification based on transfer of economic resources prior to liquidation</b>	<b>Classification based on amount of economic resources independent of the entity's economic resources</b>
<b>Existing IFRS guidance</b>	IAS 1 <i>Presentation of Financial Statements</i> contains presentation requirements for sub-classes of liabilities based on current vs non-current distinction and order of liquidity. IFRS 7 <i>Financial Instruments: Disclosures</i> requires a maturity analysis for financial liabilities.	No specific guidance.

	<b>Classification based on transfer of economic resources prior to liquidation</b>	<b>Classification based on amount of economic resources independent of the entity's economic resources</b>
<b>Staff's view</b>	No additional requirements for sub-classes are necessary.	Additional sub-classifications that distinguish claims for an amount independent of the entity's economic resources from those that depend on the entity's economic resources would be helpful. In addition to arranging claims by order of liquidity, entities should be permitted (or required if relevant) to present claims in order of priority on the statement of financial position.

The Board generally welcomed the overall staff analysis, which focused on both financial position and financial performance and acknowledged the value in distinguishing between promised and residual returns. However, Board members expressed different views on where to show that distinction in returns. The staff will further explore potential improvements to performance reporting, the use of OCI and whether the income and expense that depend on a residual return could be seen as a contribution or distribution within equity.

### **KPMG insight**

The staff's analysis highlighted that using OCI for a new type of income or expense would expand the use of OCI and may lead to structuring opportunities for entities to avoid reporting changes in the carrying amount of claims in profit or loss. The IASB may need to consider this as part of its broader project on primary financial statements.

Presenting claims in the statement of financial position in order of priority – in addition to order of liquidity – may be difficult as it involves combining two different criteria. To address this, the Board may need to consider the use of one criterion for ordering in the statement of financial position and the use of either:

- an alternative criterion as an additional descriptor or category; or
- additional disclosures in the notes to the statement of financial position.

**Sub-classes within equity may provide additional information about relevant features.**

## **Sub-classes within equity**

### **What's the issue?**

Under approach Gamma, claims will be classified as equity if they both:

- require the transfer of economic resources only at liquidation; and
- the amount of economic resources required to be transferred at liquidation depends on the available economic resources.

Although the claims within equity under approach Gamma will require neither an outflow of resources before liquidation, nor a fixed return, there are still differences between equity claims.

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### **What was discussed?**

The staff believed it would be useful to distinguish different classes of equity, on the basis that there are a number of factors that cause differences between equity claims – e.g. priority to the residual net assets, contingencies, and restrictions on dividends.

Sub-classes within equity would however be more important under approaches Alpha and Beta. Under approach Alpha, claims within equity may oblige the entity to produce a fixed or determined return. Under approach Beta, claims within equity may require the entity to transfer economic resources prior to liquidation. The staff therefore believed that in these cases those obligations should be presented prominently in the statement of financial position within equity.

The staff also expressed the view that the attribution of total comprehensive income should be expanded to other classes of equity, which could include non-cumulative preference shares, derivatives on own equity and equity components of compound instruments. This would help users assess the allocation of returns amongst different classes of equity. The carrying amounts for these classes would then be updated by the amount attributed.

In order to carry out the attribution, one class of equity would need to be identified as the residual. This would usually be ordinary shares because they:

- have the most residual claim; and
- require a transfer of economic resources:
  - only at liquidation; and
  - for an amount equal to a pro rata share of the entity's net assets.

The other classes of equity would then be seen as senior classes of equity as they reduce the net assets available to ordinary shares.

The Board supported the staff exploring the use of attribution of profit or loss and OCI as a tool to provide additional information. However, they acknowledged the need to first consider the treatment of derivatives on own equity.

**Challenges can arise when establishing whether there is a right to avoid a liability settlement outcome.**

## **KPMG insight**

Presenting sub-classes of equity is not an entirely new concept as many entities already show different classes of equity – e.g. preference shares and ordinary shares. As the staff noted, sub-classes within equity would be more important under approaches Alpha and Beta. We therefore note that the ultimate impact on presentation of equity would depend on the preferred approach selected by the Board.

## **Claims with conditional alternative settlement outcomes**

### **What's the issue?**

Some claims with alternative liability or equity settlement outcomes are:

- conditional on rights within the control of the entity (rather than the counterparty or holder); or
- contingent on the occurrence or non-occurrence of uncertain future events beyond the control of both the entity and holder of the claim.

Many of the associated challenges relate to establishing whether the entity has the right to avoid a liability settlement outcome.

### **What was discussed?**

The staff focused their analysis on non-derivatives and acknowledged that it is sometimes challenging to determine whether an event is within the control of the entity or beyond its control, particularly when it relates to the entity's future activities, financial performance, or financial position.

In the staff's view, approach Gamma might simplify the classification of financial instruments that require the transfer of a specified amount but still allow the entity to defer transferring economic resources until liquidation or to settle the claim by transferring a variable number of ordinary shares – because each alternative outcome would be a liability outcome. However, this approach would not resolve all of the challenges, especially where claims contain alternative liability and equity settlement outcomes – e.g. the entity has a right to settle a claim either by transferring a fixed number of equity instruments or a specified amount of cash.

The staff considered whether the stated right of the entity to choose an equity settlement outcome should be substantive. They considered the guidance on indirect obligations in IAS 32 and the proposed wording in the Conceptual Framework ED regarding terms with no commercial substance. In particular, they argued that a claim with alternative settlement outcomes conditional on rights within the control of the entity should be a financial liability if the equity settlement outcome has no commercial substance – i.e. no discernible effect on the economics of the contracts.

Assuming the right to an equity settlement outcome is substantive, the staff then considered whether the entity has the practical ability to exercise that right using

the proposed guidance on 'practical ability to avoid a transfer' in the Conceptual Framework ED.

The staff also expressed the view that many uncertain future events depend on various risks and actions of parties that are beyond an entity's control, even if they somehow relate to the entity's future actions.

The Board was in favour of the staff considering other facts and circumstances beyond the boundary of the contract in their analysis. The staff will further consider how to take into account the favourability of rights in assessing whether they are substantive and will bring an analysis of the effects on particular types of instruments to a future meeting.

### **KPMG insight**

The staff highlighted that both the IASB and the Interpretations Committee have previously considered the application of IAS 32 to various types of claims. On this basis, the staff argued that there is a need to update the requirements of the standard to reflect the IASB's current thinking regarding the substance of rights and obligations. There are also numerous references in the agenda papers to the Conceptual Framework ED.

With this in mind, we note that – as this project progresses – it will become increasingly important to leverage off existing decisions taken by the IASB and the Interpretations Committee on previous submissions and on other relevant projects.

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Financial instruments



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Business combinations and consolidation



Presentation and disclosures



SlideShare

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

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