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Financial instruments
IFRS Newsletter

"Now that the technical deliberations on FICE are largely completed, we welcome the planned publication of a discussion paper."

– Chris Spall
KPMG's global IFRS financial instruments leader

The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB's discussions in March 2017.

The IASB continued its discussions on financial instruments with characteristics of equity, having previously considered applying the Gamma approach to the contractual terms of a financial instrument and to the accounting within equity for different types of equity instruments.

Highlights

Financial instruments with characteristics of equity (the 'FICE project')

The Board discussed:

- the classification under the Gamma approach of derivatives on non-controlling interests (NCI) with an exercise price denominated in a foreign currency; and
- the interaction of the FICE project with other standards and research projects.

The Board also considered the due process steps undertaken and gave permission for the staff to draft the discussion paper (DP).

The next steps for the project will be to publish the DP towards the end of 2017.

Dynamic risk management

The IASB staff outlined the proposed project approach, project stages and next steps.

Contents

Financial instruments with characteristics of equity

The story so far…

IAS 32 *Financial Instruments: Presentation* includes requirements for the classification of financial instruments between liabilities and equity that result in significant practice issues when applied to many financial instruments with characteristics of equity. In the past, the IFRS Interpretations Committee received several queries in this area and referred some to the IASB because the issue required consideration of fundamental concepts in IFRS.

The Board issued a DP *Financial Instruments with Characteristics of Equity* in 2008. Since then, the Board has discussed some of the challenges as part of its project on the *Conceptual Framework for Financial Reporting*.[1]

In May 2015, the Board formally resumed the project on financial instruments with characteristics of equity, having decided to split it into two work streams – classification, and presentation and disclosures.

Meeting date	What was discussed?
May 2015	The conceptual and application challenges in distinguishing between liabilities and equity.
June 2015	Features that are relevant in measuring claims and in distinguishing between liabilities and equity.
July 2015	The relevance of these features for assessments that users might make using information in the statements of financial position and performance.
September 2015	– The classification of non-derivatives. – The extent to which the requirements in IAS 32 capture the features that users need to make their assessments. – Three possible classification approaches (Alpha, Beta and Gamma).
October 2015	The challenges of classifying and accounting for derivatives on 'own equity' and how IAS 32 addresses these challenges.
February 2016	– Using subclasses of financial liabilities to provide additional information for assessing financial performance and position, and using subclasses within equity to provide additional information about relevant features. – Claims with conditional alternative settlement outcomes.
April 2016	– The scope of any separate presentation requirements for liabilities that depend on a residual amount. – Possible ways to attribute profit or loss and other comprehensive income (OCI) to equity claims (both non-derivatives and derivatives) other than ordinary shares.
May 2016	Attribution approaches, including another way to attribute profit or loss and OCI to derivative equity claims.
July 2016	How to apply the Gamma approach to: the classification of derivatives on own equity, asset/equity exchange derivatives and liability/equity exchange derivatives.
September 2016	For derivatives on own equity under the Gamma approach: – the presentation of specific types of derivatives classified as liabilities; and – how disclosures could complement approaches to classification and presentation.
October 2016	Claims where an issuing entity can choose between alternative settlement outcomes and whether economic incentives should affect classification.
November 2016	Classification under the Gamma approach of instruments meeting the existing puttables exception in IAS 32 and the merits of retaining the exception.
December 2016	The application of the Gamma approach to derivatives on own equity and, in particular, how it addresses some issues that arise in practice when applying the fixed-for-fixed condition in IAS 32.
February 2017	– Whether the effects of law should be considered for the purposes of classifying financial instruments under the Gamma approach. – Proposed application guidance and illustrative examples that clarify how the Gamma approach would apply to the accounting within equity for different subclasses of equity instrument.

1. In May 2015, the IASB 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.

The Board discussed the classification of derivatives on NCI with an exercise price denominated in a foreign currency.

Application of Gamma approach to derivatives on own equity

What's the issue?

The Board previously discussed the fixed-for-fixed condition under the Gamma approach and how the focus should be on the underlying principle that the amount of the derivative should depend solely on the residual amount to meet equity classification. A derivative is 'solely dependent' on the residual amount if the only variable affecting the amount of that derivative is the value of the equity instruments to be delivered – e.g. a derivative contract to receive cash or other financial assets equal to a fixed amount of the entity's functional currency and to deliver a fixed number of its own equity instruments.

At this meeting, the staff addressed the interaction between two variables – foreign currency and the equity instruments of a subsidiary entity – and how they affect the classification of derivatives on own equity under this approach.

What was discussed?

IAS 21 *The Effects of Changes in Foreign Exchange Rates* contains the following definitions.

Functional currency	The currency of the primary economic environment in which the entity operates
Foreign currency	A currency other than the functional currency of the entity
Presentation currency	The currency in which the financial statements are presented

Under the Gamma approach, a derivative issued by a subsidiary would be classified as an equity instrument in the separate financial statements of the subsidiary if:

- the derivative is based on its own equity instruments;
- the derivative is denominated in its functional currency; and
- the derivative's amount is solely dependent on the residual amount of the subsidiary.

In some cases, an entity may issue a derivative that is based on the shares of another entity within the group – e.g. a parent entity may issue a derivative based on a subsidiary's equity shares. The functional currency is determined for each individual entity – i.e. the group does not have a functional currency. This leads to the question of which entity's functional currency should be considered in the evaluation. In these circumstances, the staff believe that the question should be evaluated using the functional currency of the entity whose equity instruments form the underlying, as opposed to the functional currency of the entity that has issued the derivative. This is because the equity instruments represent a claim on the residual amount of a specific entity and the residual amount is measured in that entity's functional currency.

Accordingly, if a parent entity issues a derivative over a subsidiary's equity instruments in the subsidiary's own functional currency – i.e. the exercise price of an option is denominated in the functional currency of the subsidiary – then the derivative could be classified as an equity instrument in the consolidated financial statements. However, if a parent entity issues a derivative over the subsidiary's equity shares in the parent's functional currency (which is different from the functional currency of the subsidiary), then it would not be classified as an equity instrument under the Gamma approach.

The Board agreed with the application of the Gamma approach described by the staff.

KPMG insight

As noted by the staff, the IFRS Interpretations Committee has previously discussed a scenario[2] in which a subsidiary entity issues a derivative on equity instruments of its parent entity. The issue related to which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency and therefore whether it qualifies for equity classification.

If the Board clarifies that the relevant functional currency is the functional currency of the entity whose equity instruments are being delivered, then this could result in a change in practice. In our view, an entity currently has an accounting policy choice, to be applied consistently, to base the classification in the consolidated financial statements on the functional currency of either the parent or the subsidiary. In addition, we believe that:

- if the derivative is denominated in a currency other than the functional currency of either the parent or the subsidiary, then it is a liability; and
- the currency in which the shares are denominated is not relevant to the analysis.

The Board discussed how the FICE project interacts with other standards and other research projects on its agenda.

Interaction with other standards

What's the issue?

The Board observed that the effects of the distinction between liabilities and equity are fundamental aspects of accounting that can be traced back to the Conceptual Framework. Therefore, any change in this distinction and any project to amend or replace IAS 32 will have implications that extend beyond IAS 32. The staff proposed including a brief discussion in the forthcoming DP of:

- potential changes to requirements in other standards that would arise as a result of the Board's preliminary views on the Gamma approach; and
- potential effects resulting from the application of requirements in other standards that currently use, or depend on, the definitions in IAS 32.

The staff will also continue to monitor and liaise with other IASB colleagues on the disclosure initiative and the primary financial statement projects, as these projects may be affected by the FICE project.

2. IFRIC Update – November 2006: IAS 32 *Financial Instruments: Presentation* – Foreign currency instruments exchangeable into equity instruments of the parent entity of the issuer.

What was discussed?

The staff analysed the interaction of the FICE project with the Conceptual Framework and several other existing standards and interpretations.

The Conceptual Framework

The Board intends to publish a revised Conceptual Framework, which will include proposed changes to the definition of a liability. These proposed changes are not intended to address challenges related to the application of the definition in distinguishing liabilities from equity, which are addressed under the FICE project.

The Board decided to focus on the Gamma approach's rationale for a distinction between liabilities and equity. The most significant potential differences from the Conceptual Framework are that:

– there is one additional feature for classification purposes: whether the amount of the obligation is independent of the entity's economic resources; and

– income and expenses that depend on the residual amount could potentially be reported in OCI, but without recycling to profit or loss.

Depending on the feedback on the DP, the staff believe that possible amendments to the Conceptual Framework may be required.

Share-based payments

Currently, the distinction between liabilities and equity under IFRS 2 *Share-based Payment* is consistent with the revised Conceptual Framework. Therefore, any proposed changes to the Conceptual Framework may necessitate changes to IFRS 2. One of the challenges of IFRS 2 is that it uses two measurement models: grant date fair value for equity-settled share-based payments and reporting date fair value for cash-settled share-based payments. The separate presentation requirements[3] for both liabilities and equity under the Gamma approach might help reduce the tension between these two measurement models.

If the Board proceeds with an approach that attributes total profit or loss and OCI to derivatives classified as equity, then it could consider whether that attribution should also be applied more broadly to equity-settled share-based payment transactions.

Other financial instruments standards and interpretations

The scope of the FICE project includes classification, presentation and disclosure. There are some areas where the classification and presentation proposals interact with the recognition and measurement requirements of IFRS 9 *Financial Instruments*. In these areas, the Board's approach is consistent with the requirements of IFRS 9. The DP will also include an analysis of the interaction of the fair value option in IFRS 9 with the separate presentation requirements for stand-alone and embedded derivative financial liabilities that depend on the residual amount.

A project to amend or replace IAS 32 will therefore be likely to trigger consequential amendments to other standards that include requirements for financial instruments, including IFRS 9 and IFRS 7 *Financial Instruments: Disclosures*.

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3. In February 2016, the Board discussed presenting separately liabilities that depend on a residual amount and updating the carrying amount of each subclass of equity to reflect any attribution of profit or loss and OCI. In September 2016, the Board tentatively decided that income and expenses arising from liabilities that meet the separate presentation requirements would be presented under OCI.

The Board tentatively decided in a previous meeting that it would not reconsider the requirements of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments,* other than for consequential amendments. The staff believes that IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* is also beyond the scope of the FICE project as it does not address classification issues.

Performance reporting standards

The separate presentation requirements for both liabilities and equity that will be proposed in the DP would require consequential changes to IAS 1 *Presentation of Financial Statements.* The Board has previously discussed some application guidance and illustrative examples for written put options on own equity. That guidance could help improve consistency between the requirements of IAS 32 and IAS 33 *Earnings per Share.* The interaction between those requirements can be unclear for instruments such as shares underlying written puts.

The following two aspects of the earnings per share (EPS) requirements are relevant to the separate presentation requirements under the Gamma approach.

- The starting point for calculating the numerator of the EPS calculation is total profit or loss, ignoring income and expense included in OCI (this aspect has implications for the separate presentation requirements for liabilities).
- Adjustments to total profit or loss are made to determine the amount attributable to ordinary equity holders of the parent (this aspect may overlap with the different attribution approaches explored in the FICE project).

The staff noted that the Board might wish to consider whether the effects of instruments that are subject to the separate presentation requirements should be considered in the denominator of the EPS calculation. For example, if an entity has 400 shares but 100 of them are puttable at fair value, then the 100 shares are classified as liabilities and measured at the redemption amount. Excluding the changes in the redemption amount from the numerator and including the 100 shares in the denominator would present earnings attributable to 400 shares that reflects the similarity of their returns.

The DP will include four possible approaches to attribute total profit or loss and OCI for derivatives classified as equity. Two of these approaches would attribute an amount weighted by the relative fair values of the derivatives and the fair values of other classes of equity. One of these two approaches would apply that weighting to total profit or loss and OCI, which is similar to the calculation of diluted EPS; however, it would use the fair value of the options instead of their intrinsic value. Therefore, these approaches could form the basis for a broader review of EPS.

Business combinations and consolidation standards

There are no direct requirements arising from IFRS 3 *Business Combinations,* IFRS 10 *Consolidated Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures* that affect the FICE project, but these standards do contain references to some requirements of IAS 32. Questions have arisen about the consistency between the requirements of IFRS 3, IFRS 10 and IAS 32, in particular for written puts on NCI. The Board's previous discussion on applying the Gamma approach to these instruments could help clarify the interactions between IAS 32 and these standards.

The Board was not asked for any decisions. One Board member requested that the DP clarify that:

- the Gamma approach applies the 'no practical ability to avoid' concept found in the definition of a liability under the revised Conceptual Framework;
- under IFRS 9 the scope of the fair value through OCI option for equity instruments is derived from the definition of equity found in IAS 32; and
- the Gamma approach does not change any measurement attributes but has measurement consequences – e.g. for compound instruments.

KPMG insight

Because EPS is such an important and prominent measure of an entity's performance, the Board should carefully consider the implications of any decisions under the FICE project on EPS. The staff have mentioned that the Board might wish to consider whether the effects of instruments that are subject to the separate presentation requirements should be considered in the denominator of the EPS calculation. However, if income and expenses arising from liabilities that depend solely on the residual amount are presented in OCI, then it could be argued that these instruments should not share in the earnings attributable to ordinary equity holders of the parent when calculating EPS.

The Board discussed the due process steps undertaken and gave permission to draft the DP.

Due process

The objective of the DP is to obtain initial views and comments to help the Board decide whether it should add a project to develop potential improvements to IAS 32 to its standard-setting programme. The DP will set out the Board's preliminary views[4] on identified challenges and possible approaches to addressing these, with the aim of developing one of these approaches into a standard-level solution.

The Board believes that it has completed all of the steps necessary to ensure that the DP is likely to meet its purpose, and gave the staff permission to prepare a ballot draft of the DP. It is expected that the DP will be published towards the end of 2017, and that a 180-day comment period will apply. The comment period – which is longer than the 120-day minimum – is intended to accommodate translation of what is expected to be a lengthy document and provide further time for the Board to conduct more outreach and education activities.

KPMG insight

The Board has noted on several occasions that it does not intend to begin from a blank sheet of paper and instead will use IAS 32 as the starting point. This will give some comfort to preparers and users who have become familiar with the long-standing principles established by IAS 32 for presenting financial instruments as liabilities or equity. Given the extent of discussions on the FICE project since its reactivation in October 2014 and the challenges of applying IAS 32, we welcome the publication of a DP and a potential project to amend or replace IAS 32.

4. The Board has not reached preliminary views on all of the matters to be discussed in the DP.

Dynamic risk management

The story so far…

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

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

Respondents to the April 2014 DP broadly supported the macro hedging project, although several acknowledged that aligning financial reporting and DRM activities would be challenging. Despite this general support, the Board identified significant diversity in views on the project's objectives. Many 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, the Board decided to:

- consider the disclosure requirements first, followed by the recognition and measurement requirements;
- prioritise dynamic interest rate risk management; and
- form an 'expert advisory panel' at a later stage in the project.

The Board also decided that the project would remain as a research project instead of being transferred to the Board's standards agenda and that a second DP should be published before issuing an ED. Furthermore, the Board decided to keep open the possibility of moving directly to an ED if a solution emerges that addresses the disclosure, recognition and measurement issues of the project.

In April 2016, the Board was provided with feedback from the 2015 agenda consultation, which noted that the key priorities of this project are to enhance the reporting of interest rate risk management in open portfolios and to overcome the limitations in the current hedge accounting requirements. The Board directed the staff to consider the findings on customer behaviour and replication of portfolios of core demand deposits when further developing the alternative approaches for dynamic risk management.

Dynamic risk management

What's the issue?

At the March 2017 meeting, the staff presented an education session to the Board. The staff explained that the objective of the session was to provide the Board with an overview of the project history and background, and map out the project approach, project stages and next steps.

Project history

The staff summarised the history of the project to date. This included feedback received by the Board that entities experience difficulties applying the existing portfolio fair value interest rate hedging model in IAS 39. These difficulties relate to the application of IAS 39 guidance focused on static assets and liabilities to a portfolio of changing assets and liabilities, the ineligibly of certain items to be designated as hedged items under the existing IAS 39 model, the assessment of hedge effectiveness and the amortisation of hedge adjustments.

The staff also provided a short summary of some of the DP feedback received, as shown in the table below.

Positive feedback	Negative feedback
– The April 2014 DP captured the critical elements of DRM – The challenges of the existing IAS 39 model were well understood – The need for the project was reinforced	– Revaluing residual risk does not necessarily reflect DRM and may lead to profit or loss volatility – Proposals for certain transactions may not reconcile with the Conceptual Framework – e.g. inclusion of the equity model book as a managed exposure under the PRA – Few alternative models were suggested

Furthermore, the staff discussed the recently published results of the outreach on DRM undertaken by the European Financial Reporting Advisory Group (EFRAG).

Project approach

The staff noted that the key point to consider when formulating the project approach is the information content in financial statements for DRM activities. The focus would be on solutions involving measurement and disclosures. The staff outlined the following questions for consideration.

- Is the information content improved, considering the objective of financial statements?
- Can users understand the risk management objective and evaluate management's ability to deliver against the stated goal?
- Does the information allow risk managers to faithfully and transparently represent their activities in the financial statements?
- Does the solution fit with the Board's Conceptual Framework project?

Project stages

The staff outlined three stages for the project.

- Stage 1: What is DRM?
- Stage 2: How would a new accounting model be evaluated?
- Stage 3: Evaluate the proposals and select a preferred approach.

The expected timeline for the project is as follows.

Project stage	Timeline
– What is DRM?	– Spring 2017
– How is DRM currently reflected in financial statements?	– Summer 2017
– How to evaluate a proposed accounting model	– Summer 2017
– Evaluate potential solutions against agreed-upon criteria	– Autumn 2017
– Select a preferred approach	– Autumn 2017
– Develop and finalise a preferred approach	– Post- autumn and beyond

Next steps

The following table summarises the next steps of the project.

Area of focus	Items to be addressed
DRM to stabilise net interest margin	– Why net interest margin (NIM) is important – The meaning of stable NIM and optimising NIM – Why time horizons are relevant
Demand deposit modelling	– What DRM is trying to accomplish with the modelling of demand deposits – What would occur if DRM did not model demand deposits – How DRM evaluates the 'substance' of a demand deposit

What did the IASB decide?

The Board did not make any decisions, but generally agreed with the project approach, project stages and expected timeline outlined by the staff.

During the meeting, a few Board members commented that two key elements of the project related to core demand deposits and open net interest rate risk positions. In this regard, they believe that developing an overall DRM accounting solution could involve addressing these two elements separately.

KPMG insight

Formulating an accounting solution that appropriately reflects DRM activities in financial statements remains a challenge. When the April 2014 DP was released, we commented that aligning financial reporting and DRM activities would be difficult. For example, revaluation of equity model book would be inconsistent with the Conceptual Framework because an entity would recognise a gain or loss for an exposure relating to its own equity. We also commented that a wide range of DRM activities exist in practice and it may prove difficult to define or differentiate them from other risk management activities.

Another challenging area for the project is demand deposits. The restrictions in the IFRS 9 hedge accounting model for demand deposits as an eligible hedged item result in entities being unable to revalue exposures that they hedge for risk management purposes in the financial statements.

It remains to be seen whether any potential accounting solution can overcome these challenges and address the concerns of all stakeholder groups.

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