KPMG

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Financial instruments

IFRS Newsletter

"A binary classification approach cannot by itself portray all useful information. New presentation and attribution requirements could help address this shortfall but more work is needed to refine how they might apply."

– Chris Spall
KPMG's global IFRS financial instruments leader

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The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB's discussions in April 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 considered:

- the use of sub-classes of financial liabilities and equity to provide additional information that a single distinction between liabilities and equity cannot convey; and
- claims with conditional alternative settlement outcomes.

Highlights

At its April meeting, the Board discussed:

- whether the scope of any separate presentation requirements for liabilities that depend on a residual amount should include stand-alone derivatives and embedded derivatives; and
- the attribution of profit or loss and other comprehensive income (OCI) to equity claims (both non-derivatives and derivatives) other than ordinary shares.

The Board was also provided with feedback from the 2015 Agenda Consultation. It was evident that current IAS 32 requirements continue to cause application challenges, especially for new instruments issued with complex terms.

The next step for the project will be to consider refinements to the definition of the residual amount, including the fixed-for-fixed condition. The Board will also further consider the presentation of income and expense that depend on a residual amount in profit or loss or OCI, the attribution approaches for derivative equity claims and disclosure requirements for equity claims.

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

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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*[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.

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.

In February 2016, the Board discussed 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. It also discussed claims with conditional alternative settlement outcomes.

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.

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The Board discussed whether the scope of any separate presentation requirements should include stand-alone derivatives and embedded derivatives

Separate presentation requirements for liabilities that depend on a residual amount

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.

Two different types of returns could arise from these liabilities:

- promised returns – e.g. interest accrued on ordinary bonds; or
- residual returns – e.g. changes in shares redeemable at fair value.

The Board previously indicated that it would be useful to distinguish and present separately income and expense arising from claims that depend on a residual amount which are classified as financial liabilities.

Shares redeemable at fair value are not the only types of financial liabilities that depend on a residual amount. The staff argued that if a hybrid financial liability depends on a residual amount, then it is likely that there is an embedded derivative that needs to be separated. For hybrid contracts, the embedded derivative could either be:

- separated from the host contract and classified at fair value through profit or loss ('FVTPL'); or
- not separated from the host contract if the whole hybrid instrument is classified as a financial liability at FVTPL.

What was discussed?

The staff believed that separate presentation requirements should apply to stand-alone derivatives that depend on a residual amount. They considered that changes in their values would be dependent on the residual amount.

For many hybrid contracts – e.g. bonds with equity-indexed interest or principal payments – there would be a difference between separating an embedded derivative and accounting for it separately from the host contract compared to measuring the hybrid instrument as a whole at FVTPL. In the latter case, changes in the fair value would also include changes related to the host contract arising from interest rate and credit risk.

The following table outlines the staff's suggested approaches for applying the separate presentation requirements to hybrid instruments that contain embedded derivatives that depend on a residual amount:

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Approach	Description	Advantage
Approach A	The separate presentation requirements are applied only to embedded derivatives that depend on a residual amount and are separated – i.e. not to any hybrid instruments classified at FVTPL.	Minimises the cost and complexity of requiring separation of all embedded derivatives that depend on a residual amount.
Approach B	Embedded derivatives that depend on a residual amount are separated under all circumstances and the separate presentation requirements are applied to those embedded derivatives.	Maximises the benefits of applying the separate presentation requirements on a granular level to all financial liabilities that depend on a residual amount.

The Board generally welcomed the overall staff analysis, and agreed that both approaches should be included in the forthcoming discussion paper. One Board member expressed a concern that the existing accounting treatment of stand-alone derivatives may be impacted, especially if there are other underlying variables in addition to the residual feature. This Board member questioned whether the Board would allow bifurcation of such derivatives and whether it would be appropriate for changes in fair value due to the residual to be presented in OCI. The Board also acknowledged that if Approach B is applied, the staff should consider whether the fair value option would still be available for any remaining hybrid instrument after separating out the embedded derivative that depends on a residual amount. The staff will develop these approaches further.

KPMG insight

Approach B would appear to go beyond presentation requirements by changing recognition and measurement requirements – i.e. it would make the separation of embedded derivatives that depend on the residual amount mandatory. This might not be feasible as it may not be possible to measure the embedded derivative separately. Both IAS 39 and IFRS 9 require an entity to designate an entire hybrid liability as at FVTPL if the entity is unable to measure separately an embedded derivative that otherwise would have to be separated.

The staff analysis discusses only stand-alone and embedded derivatives that depend on a residual amount and would be classified as liabilities. It does not discuss whether separate presentation requirements might apply for derivative assets that depend on a residual amount.

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The Board discussed different attribution approaches for equity claims (both non-derivatives and derivatives) other than ordinary shares

Attribution of profit or loss and OCI to classes of equity claims other than ordinary shares

What's the issue?

Currently, more information is provided in financial statements for items classified as liabilities than those classified as equity. The Board previously indicated it would be useful to attribute profit or loss and OCI to some or all subclasses of equity other than the ordinary shares of the parent and to update the carrying amount of each subclass of equity to reflect any such attribution.

IAS 33 *Earnings per Share* contains attribution principles for the purpose of calculating basic earnings per share and includes the effect of dilutive instruments (including derivatives) in the calculation of diluted earnings per share (EPS). These principles may be able to provide a basis for the attribution of amounts to classes of equity claims other than ordinary shares.

What was discussed?

The staff believed the existing requirements in IAS 33 should be followed for the attribution of total profit or loss and OCI to non-derivative equity claims – e.g. non-cumulative preference shares, other participating equity claims and non-derivative equity components of compound instruments.

The staff presented the following potential approaches for attributing total profit or loss and OCI to derivative equity claims – e.g. forwards, written and purchased options to issue equity instruments, purchased options to purchase equity instruments, derivative equity components of compound instruments:

Approach	Description	Observations
Approach A	Changes are not attributed – i.e. the existing treatment of only disclosing the effect through diluted EPS is continued.	Unlikely to improve the information provided by the existing requirements regarding the effect on ordinary shares of other classes of equity.
Approach B	Changes are attributed based on the change in the fair value of the derivative.	Provides more information regarding the effect on ordinary shares of other classes of equity and does not depend on other calculations. However, if the change in the fair value of the derivative is greater than the recognised residual return, this would result in the attribution of a deficit amount for ordinary shares.

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Approach	Description	Observations
Approach C	Changes are attributed on a relative fair value basis – i.e. based on changes in the attribution of total recognised equity on a relative fair value basis between derivatives and other classes of equity.	The total recognised equity would be allocated on a pro rata basis. However, the amount attributed to the derivative would only be relevant in comparison to the amount attributed to ordinary shares. This approach would be the most costly.

The amount attributed to derivatives on own equity would affect the numerator for the basic EPS calculation, but would be reversed for the purpose of calculating diluted EPS. Under all three approaches, the calculation of diluted EPS would be the same because it assumes that the derivative was exercised.

The Board was not asked for decisions at this meeting, although it acknowledged that users want more information on dilution and participation rights. Approach A is the most pragmatic approach because it does not change the existing calculation of EPS. However, some Board members believed that Approach A should be supplemented with additional disclosures. A number of Board members pointed out that the amount attributed under Approach C is a calculated number and questioned its meaning. Board members acknowledged that Approach B, on the other hand, amplifies the consequences of partial recognition and mixed measurement and could result in an amount attributable to the entity from ordinary shareholders. One Board member suggested that an alternative to attribution is to change the calculation of diluted EPS to reflect the fair value of options and not merely their intrinsic value. The staff will develop the attribution approaches further.

KPMG insight

Using attribution to convey additional information to users which cannot be achieved through a binary classification approach could be very helpful – especially if an entity has a complex capital structure.

The statement of profit or loss and OCI is presented from an entity perspective. However, investors benefit from understanding the link between the entity's earnings and their current or potential share in the entity's earnings.

Investors in equity instruments other than ordinary shares also have a claim on the net assets of the entity in the case of liquidation. As previous user feedback indicated, one method to acknowledge their claims would be for the entity to classify only ordinary shares as equity and all other instruments as liabilities. However, considering how classification approaches Alpha, Beta and Gamma have been developed, this method would not distinguish instruments based on their relevant features. Attribution could be a way to convey information that is more useful to users.

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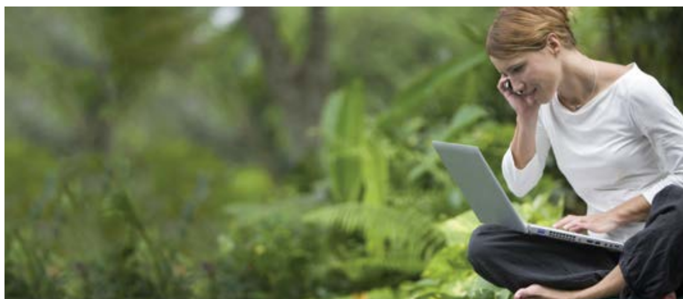
Keeping you informed



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