

# Financial instruments

## IFRS Newsletter



**“The development of a classification principle based on defining ‘residual amount’ will require more effort but may help improve consistency in classifying derivatives on own equity.”**

– 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 December 2016 on its project on financial instruments with characteristics of equity (the ‘FICE project’).

The IASB has continued its discussions on financial instruments with characteristics of equity, having previously considered the classification under the Gamma approach of instruments meeting the existing puttables exception in IAS 32 and the merits of retaining the exception.

### Highlights

At its December meeting, the Board discussed the application of the Gamma approach to derivatives on own equity. In particular, it focussed on some issues that arise in practice when applying the fixed-for-fixed condition in IAS 32.

The next steps for the project will be to consider the:

- substance of rights and obligations in contracts and their interaction with legal and regulatory requirements; and
- recognition, derecognition and reclassification of equity instruments.

In addition, the Board agreed to add to its agenda a narrow-scope project on the classification under IFRS 9 *Financial Instruments* of financial assets with symmetric make-whole prepayment options. The Board will discuss this topic in January 2017.

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

# 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 which 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 discussion paper (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*.<sup>1</sup>

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?
<a href="#">May 2015</a>	The conceptual and application challenges in distinguishing between liabilities and equity.
<a href="#">June 2015</a>	Features that are relevant in measuring claims and in distinguishing between liabilities and equity.
<a href="#">July 2015</a>	The relevance of these features for assessments that users might make using information in the statements of financial position and performance.
<a href="#">September 2015</a>	<ul style="list-style-type: none"> <li>– The classification of non-derivatives.</li> <li>– The extent to which the requirements in IAS 32 capture the features that users need to make their assessments.</li> <li>– Three possible classification approaches (Alpha, Beta and Gamma).</li> </ul>
<a href="#">October 2015</a>	The challenges of classifying and accounting for derivatives on 'own equity' and how IAS 32 addresses these challenges.
<a href="#">February 2016</a>	<ul style="list-style-type: none"> <li>– 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.</li> <li>– Claims with conditional alternative settlement outcomes.</li> </ul>
<a href="#">April 2016</a>	<ul style="list-style-type: none"> <li>– The scope of any separate presentation requirements for liabilities that depend on a residual amount.</li> <li>– Possible ways to attribute profit or loss and other comprehensive income (OCI) to equity claims (both non-derivatives and derivatives) other than ordinary shares.</li> </ul>
<a href="#">May 2016</a>	Attribution approaches including another way to attribute profit or loss and OCI to derivative equity claims.
<a href="#">July 2016</a>	How to apply the Gamma approach to: the classification of derivatives on own equity, asset/equity exchange derivatives and liability/equity exchange derivatives.
<a href="#">September 2016</a>	For derivatives on own equity under the Gamma approach: <ul style="list-style-type: none"> <li>– the presentation of specific types of derivatives classified as liabilities; and</li> <li>– how disclosures could complement approaches to classification and presentation.</li> </ul>
<a href="#">October 2016</a>	Claims where an issuing entity can choose between alternative settlement outcomes and whether economic incentives should affect classification.
<a href="#">November 2016</a>	Classification under the Gamma approach of instruments meeting the existing puttables exception in IAS 32 and the merits of retaining the exception.

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 how the Gamma approach addresses some issues that arise in practice when applying the fixed-for-fixed condition in IAS 32.**

## **Application of the Gamma approach to derivatives on own equity**

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

Under IAS 32, a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments is classified as an equity instrument (the 'fixed-for-fixed' condition). However, there is little additional guidance on how to interpret the fixed-for-fixed condition.

The Gamma approach incorporates the fixed-for-fixed condition. Under the Gamma approach, an entity would classify derivatives for the receipt of cash or other financial assets, or the extinguishment of a financial liability, in exchange for the delivery of equity instruments as equity instruments if:

- they meet the fixed-for-fixed condition – i.e. the amount of claims depend solely on the residual amount; and
- are either physically settled or net-share settled – i.e. there is no requirement to transfer economic resources before liquidation.

To meet the fixed-for-fixed condition under the Gamma approach, the staff believe the focus should therefore be on the underlying principle that the amount of the derivative should solely depend on the residual amount. This raises the question of whether some variables introduced to an otherwise fixed-for-fixed contract would still be consistent with this principle.

### **What was discussed?**

The staff noted that the definition of the term 'residual amount' is key to classification. The residual amount is the difference between the entity's economic resources, and the claims against the entity that specify an amount that is independent of the entity's economic resources.

The Gamma approach aims to make it easier to assess the extent to which an entity:

- has sufficient economic resources to satisfy the total claims against it; and
- has produced a sufficient return on its economic resources to satisfy the promised return on claims against it.

If the amount of a claim depends on the residual amount, such an instrument will not be relevant to these assessments because its amount depends on the amount of economic resources available – i.e. if none are available after satisfying claims of an independent amount, then the amount of such a claim is zero.

The staff noted that the Board had tentatively decided that a derivative should be classified in its entirety, considering both its receive leg and its pay leg. Thus, a derivative can be equity classified if it includes both an amount that is independent of the entity's resources and an amount that depends on the residual amount – provided that in its entirety the amount of the derivative depends solely on the residual amount. This would be the case if, for example, the receive leg is a fixed amount of cash and the pay leg is a fixed number of equity shares.

The terms and conditions of derivatives may introduce several variables that affect the amount of the claim. Some of these variables depend on the residual amount and some do not. Therefore, the entire amount of the derivative (which is physically

settled or net share-settled) could only be classified as equity if all variables depend solely on the residual amount. The staff believe that one way of operationalising this principle is to consider whether the derivative includes a variable that introduces changes in the amount of the derivative that do not depend on the residual amount. The staff explained that the amount of the claim is the contractually specified amount and should be distinguished from the value of the claim, which is affected by various factors – e.g. the amount of the claim, and credit risk.

Based on the discussions by the IFRS Interpretations Committee and previous consultations on the project, the staff identified and analysed the following variables that change the amount of the derivative.

- Time value of money (TVM).
- Currency.
- Dilution.
- Distributions to holders of equity instruments.
- Variable that depends on a specific part of the residual amount.
- Non-controlling interest.
- Contingency that affects the amount of a derivative.

Below is a summary of the staff’s analysis of each variable followed by a description of how the underlying principle could apply to some example instruments. The staff emphasised that its analysis relates to explaining the principle underpinning the Gamma approach and not to the application of IAS 32.

### Time value of money (TVM)

Compensation for the TVM is a component of all derivatives which, by definition, are settled at a future date. Therefore, contractual terms reflecting compensation for the TVM do not preclude an instrument from being considered to be solely dependent on the residual amount. However, if the TVM variable is leveraged or unrelated to the derivative, then the derivative is not classified as equity.

Example instrument	Proposed classification
An instrument whose option strike price changes based on a variable depending on the exercise date (Bermudan option).	<ul style="list-style-type: none"> <li>– If the strike price is indexed to a relevant market interest rate which compensates only for the TVM – <i>equity classification would not be precluded.</i></li> <li>– If the strike price is indexed to foreign currency or an unrelated or leveraged interest rate – <i>derivative would not be an equity instrument.</i></li> </ul>

### Currency

Because the availability of economic resources and the entity’s performance are measured in the reporting entity’s functional currency, the ‘fixed amount of cash or other financial assets’ refers to a fixed amount in the reporting entity’s functional currency. Furthermore ‘fixed amount’ does not refer to the volume, or number,

of specified assets to be received, but to the amount of functional currency units they represent.

Example instruments	Proposed classification
Derivatives to exchange a fixed amount of foreign currency units for a fixed number of own equity instruments.	Would not be classified as equity because the amount <i>does not solely depend on the residual amount</i> . It also depends on the foreign exchange rate.
Derivatives to exchange a fixed number of financial assets that are indexed to a commodity price for a fixed number of own equity instruments.	If the fixed number of financial assets is indexed to a commodity price, then the derivative would not be classified as equity because the amount of the claim <i>does not solely depend on the residual amount</i> .

### Dilution

Some derivatives such as warrants and options embedded in convertible bonds contain an anti-dilution provision which protects the holder of the derivatives from dilution. Dilution results from later issuances of equity instruments that increase the total number of shares in order to reduce the derivative holder's share of the residual amount.

Provisions may be:

- asymmetric – i.e. they adjust the number of shares to be issued only when there is an increase in the total number of shares in issue; or
- symmetric – i.e. they adjust for both increases and decreases in the total number of shares outstanding to ensure a fixed proportion of the residual amount.

A derivative that ensures the holders have a fixed proportion of the residual amount as their share – i.e. requires exchange of a fixed proportion of the total number of that class of equity instruments for receipt of a fixed amount of financial assets – solely depends on the residual amount.

Example instruments	Proposed classification
Warrant with a strike price of \$1 for 2.5% of the shares currently in issue.	A fixed % of shares currently in issue is another way to express a fixed number of shares. Such a variable <i>would not preclude equity classification</i> .
Option with a change in control provision that promises a fixed proportion of the residual amount – i.e. the conversion ratio is adjusted relative to what it would have been in the absence of the change of control.	The amount of claims arising from the option solely depends on the residual amount. Such a variable <i>would not preclude equity classification</i> .

A fixed amount anti-dilution provision that, on issuance of additional equity instruments, requires the entity to issue a variable number of shares equal to a fixed amount – e.g. share conversion option with a floor value of CU100.	The provision ensures that the holder has a specific amount independent of the entity’s economic resources. Therefore, the instrument would not be an equity instrument.
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### Distributions to holders of equity instruments

If the contractual terms of an instrument adjust the conversion ratio or exercise price to compensate the future equity instrument holder for missed payments that it would be entitled to – e.g. dividends – it would not violate the instrument being solely dependent on the residual amount. Discretionary dividends represent a part payment of the residual amount rather than a part payment of an independent amount.

Compensation for missed dividends seeks to protect the conversion option holder from the reduction of a claim resulting from distribution of the residual amount. Because instruments classified as equity can have different rights to distributions, the presence of such rights does not itself trigger changes in the amount of the derivatives that do not depend on the residual amount.

Example instruments	Proposed classification
Convertible bond that mandatorily converts to equity shares and the conversion ratio is adjusted if dividends are paid to ordinary shareholders.	The compensation for missed dividends seeks to protect the holder of the conversion option from the reduction of claims resulting from a distribution of the residual amount. Such a variable <i>would not preclude equity classification</i> .
Convertible bond with a coupon indexed to a benchmark interest rate that is mandatorily converted to equity shares based on a fixed conversion ratio at maturity. The coupon, if unpaid, accumulates and converts into shares.	Coupons do not represent a share of the residual amount. The relevant variable to consider is TVM because the variability in the number of shares to be delivered is introduced by changes in the benchmark interest rate. <i>Equity classification would not be precluded</i> unless the benchmark interest rate is leveraged or if it is unrelated to the instrument, in which case the variability in the number of shares to be delivered would make the conversion obligation no longer solely dependent on the residual amount.

### Variable that depends on a specific part of the residual amount

If an instrument depends solely on the residual amount, then the amount cannot be beyond the residual amount, but it can be a component of the residual amount. A share of the residual amount could be specified with reference to a variable such as the entity’s recognised net assets, unrecognised net assets, or profit or loss and

OCI because those variables solely depend on the residual amount. The holder will share the residual amount of the issuer with other equity instrument holders. This type of variable does not preclude equity classification of the instrument.

Example instruments	Proposed classification
Derivative whose amount depends on a specific % of earnings before interest, tax, depreciation and amortisation (EBITDA).	EBITDA does not represent a share of the residual amount; it represents economic resources before deducting all relevant claims or charges that are independent of the economic resources. It is not a variable that solely depends on the residual amount. The derivative <i>would not be classified as an equity instrument</i> .
Derivative that obliges an entity to exchange a fixed number of shares of one class of its own equity (e.g. non-cumulative preference shares) for a fixed number of shares of another class (e.g. ordinary shares).	If both classes of equity instrument solely depend on the residual amount, then the derivative will also solely depend on the residual amount. It is not necessary for all instruments that are classified as equity to have an equal pro rata share of the residual amount. Therefore <i>equity classification would not be precluded</i> .

### Non-controlling interest (NCI)

The amount of the NCI depends on the available economic resources of the subsidiary – i.e. solely depends on the residual amount of the subsidiary. The residual amount of the subsidiary is part of the residual amount of the consolidated group.

Example instruments	Proposed classification
A written call option to issue a fixed number of equity instruments of a subsidiary for receipt of a fixed amount of financial assets (strike price is in the functional currency of the reporting parent entity)	The written call option depends solely on the residual amount and <i>would not preclude equity classification</i> .
Derivative that obliges an entity to exchange a fixed number of its own shares for a fixed number of its subsidiary's shares – i.e. the entity issues additional shares in return for buying back additional shares in subsidiaries.	Because the amount of claims arising from the derivative depends on the residual amount of the group and the subsidiary, and no other variable, the derivative solely depends on the residual amount and <i>equity classification would not be precluded</i> .

### Contingency that affects the amount of a derivative

A contract to exchange a fixed amount of cash or other financial assets for a fixed number of ordinary shares is classified as equity even if its exercise is contingent on an event beyond the control of both the entity and the counterparty. If the event occurs, then the contract is exercised; if it does not occur, then the contract expires. Whether the contract is exercised does not affect the amount of the claim. However, if a contingency affects the amount of a claim, then the entity would need to determine whether the variability introduced by a contingency solely depends on the residual amount.

Example instruments	Proposed classification
A derivative that requires the exchange of CU100 for the issuance of 100 ordinary shares and is mandatorily exercisable if event A occurs.	The probability of the contingent event occurring will affect the value of the derivative but not the amount of the claim arising. Therefore the contingency <i>would not preclude equity classification</i> .
Written call option with a predetermined number and price of exchange that depends on a contingent event – e.g. if event B occurs, then exchange 120 shares for CU100; if event B does not occur, then exchange 100 shares for CU100.	Unless Event B is a 20% increase in the number of shares – i.e. the amount of the claim is a fixed proportion of the residual amount, the contingency will introduce a variable that is independent of the economic resources of the entity, and therefore the instrument <i>would not be an equity instrument</i> .
A conversion obligation to deliver a variable number of own equity instruments to equal a fixed amount of cash, subject to a cap and a floor.	Such a conversion obligation is not an equity instrument because the amount changes in response to an amount independent of the economic resources of the entity under one possible settlement outcome. The fact that the adjustment to the number of shares varies with the share price <i>would not make it an equity instrument</i> . Not all variables that might be linked to a share price depend on the residual amount. The classification outcome would not change even if the number of shares to be transferred is restricted to a particular range by a cap and a floor.

Several Board members expressed support for the general direction of the staff's analysis. This included emphasising the importance of dependence on the residual amount and the need to define residual amount for the purposes of equity classification.

Some Board members questioned how variability in cash flows based on the time value of money could be consistent with the sole dependence on the residual amount. Also, some Board members mentioned that an interest rate or index could include elements other than time value of money, such as compensation for credit risk.

Board members also questioned how the requirement for a fixed amount of cash or other financial assets to be a fixed amount in the reporting entity's functional currency should apply in the context of a reporting entity that included multiple operations with different functional currencies. For example, there was a discussion about how to classify an equity derivative issued by a foreign subsidiary denominated in its own functional currency in the consolidated financial statements of a parent with a different functional currency. In such cases the reporting entity did not have a single functional currency. It was also observed that addressing such questions was tied to the notion of a component of the residual amount of the reporting entity and it is possible that different parts may have different currency exposures. This concept is similarly relevant in considering derivatives over NCIs more broadly – e.g. the residual amount of a subsidiary is a component of the consolidated residual amount.

The staff agreed to look further at issues raised by Board members. In particular, the Board asked the staff to consider the application of the Gamma approach to the classification of derivatives on NCIs with an exercise price denominated in a foreign currency.

Some Board members asked whether the Gamma approach would be consistent with the current exception in IAS 32 that allows rights to acquire a fixed number of the entity's own equity instruments for a fixed amount of foreign currency to be classified as equity if they are offered pro rata to existing equity shareholders. The staff replied that these instruments would be classified as liabilities under the Gamma approach but may be subject to separate presentation of gains and losses in OCI in line with [the Board's tentative decision in September](#). The staff also observed that whether the exception should be preserved is an additional question.

The Board was not asked for any decisions.

### KPMG insight

IAS 32 provides little guidance on how to interpret the fixed-for-fixed condition. As a result, practitioners have developed positions to address some of the issues discussed by the Board and experienced in practice.

To promote consistency in practice, it may be useful to have a broader underlying principle supported by more practical application guidance. The Board's discussions this month indicate a possible way forward through focussing on whether the amount of the derivative is solely dependent on the residual amount. However, there would seem to be more work to do in clarifying the relevant concepts and testing their application and consistency. Also, it is not clear whether variations in amounts based on interest rates are a part of the underlying principle or an addition or exception to it.

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# KPMG contacts

## Americas

### Reza van Roosmalen

T: +1 212 954 6996

E: [rezavanroosmalen@kpmg.com](mailto:rezavanroosmalen@kpmg.com)

### Dilshad Hassen

T: +1 416 777 8978

E: [dhassen@kpmg.ca](mailto:dhassen@kpmg.ca)

## Asia-Pacific

### Reinhard Klemmer

T: +65 6213 2333

E: [rklemmer2@kpmg.com.sg](mailto:rklemmer2@kpmg.com.sg)

### Tamami Okawa

T: +81 3 3548 5107

E: [Tamami.Okawa@jp.kpmg.com](mailto:Tamami.Okawa@jp.kpmg.com)

## Europe, Middle East and Africa

### Colin Martin

T: +44 20 7311 5184

E: [colin.martin@kpmg.co.uk](mailto:colin.martin@kpmg.co.uk)

### Venkataramanan Vishwanath

T: +91 22 3090 1944

E: [vv@kpmg.com](mailto:vv@kpmg.com)

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

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