KPMG

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Financial instruments

IFRS Newsletter

"The effort to supplement a binary classification approach with presentation and disclosure improvements is a welcome step in moving the FICE project forward."

– 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 September 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 how to apply the Gamma approach[1] to: the classification of derivatives on own equity, asset/equity exchange derivatives and liability/equity exchange derivatives.

Highlights

At its September meeting, the Board continued its discussion on derivatives on own equity under the Gamma approach but focused on:

- the presentation of specific types of derivatives classified as liabilities; and
- how disclosures could complement approaches to classification and presentation.

The next steps for the project will be to consider:

- classification of instruments meeting the existing puttables exception;
- accounting for conditional alternative settlement outcomes; and
- recognition, derecognition and reclassification of equity instruments.

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

The Board issued amendments to IFRS 4 *Insurance Contracts* in response to concerns about temporary accounting mismatches and volatility, and increased costs and complexity due to the differing effective dates of IFRS 9 *Financial Instruments* and the forthcoming insurance contracts standard. These amendments include optional approaches that can mitigate those impacts for insurers but they will need to consider their IFRS 9 implementation plans carefully to decide if, and how, to use them. Read our web article to find out more.

1. See September 2015 IFRS Newsletter: Financial Instruments.

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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. 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*.[2]

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 revisit the project formally until May 2015, when it discussed the conceptual and application challenges in distinguishing between liabilities and equity.

Meeting date	What was discussed?
June 2015	The Board identified features that are relevant in measuring claims and in distinguishing between liabilities and equity.
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.
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).
October 2015	The Board discussed the challenges of classifying and accounting for derivatives on 'own equity' and how IAS 32 addresses these challenges.
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.
April 2016	The Board considered the scope of any separate presentation requirements for liabilities that depend on a residual amount. It also discussed 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	The Board continued its April discussions on attribution approaches and explored another possible way to attribute profit or loss and OCI to derivative equity claims.
July 2016	The Board discussed how to apply the Gamma approach to: the classification of derivatives on own equity, asset/equity exchange derivatives and liability/equity exchange derivatives.

2. 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.

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The Board discussed two presentation approaches for derivatives on own equity that are partially dependent on the residual amount

Presentation of derivatives on 'own equity' classified as liabilities

What's the issue?

Under the Gamma approach, the following types of derivatives would be classified as liabilities.

Type 1	Value is solely dependent on the residual amount but will be net-settled in cash or financial assets before liquidation.
Type 2	Value is completely independent of the residual amount.
Type 3	Value is neither completely independent nor solely dependent on the residual amount.

The Board previously agreed that it would be useful to distinguish between liabilities (and associated income or expense) that are independent of the residual amount and those that depend on the residual amount by applying separate presentation requirements.

In April 2016, the Board discussed applying these requirements to Type 1 derivatives classified as liabilities, but not to Type 3 derivatives.

What was discussed?

The staff set out two alternative approaches for applying the separate presentation requirements to Type 3 derivatives. The staff's analysis referred to the use of OCI for separate presentation. However, the Board has not yet decided whether separate presentation should mean separate presentation in profit or loss using a subtotal or separate presentation in OCI.

Disaggregation approach

This approach disaggregates the total income and expenses of the derivative into:

- those arising from variables that are independent of the residual amount (presented in profit or loss); and
- those arising from variables that represent the residual amount (presented in OCI).

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Consider the following example of an issue of 1,000 call options to receive a fixed amount of cash in a foreign currency in exchange for one ordinary share.

	Year 0	**Year 1**
Number of options	1,000	1,000
Exercise price in foreign currency (AC[1])	AC 10	AC 10
Exchange rate	1:1	1:1.10
Exercise price in functional currency (FC)	FC 10	FC 9.09
Share price	FC 10	FC 12
Fair value of derivative	FC 2,280	FC 4,680
Value of options holding FX rate and FX volatility constant		FC 4,080
Value of options holding share price and share price volatility constant		FC 2,850

When the effect of changes in the residual amount is isolated (i.e. holding FX rate and FX volatility constant), the following disaggregation results.

Total fair value changes (4,680-2,280)	FC 2,400
Changes arising from the independent FX variables presented in profit or loss (4,680-4,080)	FC 600
Changes that depend on the residual (2,400-600 or 4,080-2,280) presented in OCI	FC 1,800

When the effect of changes in the fair value resulting from variables not dependent on the residual amount is isolated (i.e. holding share price and share price volatility constant), the following disaggregation results.

Total fair value changes (4,680-2280)	FC 2,400
Changes arising from the independent FX variables presented in profit or loss (2,850-2,280)	FC 570
Changes that depend on the residual (2,400-570 or 4,680-2,850) presented in OCI	FC 1,830

The way these calculations result in different amounts highlights the disadvantage of applying a disaggregation approach. Disaggregation of fair value changes into the individual variable level is not always sufficient due to the interdependency of variables.

3. Alternative currency – i.e. the foreign currency.

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Applying the disaggregation approach to the presentation in the statement of financial position would result in the disaggregation of the carrying amount of a single derivative into two portions that purport to represent:

- the portion that is independent of the entity's economic resources; and
- the portion that depends on the residual amount.

This allocation is likely to be arbitrary and would be inconsistent with the Board's prior acknowledgement that derivatives should not be classified into sub-components.

All-in or all-out approach

This approach would require separate presentation of all income and expenses arising from a derivative of this type if the following criteria are met:

- the derivative would have been considered solely dependent on the residual amount had it not been denominated in a currency other than the issuer's functional currency;
- the foreign currency exposure is not leveraged;
- a party to the contract does not have an option to choose which currency to deliver or receive under the derivative; and
- the foreign currency denomination is imposed by the market rather than as a result of the entity's choice – i.e. it would not have been practically possible to enter into the same derivative denominated in the entity's functional currency.

Following on from the example used above, under this approach, if the call options meet the criteria, then the entire change in the fair value of FC 2,400 would be presented separately in OCI. If they do not meet the criteria, the entire change would be presented in profit or loss.

Applying the all-in or all-out approach to the presentation in the statement of financial position would result in presenting the entire carrying amount of the derivative without further split. Therefore, derivatives that are neither completely independent nor solely dependent on the residual amount could be presented as a separate class. However, this means that some changes that do not depend on the residual amount will sometimes be presented separately.

What did the Board decide?

The Board agreed that both approaches should be included in the discussion paper, with a preliminary view in favour of the all-in or all-out approach. The Board decided that application of the separate presentation requirements should be limited to specific types of derivatives with foreign currency exposure, and only under certain circumstances. A Board member argued that foreign currency exposures are special enough to warrant separate presentation for changes in value but not so special that they should override the basic classification criteria. The staff were asked to clarify what was meant by 'imposed by the market' in the last criterion for the all-in or all-out approach and one board member questioned whether the motivation for taking on the foreign currency exposure was important.

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The Board decided that income and expenses arising from financial instruments that meet the separate presentation requirements, including derivatives on 'own equity', should be presented in OCI. Some Board members argued that presenting a separate line item in profit or loss would not be useful as counterintuitive amounts linked to the performance of an entity would be included in earnings. One Board member asked the staff to consider whether transfers within equity would be allowed if OCI is never recycled through profit or loss. Another Board member asked the staff to develop an alternative to using a separate line item in profit or loss or using OCI, even if that approach touches on performance reporting aspects.

The Board decided that the discussion paper should include its decisions to date regarding the classification and presentation of derivatives on 'own equity' under the Gamma approach.

KPMG insight

We support the Board's focus on achieving better information for users of financial statements through presentation changes. However, the Board will need to consider carefully whether changes might introduce additional complexity and costs for users or preparers that would undermine or outweigh potential benefits. The staff flagged these as potential concerns with a disaggregation approach.

By contrast, an all-in or all-out approach may give a simpler presentation with a less rich mix of information, and be cheaper to apply. However, all-or-nothing type approaches mean that slight changes in facts – or judgements about the facts – can have a big impact on the result. For example, the criteria suggested by the staff would mean that much might depend on evaluating whether a foreign currency denomination was 'imposed by the market.' Similarly, even a small amount of dependency on a variable other than the entity's share value or a foreign currency would disqualify a derivative from separate presentation. It appears that the Board's tentative decision – that income and expenses arising from financial instruments meeting the separate presentation requirements should be presented in OCI – applies also to non-derivative instruments. The application of the separate presentation requirements to non-derivatives – e.g. shares redeemable for their fair value – was discussed in February 2016. However, it is not yet clear whether or how these requirements would apply to non-derivative liabilities whose returns depend partly on the residual amount and partly on other factors.

The tentative decision to use OCI may be a controversial issue and interacts with the Board's other projects on the Conceptual Framework and performance reporting. In our view, the first step is to develop founding principles for the dividing line between profit or loss and OCI. To do so, there should be a proper debate around the notion of performance.

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The Board discussed additional disclosures on priority of claims, potential dilution of ordinary shares, and information to support the presentation and classification requirements of the Gamma approach

Disclosures to complement the classification and presentation approaches

What's the issue?

Currently there is a significant difference between the information provided for items classified as equity compared with those classified as liabilities. Providing disclosures on equity at the same level as for liabilities would enable users to make an informed assessment for all claims regardless of their classification. The staff considered:

- the information requested by investors and other users in their responses to various IASB consultations;
- which disclosures would support the classification and presentation requirements being developed under the Gamma approach; and
- how existing requirements could be improved.

What was discussed?

The staff identified that classification and presentation under the Gamma approach does not provide information directly about the priority feature of claims. In addition, classification and presentation capture some aspects of potential dilution of ordinary shares, but additional information about both liabilities and equity that are settled using ordinary shares, could help users assess the effect on ordinary shareholders. The staff also identified additional complementary information.

Priority

The priority of a claim is a feature that is relative to other claims against the entity. The Board previously discussed presenting liabilities in order of priority on the face of the financial statements or in the notes. Within both liability and equity classes, there is a variety of claims with different possible levels of seniority and subordination. Information on the priority feature helps users assess how any potential shortfall or excess of economic resources, and related returns, will be distributed amongst claims.

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The staff proposed the following objective and disclosures:

Objective	Disclosures

Provide information to help users assess how an entity's capital structure, including the priority of financial instruments, affects how various claim holders participate in the entity's prospects for future cash flows.	List of all financial liabilities and equity, ranking each group of instruments in order of priority.
	
	For each group of instruments, disclose:
	
	– the terms and conditions that:
	  - indicate priority;
	  - could lead to changes in priority; and
	  - indicate promised returns and/or rights to dividends/distributions; and
	
	– other features affecting capacity to share in the entity's economic resources and returns.
	
	Give reasons for any changes in priority of any group of financial instruments.

Potential dilution

Under IAS 33 *Earnings per Share*, potential ordinary shares are considered dilutive if they decrease earnings (or increase loss) per share from continuing operations. Potential dilution of ordinary shares can arise from either liability or equity instruments. Presentation under the Gamma approach captures some aspects of how other financial instruments affect the distribution of residual returns to ordinary shareholders. However, users also benefit from knowing to what extent ordinary shares have been or will be diluted by the issuance of additional ordinary shares. Information on potential dilution helps users to assess the distribution of returns amongst claims against the entity. The staff have defined the following terms.

Ordinary shares	The class of equity that is the most residual and requires the entity to transfer economic resources only at liquidation for an amount equal to a pro rata share of the entity's net assets on liquidation.
Dilution	Any actual or potential increase in the number of issued ordinary shares.

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The staff proposed the following objective and disclosures:

Objective	Disclosures
Provide information to help users assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares.	Complete list of all financial instruments that are potential sources of dilution at each reporting date. For each group of dilutive financial instruments, disclose: – terms and conditions indicating potential settlement by ordinary shares, including how the number of ordinary shares required for settlement is determined; – expected dates of share settlement; and – expected number of shares to be delivered, based on conditions at the reporting date. Provide a reconciliation of the movement in the number of ordinary shares and the maximum number of potential additional ordinary shares during the period, including: – total number of ordinary shares and potential additional ordinary shares, outstanding at the beginning and end of the reporting period; – sources of changes in the number of ordinary shares and potential additional ordinary shares; – dates of settlement which lead to changes in the number of ordinary shares; and – details of any share repurchase plans.

The staff believe that the information about potential dilution of ordinary shares could be incorporated with existing disclosures on the number of ordinary shares and that some of the information would already be collected if an entity is applying IAS 33.

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Supplementing the classification and presentation requirements

The Board previously discussed four possible attribution approaches for derivative equity claims. Three of these approaches require fair value measurement of derivative equity claims at the beginning and end of a reporting period. The staff believe additional information could be provided on the fair value measurement of derivative equity claims to help users understand the attribution of amounts to such claims.

For liability claims settled by cash, the staff believe additional information could be provided about the specific timing of settlement, which is useful for assessing liquidity. Furthermore, to assess the extent of economic resources to meet an entity's obligations as and when they fall due, the staff believe additional information could be provided about how the settlement amount is determined and the expected amount of cash outflows.

The staff proposed the following objectives and disclosures:

Objective	Disclosures
Help users assess the allocation of residual returns by providing information on the fair value measurement for derivative equity claims	For each group of financial instruments classified as derivative equity claims, disclose: – fair value of the group of financial instruments at the beginning and end of the reporting period; – reconciliation of changes in fair value during the reporting period, including qualitative and quantitative descriptions of the changes in major inputs to the valuation; – description of valuation techniques, inputs and assumptions used; and – sensitivity analysis of how fair value at the reporting date would respond to changes in some of the major inputs, if changes in those inputs are expected to be volatile.
Help users assess the timing and amount of economic resources required to settle each group of financial liabilities	For each group of financial liabilities settled by cash only, disclose: – terms and conditions relevant to determining the settlement amount; and – expected date and amount of cash outflows – e.g. in the form of a maturity analysis (the staff note that a maturity analysis is already required by IFRS 7 *Financial Instruments: Disclosures*).

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What did the Board decide?

The Board decided to include a discussion of the proposed disclosures outlined above in the discussion paper.

Board members generally welcomed the proposed disclosures about priority of claims on liquidation and potential dilution of ordinary shares. However, the staff were directed to focus on setting objectives for the priority disclosures rather than prescribing the way information is to be presented. One Board member said that the purpose in developing the disclosures on potential dilution is not to rethink earnings per share requirements but rather to establish what information is necessary to supplement existing disclosures.

Some Board members questioned whether all of the proposed disclosures on fair value measurement were necessary, and one member pointed out that IFRS 13 *Fair Value Measurement* allows some reductions in disclosure for instruments that are not measured at fair value in the statement of financial position.

KPMG insight

The recommended objectives and disclosures would represent a significant extension in the breadth of disclosures about financial instruments – they would aim to provide a much greater level of focus and detail on equity claims than currently, making the level of disclosure more similar to that for other financial instruments. Shining a brighter light into this area may be of special interest for ordinary and other shareholders who wish to better understand their own place in the capital structure. This may be particularly true for financial institutions that have issued new types of equity instruments in response to regulatory requirements, and other entities with complex capital structures. More structured information on the terms and conditions and ranking of liabilities may also aid analysis by users.

In providing disclosures, it is important to avoid:

- overburdening users and obscuring essential information with excessive detail; and
- providing inadequate information.

It is commendable that the staff acknowledge that the objective is not simply to add more disclosure but to look at existing disclosure requirements (which for equity instruments are light) to see whether they can be more effective.

When recommending disclosure of the expected date and amount of cash outflows from financial liabilities, the staff identify that a maturity analysis for financial liabilities is already required by IFRS 7. However, the existing IFRS 7 maturity analysis is generally based on contractual maturities, including assuming that a creditor demands repayment as soon as he contractually can. Therefore, expected maturities may differ from contractual maturities.

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