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Financial instruments
IFRS Newsletter

"Stakeholders will have 30 days to respond to a rapid-fire exposure draft on symmetric prepayment options this April."

– Chris Spall
KPMG's global IFRS financial instruments leader

Contents

The future of financial instruments accounting

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

Highlights

Symmetric prepayment options project

– The Board discussed the due process steps taken in developing the proposed amendments to IFRS 9 *Financial Instruments* and agreed to allow 30 days for comments on the exposure draft (ED) expected to be published in April.

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

– The Board tentatively decided:
  - to require an entity to apply the Gamma approach to the contractual terms of a financial instrument consistently with IAS 32 *Financial Instruments: Presentation* and IFRS 9;
  - to consider whether it should take any action to address the accounting for mandatory tender offers, including potential disclosure requirements; and
  - not to reconsider IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*.

– The Board also discussed proposed application guidance and illustrative examples for clarifying how the Gamma approach would apply to the accounting within equity for different subclasses of equity instrument.

Modification or exchange of financial liabilities

The Board agreed with the IFRS Interpretations Committee's conclusion that under IFRS 9 a modification not resulting in derecognition leads to a recalculation of amortised cost, with any adjustment recognised in profit or loss. It decided that the Committee should not proceed with an interpretation but educative material should be published instead.

IFRS 9 impairment

The Board discussed a summary of the requirements of IFRS 9 that apply to revolving credit facilities – such as credit cards – specifically in determining the period of exposure. Read our IFRS Newsletter: Impairment to find out more.

Insurance contracts project

The Board addressed feedback received from the external testing and drafting process of IFRS 17 *Insurance Contracts* – which is expected to be issued in May 2017. Read our IFRS Newsletter: Insurance to find out more.

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

Symmetric prepayment options

The story so far…

For a financial asset that is a debt instrument to be eligible for measurement at amortised cost or at fair value though other comprehensive income (FVOCI), IFRS 9 requires the contractual cash flows to meet the 'solely payments of principal and interest' (SPPI) criterion.

For contractual terms that permit the borrower to prepay a debt instrument (or permit the lender to put a debt instrument back to the borrower before maturity), IFRS 9 states that the contractual cash flows meet the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding. The prepayment amount may include reasonable additional compensation for early termination of the contract.

In November 2016, the IFRS Interpretations Committee (the Committee) discussed the classification of debt instruments that include symmetric 'make-whole' prepayment options or fair value prepayment options. Most Committee members believed that such debt instruments fail to meet the SPPI criterion. This is because the borrower can choose to prepay and the lender can be forced to accept less than the amount of outstanding principal and interest. They believed that the SPPI criterion accommodates only instruments for which the party exercising its option to terminate the contract compensates, or pays a prepayment penalty to, the other party.

In November 2016, the Committee suggested that the Board consider changing the requirements of IFRS 9 in this area.

At its meeting in December 2016, the Board agreed to add a narrow-scope project to its agenda to consider amending IFRS 9 to allow particular financial assets with symmetric make-whole prepayment options to be measured at amortised cost or FVOCI.

In January 2017, the Board discussed a narrow exception for symmetric prepayment options that would have met the existing prepayment requirements in IFRS 9 except for the fact that they could incur "reasonable negative compensation for the early termination of the contract". In addition, for a financial asset with such a symmetric prepayment option to be measured at amortised cost or FVOCI, the fair value of the prepayment feature should be insignificant on initial recognition of the asset. The Board aims to issue a final amendment in Q4 2017 – i.e. before IFRS 9 becomes effective.

The Board agreed a 30-day comment period for the forthcoming ED and discussed the steps taken in developing the proposed amendment

Due process steps

What's the issue?

The Board normally allows a minimum period of 120 days for comment on an ED. However, if the matter is narrow in scope and urgent, then it may set a comment period of no less than 30 days subject to obtaining approval from the Due Process Oversight Committee (DPOC).

What was discussed?

The staff recommended a comment period of no less than 30 days for the ED. They believe the proposed amendments to IFRS 9 are both narrow in scope and urgent. This is because:

- the scope of the proposed exception is extremely limited and the principles underpinning the classification and measurement requirements in IFRS 9 remain unchanged; and
- the amendment needs to be finalised as quickly as possible so that it can have the same effective date as IFRS 9 – i.e. annual periods beginning on or after 1 January 2018.

Different effective dates would result in entities incurring significant costs in changing to a fair value measurement approach for particular portfolios when initially applying IFRS 9 that is then no longer required once the proposed amendment becomes effective.

The DPOC agreed with the staff that the matter is sufficiently narrow in scope and urgent and therefore approved a comment period of no less than 30 days.

The staff believe that implementing the amendment should not be burdensome for affected preparers because they would already have the required information to account for instruments with prepayment options in accordance with the amendment – i.e. that information would have been necessary to apply the existing requirements in IAS 39 *Financial Instruments: Recognition and Measurement*.

The staff summarised the due process steps taken so far in the development of the proposed amendments to IFRS 9. They noted that the required steps have been completed and requested permission to prepare the ED for balloting.

The Board:

- confirmed that it was satisfied that it had complied with the necessary due process for developing the amendment;
- gave the staff permission to begin the balloting process; and
- agreed to allow 30 days for comments on the ED.

One Board member indicated that he may dissent from the proposed amendment to IFRS 9.

Next steps

The next steps for the project will be to:

- publish an ED in April 2017; and
- issue a final amendment in the Q4 2017 – i.e. before IFRS 9 becomes effective.

KPMG insight

Because the Board plans to proceed with issuing an ED, it will be critical to keep the scope of the project as narrow as intended. This will ensure that there are limited impacts on preparers' implementation projects and that any final amendment to IFRS 9 can be delivered by the beginning of Q4 2017, ahead of IFRS 9's effective date of 1 January 2018. Even if a final amendment is published in 2017, it may not be available before 2018 for application by companies in jurisdictions where endorsement of new IFRSs into local law is required – e.g. the EU.

Financial instruments with characteristics of equity

The story so far…

IAS 32 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 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*.[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.

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 whether the effects of law should be considered for the purposes of classifying financial instruments under the Gamma approach.

Scope of contractual rights and obligations

What's the issue?

One of the defining aspects of all financial instruments is that the rights and obligations arise from a contract between the parties. Therefore, any external rights and obligations – e.g. statutory requirements imposed by governments – that arise independently from a contract are not financial liabilities or financial assets.

A question arises whether – if the law affects the rights and obligations under a contract – the contract is limited to the contractual terms or includes other rights and obligations arising from the law (other than enforceability). The staff defined the term 'law' as "statutes, legislation, regulation or any other legal instrument issued by an authority in a particular jurisdiction".

IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* is an interpretation of IAS 32 that discusses this question in a very narrow fact pattern. It applies to equity instruments that grant the holder a right to request redemption but are subject to limits on whether the entity is required to redeem them. In this case, an entity is required to consider all terms and conditions of the financial instrument, including relevant local laws, regulations and the entity's governing charter in effect at the date of classification. The staff do not believe IFRIC 2 needs to be reconsidered given the lack of any application challenges.

However, the staff sought to explore the issue more broadly for the purposes of applying the Gamma approach to classification. It was aware of two types of transactions affected by laws – i.e. mandatory tender offers and some types of contingent convertible bonds – that present challenges.

What was discussed?

Contingently convertible bonds (convertible to ordinary shares as a result of regulatory requirements)

Applying the Gamma approach to a contractually contingent convertible bond would result in it being classified as a financial liability. An equity component would only be recognised if the contingent conversion option is solely dependent on the residual amount.

The staff discussed whether laws that impose contingent conversion features on particular types of claims issued by an entity should be considered as part of the classification of such instruments as liabilities or equity.

Under IFRS 9, the holder is required to analyse the contractual terms of a financial asset to determine whether the asset gives rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. The holder would not consider the payments that arise only as a result of the government's or other authority's legislative power to impose losses on the holder in its analysis.

To achieve consistency with the treatment for the equivalent financial asset, any contingent equity conversion feature that is only a result of the national resolving authority's power derived from legislation should not be considered by the issuer for classification purposes. This would result in the instrument being classified as a liability in its entirety.

Mandatory tender offers

The Committee received a request to address the accounting for mandatory purchases of non-controlling interests (NCI) that arise as a result of business combinations. One of the questions asked was whether mandatory tender offers (MTOs) required by law should be recognised as a liability. The Committee noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts that are executory in nature and concluded that no liability needed to be recognised for the MTO. However, some members later expressed the view that a liability should be recognised in a manner consistent with IAS 32 while other members expressed the view that an MTO is not in the scope of IAS 32 or IAS 37 so no liability is recognised.

Because an MTO is economically similar to a written put option on an NCI, it might be desirable for MTOs to be accounted for similarly to written put options. However, if the entity's legal obligation to offer to repurchase the NCI is not considered for classification purposes, then diversity might arise in practice in accounting for economically similar instruments. The staff believe the Board should then consider the best way to address this diversity and should consider disclosure requirements to address the circumstances around MTOs.

Limiting the assessment to contractual terms or considering the effect of law on existing contracts?

If laws affect the rights and obligations in a contract, then there are economic consequences for the entity. The staff argued that if those economic consequences are similar to those that would arise if the rights and obligations were contractually agreed, then ideally they would be accounted for similarly.

However, the staff said that the financial instrument standards were not developed to account for rights and obligations arising from law. Law-making authorities have the power to take unilateral action that changes the rights and obligations of an entity or a contractual arrangement. However, for a typical contract between parties, to change the rights and obligations in the contact the parties would need to undertake a transaction or mutually agree to the change.

If laws are taken into account, then the staff believe that additional requirements would need to be developed under the Gamma approach and potentially IFRS 9. Neither IAS 32 nor IFRS 9 addresses recognition, derecognition and reclassification requirements to take into account the possibility of legislation being introduced, repealed or amended. An entity would need to continually monitor these changes in law or their application if they are required to be reflected in the recognition, derecognition and classification of financial instruments.

If laws create an obligation that meets the definition of a liability and is outside the scope of IAS 32, then the instrument might fall in the scope of other standards that are not designed to address matters related to the classification of liabilities and equity.

Also, if laws are considered, then a follow-up question arises over when they should be considered – i.e. from inception of a particular contract or only under particular circumstances.

The staff therefore believe that the Gamma approach should be applied consistently with IAS 32 and IFRS 9 – i.e. an entity should classify financial liabilities and equity instruments based on the contractual terms.

A Board member noted that a settlement alternative in a contract could be illegal – e.g. if the law invalidates a contractual term. In that case, the analysis should consider whether the contractual terms are genuine.

What did the Board decide?

The Board tentatively decided:

- to require an entity to apply the Gamma approach to the contractual terms of a financial instrument consistently with IAS 32 and IFRS 9;
- to consider whether it should take any action to address the accounting for MTOs, including potential disclosure requirements; and
- not to reconsider IFRIC 2, given that it is not aware of any challenges to its application.

KPMG insight

Interaction between contractual and legal terms

The staff's analysis mentions that laws can affect the rights and obligations of an existing contract (other than the enforceability of the contract) without going into further detail. However, in practice analysing the nature and extent of the interaction between contractual and legal terms is not always straightforward or clear. In some cases, the law may specify that certain features are included in the contractual terms. For example, in the context of bail-in legislation and non-viability requirements, various scenarios may be possible:

- the contractual terms of an instrument may include only a general reference to the bail-in legislation applicable in the country of issuance;
- the contractual terms include an undertaking by the holder that it will be bound by applicable bail-in legislation;
- the contractual terms include a 'copy and paste' of the legislative text so that the contract incorporates the exact wording of the bail-in legislation; or
- the contractual terms state that each holder is subject to the exercise of any home-country bail-in power by the relevant home-country resolution authority regardless of the law that the instrument is issued under (applicable to cross-border instruments).

It may be important to assess whether the relevant contractual terms include any incremental rights or obligations above those that arise from the legislation itself. In particular, the terms of a contract may voluntarily include features to achieve a specific regulatory or tax outcome – i.e. the feature is a qualifying condition for obtaining that outcome but the law does not require its inclusion as a matter of course in all similar contracts. This may include determining whether a clause is 'dynamic' – i.e. its effect changes with and as the related legislation changes.

The Board discussed proposed application guidance and illustrative examples that clarify how the Gamma approach would apply.

Accounting within equity

What's the issue?

IAS 32 contains initial recognition requirements for equity instruments but it does not contain much guidance on the subsequent accounting. A number of aspects of the accounting for NCI puts have resulted in diversity in practice, including:

- when applying the redemption obligation requirement[2] and reclassifying the present value of the redemption amount from equity, which account should be debited – NCI or a contra-equity account;
- how to account within equity for the premium received for an NCI put; and
- how to account for the expiration or exercise of the NCI put.

The Board had previously decided that an entity should provide more information about subclasses of equity, which would provide users with relevant information about the variety of claims against the entity regardless of their classification. One aspect discussed was the attribution of profit or loss and OCI to some or all subclasses of equity other than ordinary shares.

The staff completed the discussion of subclasses of equity by illustrating how other changes in the carrying amounts would be accounted for under the Gamma approach to address some of the practical challenges identified, in particular for written put options on own equity.

What was discussed?

To provide guidance on the mechanics within equity, the staff illustrated the application of the Gamma approach using the examples of a convertible bond and a written put option on own equity, two instruments that have similar liability and equity outcomes. In addition to the accounting within equity, the examples help illustrate the following other aspects of the Gamma approach:

- bifurcation of compound instruments into liability and equity components;
- redemption obligation requirements, and the associated accounting within equity that is required to achieve consistent accounting for similar liability/equity settlement outcomes;
- recognition of changes in the measurement of the liability;
- attribution of profit or loss and OCI to derivative equity instruments; and
- accounting for the settlement outcomes within equity.

2. Paragraph 23 of IAS 32 states that if a contract contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset, then the contract gives rise to a financial liability for the present value of the redemption amount.

Example 1 – Convertible bond

The entity issues a bond for CU100 in cash, with two settlement options to be exercised by the holder. Either the entity is required to pay CU110 in cash two years from the date of issuance, or the holder has the right to elect to receive 100 ordinary shares of the entity. Assume that the present value of CU110 payable in two years is CU82. The claim does not have any interest payments and is not convertible or redeemable by the counterparty or the entity before two years.

- Scenario 1 – the holder exercises the option to require the entity to pay CU110 in cash at the end of Year 2.
- Scenario 2 – the holder exercises the option to receive 100 ordinary shares of the entity, immediately after the end of Year 2.

Assume the following additional information.

	Date of issuance	End of Year 1	End of Year 2 (Scenario 1)	End of Year 2 (Scenario 2)
Ordinary share price	CU0.9 per share	CU0.8 per share	CU1 per share	CU1.25 per share
Fair value of conversion option	CU18	CU10	CU0[3]	CU15

Application of the Gamma approach

The entity analyses the convertible bond to determine whether there is a conversion option that solely depends on the residual amount. If this is the case, then it initially recognises a compound instrument containing:

- a liability component – i.e. the carrying amount determined based on an equivalent instrument without the equity conversion feature; and
- an equity component for the option to convert it into an equity instrument of the entity – i.e. the difference between the carrying amount of the liability component and the fair value of the convertible bond.

Under IAS 32, there are no further requirements for the derecognition or reclassification of the initially recognised equity component, even if the compound instrument is settled by transferring cash. IAS 32 notes that the equity component may be transferred from one line item within equity to another.

The Gamma approach would not change the basic requirements of IAS 32 relating to convertible bonds. However, it would potentially require attribution within equity, which would require additional guidance for other changes to the carrying amount when the conversion option expires or when equity instruments are issued to settle an equity-classified derivative. One possible approach is to attribute profit or loss and OCI to classes of derivative equity claims on the basis of changes in fair value of the conversion option. This results in updating the equity component initially recognised to its fair value at each reporting date. Another possible approach is not to attribute any profit or loss or OCI to classes of derivative equity claims. The difference arising from not doing any attribution is explained in the footnotes.

3. Conversion option does not have value at that time for the instrument holder to exercise it.

Journal entries under both scenarios

On initial recognition

	Debit	Credit
Cash	CU100	
Financial liability		CU82
Equity – conversion option		CU18
To recognise cash received and liability and equity components		
Year 1		
Interest expense	CU13	
Financial liability		CU13
Accrual of interest (based on accretion from CU82 initial measurement to CU110 cash redemption amount)		
Equity – conversion option	CU8	
Attribution to conversion option		CU8[4]
Attribution of profit or loss to the conversion option – i.e. decrease in fair value from CU18 to CU10		
Year 2		
Interest expense	CU15	
Financial liability		CU15
Accrual of interest		

Journal entries for Scenario 1 – Liability settlement

	Debit	Credit
Equity – conversion option	CU10	
Attribution to conversion option		CU10[5]
Attribution of profit or loss to the conversion option – i.e. decrease in fair value from CU 10 to nil		
Financial liability	CU110	
Cash		CU110
To recognise the transfer of cash on settlement		

4. If there is no attribution within equity, then there is no entry at this point.
5. If there is no attribution within equity, then there is no entry at this point. However, on settlement by transferring cash, the carrying amount for the conversion option would be required to be transferred to ordinary shares.

Journal entries for Scenario 2 – Equity settlement

	Debit	Credit
Attribution to conversion option	CU5[6]	
Equity – conversion option		CU5
Attribution of profit or loss to the conversion option – i.e. increase in fair value from CU10 to CU15		
Financial liability	CU110	
Equity – conversion option	CU15	
Equity – ordinary shares		CU125
Settlement of the convertible bond through issuance of ordinary shares measured at fair value		

Scenario 1 – Simplified statement of changes in equity

In currency units (CU)	Conversion option	Ordinary shares	Total equity
Beginning of Year 1	**0**	**100**	**100**
Convertible bond issued	18	0	18
Attribution of total comprehensive income	(8)	135	127
End of Year 1	**10**	**235**	**245**
Attribution of total comprehensive income	(10)	95	85
End of Year 2	**0**	**330**	**330**

Scenario 2 – Simplified statement of changes in equity

In currency units (CU)	Conversion option	Ordinary shares	Total equity
Beginning of Year 1	**0**	**100**	**100**
Convertible bond issued	18	0	18
Attribution of total comprehensive income	(8)	135	127
End of Year 1	**10**	**235**	**245**
Attribution of total comprehensive income	5	95	100
Settlement of convertible bond through issuance of shares	(15)	125	110
End of Year 2	**0**	**455**	**455**

6. If there is no attribution within equity, then there is no entry at this point. However, on settlement by issuing shares, the carrying amount for the conversion option that has not been updated for attribution (CU18) would be required to be transferred to ordinary shares.

Example 2 – Written put option

The entity issues 100 ordinary shares for CU0.9 each. Simultaneously, it issues a written put option on 100 ordinary shares at a strike price of CU1.1 each. The put option is exercisable in two years and in return the entity receives CU10 in cash as a premium. Therefore, the total cash received by the entity is CU100. Assume that the present value of the redemption amount (CU1.1 per share x 100 ordinary shares) is CU82.

- Scenario 1 – the holder exercises the put option on ordinary shares, requiring the entity to pay CU110 in cash at the end of Year 2.
- Scenario 2 – the holder does not exercise the put option.

Assume the following additional information.

	Date of issuance	End of Year 1	End of Year 2 (Scenario 1)	End of Year 2 (Scenario 2)
Ordinary share price	CU0.9 per share	CU0.8 per share	CU1 per share	CU1.25 per share
Fair value of put option	CU10	CU13	CU10[7]	CU0[8]
Fair value of equivalent conversion option	CU18	CU10	CU0[9]	CU15[10]

Application of the Gamma approach

In July 2016, the Board tentatively decided that an entity should apply a requirement similar to the existing redemption obligation requirement of IAS 32 to ensure that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured. Furthermore, the Board decided that the Gamma approach needs to reconcile the interaction of the redemption obligation requirement with the requirement that fixed-for-fixed derivatives that exchange a liability for equity instruments are classified as equity.

The effects of these decisions are that a written put issued on ordinary shares, together with the ordinary shares, would be accounted for consistently with a convertible bond under the Gamma approach, as both have similar liability and equity outcomes. Both arrangements result in:

- the entity receiving CU100 in cash; and
- the holder having the option to choose after two years either a cash payment of CU110 or 100 ordinary shares.

7. Represents the redemption amount (CU110) less the value of the underlying shares (CU100).
8. Zero because the value of the redemption amount is less than the underlying shares.
9. Zero because the value of the underlying shares is less than the redemption amount.
10. Represents the value of the underlying shares (CU125) less the redemption amount (CU110).

This would require:

- derecognition of the fair value of the ordinary shares on which a written put option is issued;
- recognition of a liability component reflecting the puttable obligation at the present value of the redemption amount (equivalent to the liability component of the convertible bond); and
- recognition of an equity component representing the holder's option to choose the equity settlement outcome over the liability settlement outcome (equivalent to the conversion option in a convertible bond).

The following journal entries arise on initial recognition.

	Debit	Credit
Cash	CU90	
Share capital – ordinary shares		CU90
Initial recognition of 100 ordinary shares at CU0.9 per share		
Equity – ordinary shares	CU90	
Cash	CU10	
Liability – redemption obligation		CU82
Equity – conversion option		CU18
To derecognise ordinary shares at fair value when the written put is issued and create a new class of equity		

The subsequent accounting would be the same as for the convertible bond (see the journal entries in Example 1). For example, if the put option expires unexercised, then it would be as if the holder had converted the liability to equity as in Example 1, Scenario 2.

NCI puts

For the particular case of NCI puts, the accounting would be the same as described above for written puts. However, the equity instruments as illustrated in Example 2 are substituted with their NCI equivalents. This means it would be necessary to:

- derecognise the NCI shares on which a written put option is issued;
- recognise a liability component reflecting the present value of the redemption amount; and
- recognise an equity component that is equivalent to a conversion option in a convertible bond in the subsidiary.

If the NCI put is a fair value put, then the NCI equity component would be zero and all of the returns on the claim would be captured by the liability component. If the amount of the claim solely depends on the residual amount, then the separate presentation requirements would also apply to the gains and losses.

Similar entries would be required for the expiry or exercise of the NCI put as illustrated in the examples above, except instead of ordinary shares being issued in Scenario 2, the entity would issue NCI shares.

Under the Gamma approach, subsequent changes to the liability components are recognised as income and expense, and subsequent changes to the equity components are recognised in the statement of changes in equity.

A Board member said that the DP should still include all four attribution approaches as the Board has not yet expressed a preliminary view on a preferred attribution approach. Another member also requested the staff to consider the impact of the attribution approaches on earnings per share when drafting the DP.

What did the Board decide?

The Board made no decisions.

KPMG insight

Attribution of total comprehensive income

The staff provided journal entries to illustrate the attribution of profit or loss to the conversion option. It is assumed that in the examples provided, the double entry when adjusting the carrying amount of the conversion option in equity would be against equity attributable to ordinary shares. Furthermore, we would not expect total comprehensive income to change based on the attribution method since the attribution entries are meant to allocate total comprehensive income among different classes of equity instruments. However, the illustration of the simplified statement of changes in equity does not seem to convey this principle because in Scenarios 1 and 2, the amount attributed to ordinary shares is the same even when the amount attributed to the conversion option changes, resulting in a different total attribution of comprehensive income in each case.

NCI puts

In September 2016, the Board tentatively decided that income and expenses arising from financial instruments that meet the separate presentation requirements – i.e. liabilities that depend on a residual amount – including derivatives on own equity, should be presented under OCI.

In the staff's analysis, if an NCI put is a fair value put (i.e. liability in its entirety) and the amount of the claim solely depends on the residual amount, then the separate presentation requirements also apply to the gains and losses – i.e. recognised in OCI. For other NCI puts, the staff state that under the Gamma approach subsequent changes to the liability components would be recognised as income and expense.

This may represent a change from current practice, depending on the entity's accounting policy choice to recognise changes in the carrying amount of the put liability in profit or loss or within equity. Such a choice was acceptable due to the IFRS Interpretations Committee acknowledging diversity in practice and citing a perceived conflict between IAS 27[11] (2008) (carried forward into IFRS 10[12]) and IAS 39.

11. IAS 27 *Consolidated and Separate Financial Statements*.
12. IFRS 10 *Consolidated Financial Statements*.

Next steps

The next steps for the project will be to:

– address the application of the Gamma approach to the classification of derivatives on NCI with an exercise price denominated in a foreign currency; and

– provide a summary of interactions with other IFRSs, IFRIC interpretations and the *Conceptual Framework*.

Modification or exchange of financial liabilities

The Board was provided with a summary of discussions of this topic held at the IFRS Interpretations Committee's November 2016 meeting.

What's the issue?

Modifications or exchanges of financial liabilities that do not result in derecognition commonly occur in practice. IFRS 9 requires that any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term.

However, IFRS 9 does not explicitly specify the accounting for other changes in the contractual cash flows of the instrument, whereas it does for modifications of financial assets that do not result in derecognition. This issue was therefore submitted to the IFRS Interpretations Committee to clarify whether an entity recognises a gain or loss in profit or loss for these modifications or exchanges of financial liabilities.

What was discussed?

The Board was provided with a summary of the discussions at the IFRS Interpretations Committee's November 2016 meeting.

The Committee concluded that modifications or exchanges of financial liabilities that do not result in derecognition of the financial liability should be accounted for consistently with the requirements for modifications of the contractual cash flows of financial assets that do not result in derecognition. Therefore, an entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate and recognises any adjustment to the amortised cost of the financial liability in profit or loss at the date of the modification or exchange.

The staff's outreach revealed that the most common practice currently under IAS 39 is to recalculate the effective interest rate at the date of the modification in addition to re-estimating contractual cash flows. Many respondents to the outreach also indicated that they expected practice to remain the same under IFRS 9. Consequently, the Committee tentatively decided to develop a draft interpretation that would explain how to apply the requirements in IFRS 9 to modifications or exchanges of financial liabilities that do not result in derecognition of the financial liabilities.

The Board agreed with the Committee's technical conclusion on how IFRS 9 should be applied. However, Board members generally believed the requirements in IFRS 9 are clear enough in this regard and therefore an interpretation was not required. A Board member noted that an interpretation would also not be effective by 1 January 2018. This Board member also commented that the specific mention in IFRS 9 of accounting for modifications of financial assets that do not result in derecognition was due to the need to distinguish between what affects the gross carrying amount and what affects the impairment line.

Accordingly, the Board objected to the Committee issuing a draft interpretation.

What did the Board decide?

The Board recommended that the Committee proceed with proposing an educative agenda decision explaining the accounting for modifications or exchanges of financial liabilities that do not result in derecognition when applying IFRS 9. The Board will also consider other ways to highlight this matter, such as a webcast.

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