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Financial instruments
IFRS Newsletter

"The discussion about retaining the IAS 32 puttables exception emphasises that no classification approach can portray all the information that is important to users."

– Chris Spall
KPMG's global IFRS financial instruments leader

The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB's discussions in November 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 claims where the issuing entity can choose between alternative settlement outcomes and the impact of economic incentives on classification.

Highlights

At its November meeting, the Board discussed the classification under the Gamma approach of instruments meeting the existing puttables exception in IAS 32 and the merits of retaining the exception.

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

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

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

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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. 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 (ED) 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 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 Board discussed the conceptual and application challenges in distinguishing between liabilities and equity.
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.
September 2016	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.
October 2016	The Board discussed claims where an issuing entity can choose between alternative settlement outcomes and agreed that economic incentives should not affect classification.

1. In May 2015, the IASB published the exposure draft Conceptual Framework for Financial Reporting (ED/2015/3). References to the Conceptual Framework in this newsletter are references to the existing *Conceptual Framework for Financial Reporting*, unless otherwise stated.

The Board discussed the classification under the Gamma approach of instruments meeting the existing puttables exception in IAS 32 and the merits of retaining the exception.

Classification of instruments that meet the puttables exception in IAS 32

What's the issue?

A puttable financial instrument contains a contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset on exercise of the put and should be classified as a liability. However, under IAS 32, if the instrument has certain features and meets specific conditions, it is classified as equity because it represents the most residual claim to the net assets of the entity. This is referred to as the 'puttables exception'.

The exception was included in IAS 32 to address concerns in relation to liability classification that:

- the entire market capitalisation of the entity could be recognised as a liability;
- changes in the carrying amount of the liability are recognised in profit or loss and these changes are counter-intuitive;
- it is possible for the entity to report negative net assets;
- the entity would be depicted as wholly, or mostly, debt funded; and
- distributions of profits to shareholders are recognised as expenses.

The result of the puttables exception is that financial instruments that are largely equivalent to ordinary shares are classified consistently across different entity structures – e.g. some partnerships, limited life entities and co-operatives.

In addition, IAS 1 *Presentation of Financial Statements* requires specific disclosures for puttable financial instruments classified as equity to allow users to assess the effect on the entity's liquidity and cash flows.

Under the Gamma approach, these puttable instruments would meet the definition of liabilities because they can be put back to the issuing entity for economic resources at any point in time before liquidation.

IAS 32 also contains a similar exception for instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. These instruments would also be classified as liabilities under the Gamma approach. Although they do not require the issuing entity to transfer economic resources prior to liquidation, they give rise to contractual obligations at a particular point in time, either:

- when liquidation is certain to occur and outside the control of the entity; or
- is at the option of the instrument holder.

The question arises whether the Gamma approach addresses the concerns that lead to the puttables exception or whether the puttables exception in IAS 32 should be retained.

What was discussed?

The staff's analysis focused on the treatment of instruments that meet the puttables exception but they clarified that the same analysis should apply to instruments that impose an obligation to deliver a pro rata share of the entity's net assets on liquidation.

The staff noted that one of the eligibility conditions for the puttables exception is that the total expected cash flows attributable to the instrument over its life are based substantially on:

- profit or loss;
- the change in the recognised net assets; or
- the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument.

This means that the total cash flows attributable to such an instrument *substantially* depend on the key drivers of the residual amount. The Gamma approach under discussion by the Board would include separate presentation requirements for instruments whose cash flows *solely* depend on the residual amount (or, possibly, the residual amount and foreign exchange rates); however, the staff believe these requirements could also be applied to instruments that meet the puttables exception criteria under IAS 32.

The staff believe that the separate presentation requirements would address some of the concerns around liability classification – e.g. if changes in the instruments' carrying amounts are presented separately in OCI, then the counter-intuitive effects on profit or loss would be avoided.

In addition, liability classification allows direct measurement at fair value which provides useful information for users to predict the potential cash outflows arising from such claims.

The staff acknowledged that classification and presentation under the Gamma approach does not address the concern that all the entity's claims may meet the definition of liabilities, such that none are classified as equity. It would also bring into question what the difference between the assets and liabilities represents and how that difference should be reported.

The staff therefore believe there are two alternatives:

- apply the Gamma approach to these types of instruments without any exception from liability classification; or
- retain the exception under IAS 32, retain the disclosure requirements for puttable instruments in IAS 1 and extend those disclosure requirements to instruments that impose an obligation to deliver a pro rata share of the entity's net assets on liquidation.

The Board noted that one of the objectives of the FICE project is to reinforce the underlying rationale of the distinction between liabilities and equity in IAS 32, but not to perform a fundamental review of IAS 32. The Board also observed that applying the Gamma approach to instruments that meet the exception might address some, but not all, of the previous concerns which led to the exception. Therefore, the exception might continue to be required. However, Board members agreed with the staff that it would be useful to determine how widely the puttables exception is applied in practice in different jurisdictions. The Board therefore decided to include its discussion in the DP.

KPMG insight

No decomposition of puttable instruments?

The staff noted that the Board had previously rejected an approach requiring separation of a puttable instrument into a put option and a host equity instrument because this would have duplicated effort of the Board's previous project on liabilities and equity.

We note that when the Board discussed applying the Gamma approach to derivatives on own equity in July 2016, it looked at instruments that require the repurchase of equity instruments in exchange for cash – e.g. written put options on own shares. The Board agreed that the Gamma approach should apply a requirement similar to the existing redemption obligation requirement in IAS 32. This results in a liability for the obligation to pay an amount of cash prior to liquidation and typically an equity component for the residual value. The Board has not discussed applying such an analysis to puttable instruments.

However, because many puttable instruments are puttable at fair value at any time, applying either the Gamma approach or the existing redemption obligation requirement may result in the same accounting treatment. This is probably why, in arguing that the Gamma approach would provide useful information for users to predict the potential for future cash outflows arising from puttable instruments, the staff mention that classifying such instruments as liabilities would allow direct measurement at fair value.

Obligations arising on liquidation

The staff noted that instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation would also be classified as liabilities under the Gamma approach if liquidation is certain to occur and outside the control of the entity or is at the option of the instrument holder. However, this is not obvious based on a literal reading of the definitions of liabilities and equity under the Gamma approach – one might have expected equity classification for these instruments because the obligation is to transfer economic resources only at liquidation and for a residual amount.

Furthermore, the Board has not yet discussed instruments with liquidation rights – e.g. a liquidation right held by the holder that becomes exercisable on the occurrence of an event that is not within the control of the entity, or a liquidation right held by instrument holders as a class rather than included in the individual instrument.

The way forward…

Whatever the Board decides on puttable instruments may be controversial. The puttables exception resulted from concerns raised by constituents about liability classification so some constituents would be likely to oppose its removal. However, retaining an exception might be seen by some as suggesting a basic problem with the Gamma approach or lead to calls for the Board to allow other exceptions.

In any event, the significance of the issue will depend to some extent on the contractual vs statutory boundary issue that the Board has yet to discuss because put rights can originate from statutory or regulatory requirements in some jurisdictions.

KPMG contacts

Americas
Reza van Roosmalen
T: +1 212 954 6996
E: rezavanroosmalen@kpmg.com

Dilshad Hassen
T: +1 416 777 8978
E: dhassen@kpmg.ca

Asia-Pacific
Reinhard Klemmer
T: +65 6213 2333
E: rklemmer2@kpmg.com.sg

Tamami Okawa
T: +81 3 3548 5107
E: Tamami.Okawa@jp.kpmg.com

Europe, Middle East and Africa
Colin Martin
T: +44 20 7311 5184
E: colin.martin@kpmg.co.uk

Venkataramanan Vishwanath
T: +91 22 3090 1944
E: 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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