

Financial instruments

IFRS Newsletter



“The FICE project has highlighted challenges in classifying derivatives on own equity but also provides welcome opportunities to enhance consistency.”

– Chris Spall
KPMG’s global IFRS
financial instruments leader

Contents

Financial instruments with characteristics of equity	2
Challenges of applying the Gamma approach	3
Asset/equity exchange derivatives	4
Liability/equity exchange derivatives	7
Keeping you informed	10
KPMG contacts	12
Acknowledgements	12

The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in July 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 possible ways to attribute profit or loss and other comprehensive income (OCI) to derivative equity claims.

Highlights

At its July meeting, the Board focused its discussion on how to apply the Gamma approach¹ to: the classification of derivatives on own equity; asset/equity exchange derivatives; and liability/equity exchange derivatives.

A next step for the project will be to consider the separate presentation requirements for different classes of liabilities including variable-for-fixed derivatives and some application challenges in applying the fixed-for-fixed condition. Issues planned for discussion at future meetings include:

- classification of instruments meeting the existing puttables exception;
- accounting for conditional alternative settlement outcomes; and
- possible improvements to disclosures about classes of equity claims other than ordinary shares.

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

The Board discussed a sweep issue regarding the interaction of IFRS 4 *Insurance Contracts* and IFRS 9 and agreed to revise the disclosure requirements for entities that apply the temporary exemption from applying IFRS 9 (as part of the proposed IFRS 4 amendments), limiting the SPPI assessment to those financial assets that are not held for trading or managed on a fair value basis. Read our [web article](#) to find out more.

1. See September 2015 [IFRS Newsletter: Financial Instruments](#).

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

In [June 2015](#), the Board identified features that are relevant in measuring claims and in distinguishing between liabilities and equity.

In [July 2015](#), the Board analysed the relevance of these features for assessments that users might make using information in the statements of financial position and performance.

In [September 2015](#), the Board focused on the classification of non-derivatives. It discussed the extent to which the requirements in IAS 32 capture the features that users need to make their assessments. It also considered three possible classification approaches (Alpha, Beta and Gamma).

In [October 2015](#), the Board discussed the challenges of classifying and accounting for derivatives on 'own equity' and how IAS 32 addresses these challenges.

In [February 2016](#), the Board discussed using subclasses of financial liabilities to provide additional information for assessing financial performance and position and using subclasses within equity to provide additional information about relevant features. It also discussed claims with conditional alternative settlement outcomes.

In [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 OCI to equity claims (both non-derivatives and derivatives) other than ordinary shares.

In [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.

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.

The Board discussed the unit of account for classifying derivatives on own equity

Challenges of applying the Gamma approach to derivatives on own equity

What's the issue?

Derivatives contain contractual rights and obligations to exchange underlying financial instruments with another party. The distinguishing characteristic of derivatives on own equity is that one of the underlying financial instruments of the exchange meets the definition of equity. For derivatives on own equity, there are two basic types of exchange (each comprising two 'legs'):

- asset/equity – in which a financial asset is received in exchange for delivering own equity, when both items are not existing financial instruments of the entity; and
- liability/equity – in which an existing financial liability or equity instrument is extinguished in exchange for delivering own equity or a financial liability.

Under the Gamma approach, the delivery leg of the contract would meet the definition of equity if it includes an obligation that both:

- does not require the transfer of economic resources at a date other than liquidation; and
- does not promise a return that is independent of the economic resources of the entity.

However, the Gamma approach does not address whether the unit of account for classification is the entire contract or the underlying legs of the derivative contract. Three alternative approaches would be to:

- provide a detailed componentisation of derivatives – resulting in the classification of all equity legs as equity;
- classify all derivatives as assets or liabilities – resulting in the classification of all derivatives with equity legs as assets or liabilities; or
- classify stand-alone derivatives in their entirety as either equity or not equity, based on both legs.

What was discussed?

Board members were not in favour of a detailed componentisation approach because of conceptual issues regarding whether the components would meet the definitions of assets, liabilities and equity and the operational complexity of applying such an approach. Board members also did not believe all derivatives on own equity should be classified as liabilities or assets because doing so will not provide the most relevant information to assess the entity's financial position and performance.

Consistent with the existing approach in IAS 32, the Board tentatively agreed that entities should classify derivatives in their entirety as either equity, or as assets or liabilities. Under IAS 32 (and generally for financial instruments under IFRS 9), the unit of account is the contract in its entirety.

The Board has previously discussed separate presentation requirements for particular types of obligations classified as liabilities – e.g. those that depend on a

The Board discussed how the Gamma approach could be applied to classify asset/equity exchange derivatives

residual amount. These presentation requirements may help address some of the challenges identified.

However, as there are concerns around the treatment of foreign exchange components, one Board member suggested that this issue be considered further in the context of classifying derivatives in their entirety.

KPMG insight

As alluded to by the staff, no single classification method can solve all challenges. Choosing a method will require the Board to consider relevance, faithful representation and costs to implement. The objectives of the Gamma approach are to provide information to assess:

- the extent to which the entity is expected to have the economic resources to meet its obligations as and when they fall due; and
- the extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it.

Applying the Gamma approach to classify asset/equity exchange derivatives

What's the issue?

In applying the Gamma approach to a derivative in its entirety, a derivative would be classified as equity if – as a whole – it:

- does not require a transfer of economic resources prior to liquidation; and
- is an obligation for an amount that depends on the residual amount.

Under IAS 32, a derivative is classified as equity if it meets the fixed-for-fixed condition – i.e. it should be physically settled by the exchange of an amount of cash (or another financial asset) that is fixed in the entity's functional currency for a fixed number of the entity's own equity instruments. Therefore, the requirement is not met by derivatives settled net in cash or net in shares or where there is variability in one of the legs of the exchange.

However there is one exception to the fixed-for-fixed condition for foreign currency rights issues. A right, option or warrant is classified as equity if the amount of cash to be received in exchange for delivering a fixed number of equity instruments is fixed in any currency and the derivative is issued pro rata to all existing holders of the same class of own equity instrument.

The question arises whether the Gamma approach is consistent with the fixed-for-fixed condition in IAS 32.

What was discussed?

The following table illustrates the staff's analysis of classification of asset/equity exchange derivatives under the Gamma approach compared to IAS 32.

Instrument	Classification under Gamma approach	Classification under IAS 32
<p>Fixed-for-fixed forward contract with physical settlement</p> <ul style="list-style-type: none"> – Contract for receipt of a fixed amount of cash in exchange for the delivery of a fixed number of ordinary shares. 	<p>Equity</p> <ul style="list-style-type: none"> – Does not require the transfer of cash or other financial assets other than at liquidation. – Amount depends on the residual amount because the asset leg is fixed and changes in the value of the derivative result only from changes in the equity leg. 	<p>Equity (fixed-for-fixed condition is met).</p>
<p>Fixed-for-fixed forward contract with net-share settlement</p> <ul style="list-style-type: none"> – Contract for the receipt of a variable number of shares equal to a fixed amount in exchange for the delivery of a fixed number of ordinary shares. 	<p>Equity</p> <ul style="list-style-type: none"> – Does not require the transfer of cash or other financial assets other than at liquidation. – Amount depends on the residual amount because the asset leg is fixed and changes in the value of the derivative result only from changes in the equity leg. 	<p>Not classified as equity because of the net share settlement (fixed-for-fixed condition is not met).</p>
<p>Net cash-settled derivative.</p>	<p>Not classified as equity because the contract could require a transfer of economic resources prior to liquidation.</p>	<p>Asset or liability (fixed-for-fixed condition is not met).</p>
<p>Contract requires delivery of a variable number of shares equal to an amount independent of the entity's economic resources, in exchange for a fixed amount of cash or other financial assets.</p>	<p>Not classified as equity because the contract in its entirety is for an amount that is completely independent of the entity's economic resources.</p>	<p>Asset or liability (fixed-for-fixed condition is not met).</p>

Instrument	Classification under Gamma approach	Classification under IAS 32
Variable-for-fixed derivatives – e.g. foreign currency forward contract or commodity indexed forward contract where the asset leg is variable and received in exchange for delivering a fixed number of ordinary shares.	No clear answer because the amount of the obligation is neither completely independent of the entity's economic resources, nor solely dependent on the residual amount.	Asset or liability (fixed-for-fixed condition is not met) unless the contract meets the foreign currency rights issue exception.

On this basis, the Gamma approach appears consistent with the fixed-for-fixed condition in IAS 32 except for the classification of:

- fixed-for-fixed net share settled contracts; and
- foreign currency rights issues that meet the exception under IAS 32.

The staff believe that applying a strict form of the fixed-for-fixed condition to classify a derivative in its entirety is pragmatic and avoids the need to componentise derivatives. Even though items that fail to meet the fixed-for-fixed condition sometimes result in changes in the equity leg recognised as income or expense, the staff believe that these challenges can be mitigated through the separate presentation requirements.

The Board tentatively agreed with the staff analysis of the application of the Gamma approach as outlined above, including that all derivatives for the receipt of a variable amount of cash or other financial assets in exchange for the delivery of a fixed number of equity instruments would be classified as liabilities under the Gamma approach.

One Board member asked the staff to perform further research into the rationale behind the fixed-for-fixed criterion and why net or gross settlement can affect liability/equity classification under IAS 32. This will help ensure that all relevant principles are considered in developing the DP.

KPMG insight

Applying the fixed-for-fixed condition strictly to classify all variable-for-fixed derivatives would mean that such derivatives are classified as assets or liabilities. This also means that foreign currency rights would be classified as liabilities unless the Board decided to continue with a specific exemption.

The Board discussed how the Gamma approach could be applied to classify liability/equity exchange derivatives

Applying the Gamma approach to classify liability/equity exchange derivatives

What's the issue?

There are two different types of liability/equity exchange derivatives:

- derivatives to redeem or repurchase a liability in exchange for issuing equity – e.g. embedded conversion options in convertible bonds; and
- derivatives to redeem or repurchase equity in exchange for a liability – e.g. written puts on own equity.

In addition to the fixed-for-fixed condition described in the section above, IAS 32 also requires an entity to classify any obligation to repurchase own equity as a financial liability for the present value of the redemption amount. This includes an obligation that is conditional on the counterparty exercising a right to redeem or that is part of a stand-alone derivative that meets the fixed-for-fixed condition.

The only exception is for a puttable instrument or obligation arising on liquidation that is classified as equity if certain conditions are met. In addition, IAS 32 addresses the accounting for compound instruments, and requires an entity to classify separately the liability and equity components of a non-derivative financial instrument.

The question arises how the Gamma approach would classify these types of derivatives and whether it should apply a requirement similar to the existing redemption obligation requirements in IAS 32.

What was discussed?

Instruments that redeem or repurchase a liability in exchange for equity

The following table illustrates the staff's analysis of the classification of liability/equity exchange derivatives under the Gamma approach compared to IAS 32. The rationale for classification is similar to that given for asset/equity exchange derivatives under the Gamma approach (see pages 5 and 6).

Instrument	Classification under Gamma approach	Classification under IAS 32
Entity receives a liability of a fixed amount in exchange for delivering a fixed number of equity instruments – i.e. physically settled and the value of the derivative is determined solely by the equity leg.	Equity	Equity

Instrument	Classification under Gamma approach	Classification under IAS 32
Derivatives net-settled in cash or require the entity to deliver a variable number of equity instruments equal to an amount independent of the entity's economic resources.	Liability	Liability
Variable-for-fixed derivatives – i.e. contracts for the redemption or repurchase of a liability of a variable amount in exchange for delivering a fixed number of equity instruments.	No clear answer because the amount of the obligation is neither completely independent of the entity's economic resources, nor solely dependent on the residual amount.	Not discussed

The Board tentatively decided that an entity should classify fixed-for-fixed derivatives that result in the exchange of a liability for equity instruments as equity, because such derivatives would be claims for an amount that solely depends on the residual amount. The Gamma approach for classifying liability/equity exchanges would then be consistent with asset/equity exchanges.

Instruments that redeem or repurchase equity in exchange for a liability

The Board previously discussed embedded redemption obligations – e.g. a share that is redeemable at fair value would be classified as a liability under the Gamma approach. Because separating the redemption clause in a separate instrument does not change the outcome of the arrangement, the staff believe identical obligations should be treated the same regardless of whether the redemption clause is embedded in the instrument being redeemed or a stand-alone derivative.

Conceptual challenges for written put options on own shares have historically related to whether the transfer leg meets the definition of a liability if the redemption price is equal to the value of the underlying share or if the written put option is settled in a variable number of shares. However, under the Gamma approach, both of these types of options would be classified as liabilities, either because they require a transfer of economic resources other than at liquidation or the obligation is for an amount independent of the entity's economic resources.

Applying the redemption obligation requirements under the Gamma approach to a written put option on own equity would, similarly to IAS 32, result in the entity recognising a liability for the obligation to pay an amount of cash that is independent of the entity's economic resources. There will typically be an equity component for the residual value. The equity component for the put option arrangement is similar to the conversion option in a convertible bond arrangement. Under the Gamma approach, a simple convertible bond would have both a liability and an equity component.

The Board therefore agreed that the Gamma approach should apply a requirement similar to the existing redemption obligation requirement in IAS 32 to ensure that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured.

Interaction between the requirements for derivatives on own equity

The staff considered the existing treatment under IAS 32 of foreign currency convertible bonds and foreign currency written put options.

A foreign currency convertible bond would be accounted for as follows.

- Classified as a liability in its entirety (conversion option does not meet the fixed-for-fixed condition).
- Foreign exchange differences recognised in profit or loss on translation of the host liability.
- Embedded conversion option liability measured at fair value through profit or loss reflecting both changes in the underlying share price and changes in foreign exchange rates.

A foreign currency written put option would be accounted for as follows.

- Liability recognised for the present value of the redemption amount.
- Option feature usually remains within equity.
- Foreign exchange differences are recognised in profit or loss on the translation of the liability.

Although structured differently, these instruments have similar features and the staff believe they should be accounted for similarly. However, under IAS 32, only the redemption obligation of the put option – not including the fair value of the option – is recognised as a liability even though the put option does not meet the fixed-for-fixed condition.

The staff therefore believes that the fixed-for-fixed condition should also apply for the redemption obligation under the Gamma approach. Under this approach a foreign currency written put option would contain a financial liability for the present value of the redemption amount and an embedded derivative liability for the option to convert the foreign currency liability to a fixed number of ordinary shares at the exercise date. However, the separate presentation requirements under the Gamma approach may mitigate some of the consequences of such an approach.

The Board largely agreed with the staff's analysis and tentatively decided that an entity should reconcile the interaction of the redemption obligation requirement with the requirement that only fixed-for-fixed derivatives that exchange a liability for equity instruments are classified as equity.

KPMG insight

Applying the fixed-for-fixed condition for the redemption obligation would change the current accounting treatment for foreign currency written put options. However, this might enhance comparability between entities that economically have similar obligations but may have structured their transactions differently.

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