

Financial instruments

IFRS Newsletter



“Attributing profits to equity claims based on relative fair values may require more complex calculations and yield less intuitive results.”

- 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 May 2016 on its project on financial instruments with characteristics of equity.

The IASB has continued its discussions on financial instruments with characteristics of equity, having previously considered:

- the scope of any separate presentation requirements for liabilities that depend on a residual amount; and
- possible ways to attribute profit or loss and other comprehensive income (OCI) to equity claims (both non-derivatives and derivatives) other than ordinary shares.

Highlights

At its May meeting, 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. The objective of this additional attribution approach would be to achieve a similar attribution to the attribution indirectly incorporated in the calculation of diluted EPS under IAS 33 *Earnings per Share*.

The next step for the project will be to consider refinements to the definition of the residual amount, including the fixed-for-fixed condition. The Board will also further consider the presentation of income and expense that depend on a residual amount in profit or loss or in OCI and disclosure requirements for equity claims.

The macro hedge accounting project was not extensively discussed during the April meeting. However, the Board was provided with feedback from the 2015 Agenda Consultation. The key priorities of this project are to enhance the reporting of interest rate risk management in open portfolios and to overcome the limitations in the current hedge accounting requirements. The Board directed the staff to consider the findings on customer behaviour and replication of portfolios of core demand deposits when further developing the alternative approaches for dynamic risk management.

Financial instruments with characteristics of equity

The story so far ...

IAS 32 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*¹.

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. It noted that a feature is relevant if it has the potential to affect the prospects for future cash flows.

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 (including different approaches for applying these presentation requirements to hybrid instruments). It also discussed possible ways to attribute profit or loss and OCI to equity claims (both non-derivatives and derivatives) other than ordinary shares.

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 different attribution approaches for derivative equity claims

Attribution of profit or loss and OCI to derivative claims classified as equity

What's the issue?

Currently, no amounts of profit or loss and OCI are attributed to classes of equity other than non-controlling interests and parent equity interests. Attribution has the advantage of presenting the effect on ordinary shares of having other classes of equity outstanding.

The Board previously discussed the following attribution approaches for derivative equity claims:

Approach	Description	Staff observations
A	Changes are not attributed – i.e. the existing treatment of only disclosing the effect through diluted earnings per share (EPS) is continued.	This is the most pragmatic approach because it does not change the existing EPS calculation. However, it is unlikely to improve the information provided by the existing requirements regarding the effect on ordinary shares of other classes of equity.
B	Changes are attributed based on the change in the fair value of the derivative.	Provides more information regarding the effect on ordinary shares of other classes of equity and does not depend on other calculations. However, if the change in the fair value of the derivative is greater than the recognised residual return, this would result in the attribution of a deficit amount for ordinary shares.
C	Changes are attributed on a relative fair value basis – i.e. based on changes in the attribution of total recognised equity on a relative fair value basis between derivatives and other classes of equity.	Provides new information to supplement the diluted EPS calculation. Total recognised equity would be allocated pro rata based on the fair values of the derivatives and the ordinary shares at the end of the period. However, the amount attributed to the derivative would only be relevant in comparison to the amount attributed to ordinary shares. This approach would be the most costly of the three approaches – i.e. A, B and C.

The amount attributed to derivatives on own equity would affect the numerator for the basic EPS calculation, but would be reversed for the purpose of calculating diluted EPS. Under all three approaches, the calculation of diluted EPS would be the same because it assumes that the derivative was exercised.

What was discussed?

The staff presented an additional attribution approach. Its objective would be to achieve a similar attribution to the attribution indirectly incorporated in the calculation of diluted EPS under IAS 33 *Earnings per Share*. However, instead of using the strike price of the derivative as per the IAS 33 calculation, the fair value of the derivative would be used. For options, this means that time value would also be reflected. The following table summarises this approach:

Approach	Description	Staff observations
D (Ordinary share equivalents approach)	Changes are attributed on a relative average fair value basis – i.e. based on the ratio of average fair values of the derivatives and ordinary shares for the period (calculated using simple or time-weighted averages, as appropriate).	Better depicts the distribution of returns in the period because it treats the equity derivatives as common share equivalents – i.e. as if they were replaced by the number of ordinary shares that would be issued in exchange for the derivatives' average fair value during the period. However, the carrying amounts attributed to the derivatives and ordinary shares would not be meaningful. Likely to be more costly than the other three approaches as additional fair values would need to be estimated.

The Board did not express a preliminary view on a preferred attribution approach and agreed that the DP should set out the objectives of each alternative, illustrating how the focus of each approach differs – e.g. allocation of net assets; allocation of profit or loss and OCI; or improving disclosures. A key consideration would be the cost vs benefit analysis for each approach. The Board acknowledged that there may be consequences for the EPS calculation and that any consequential amendments to IAS 33 would be considered at a later stage. Some Board members questioned whether warrants should be classified as equity or liabilities and noted that warrant holders are not yet current holders of ordinary shares.

KPMG insight

As noted by the staff, Approach C would provide new information to supplement the diluted EPS calculation. However, Approach D would provide similar information to the diluted EPS calculation. In light of this and the impact of these approaches on basic EPS, the Board might wish to consider whether to extend the scope of this project to include amendments to the requirements of IAS 33.

Because the attribution approaches and the classification approaches (Alpha, Beta and Gamma)² are inter-related, the ultimate impact on presentation may depend on the preferred classification approach selected by the Board.

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

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Acknowledgements

We would like to acknowledge the efforts of the principal author of this publication: Angie Ah Kun.

We would also like to thank Chris Spall for his input.

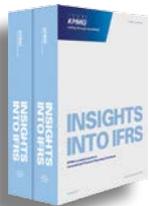
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Publication name: *IFRS Newsletter: Financial Instruments*

Publication number: Issue 30

Publication date: May 2016

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