

Financial instruments

IFRS Newsletter



“Broader consideration of economic incentives in the classification of claims with alternative settlement outcomes would represent a significant change from current practice.”

– 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 October 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 the presentation of specific types of derivatives on own equity classified as liabilities and how disclosures could complement approaches to classification and presentation.

Highlights

At its October meeting, the Board discussed claims where the issuing entity can choose between alternative settlement outcomes and considered whether economic incentives should affect the classification.

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

- classification of instruments meeting the existing puttables exception;
- accounting for alternative settlement outcomes that are contingent on events beyond the control of both parties;
- substance of rights and obligations in contracts and their interaction with legal and regulatory requirements; and
- recognition, derecognition and reclassification of equity instruments.

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

Contents

Financial instruments with characteristics of equity	2
Alternative settlement outcomes within the issuer’s control	3
KPMG contacts	7
Acknowledgements	7
Keeping in touch	8

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.

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 claims where an issuing entity can choose between alternative settlement outcomes and considered whether economic incentives should affect the classification

Alternative settlement outcomes within the issuer’s control

What’s the issue?

Some claims grant the issuer the right to choose between alternative settlement outcomes – e.g. a reverse convertible bond. In this case, the bond is convertible into a fixed number of ordinary shares at the issuing entity’s option. This is the opposite of a typical convertible bond where the holder has the option to choose settlement in cash or shares. The amount of the entity’s obligation is effectively limited to the lower of:

- the value of the specified number of shares; and
- the specified amount of cash.

Under IAS 32, classification is based on the substance of the contractual arrangement. If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, then the obligation meets the definition of a financial liability. The reverse convertible bond would usually be classified as equity in its entirety because the entity has the unconditional right to avoid delivering cash by settling the claim with a fixed number of ordinary shares. This may be the case even if the value of the shares might be higher than the cash payment amount.

An economic incentive to settle in a particular manner – even if it is strong enough to be considered ‘economic compulsion’ – does not by itself create a liability. However, IAS 32 does discuss how the terms and conditions of a contract may indirectly establish an obligation that would meet the definition of a liability. For example, this occurs if the value of the share settlement alternative is determined to substantially exceed the value of the cash settlement alternative such that the entity will settle in cash (see paragraph 20 of IAS 32).

Based on the above, two prevailing views have emerged regarding the role of economic incentives in a new classification model.

View	Rationale
Economic incentives should not be considered	The IAS 32 classification faithfully represents the rights and obligations of the entity. In the example of the reverse convertible bond, there is typically no obligation to transfer economic resources until the entity waives its right to transfer shares.
Economic incentives should be considered	The IAS 32 classification result is counterintuitive. In the example of the reverse convertible bond, it may be classified as equity even if it is highly likely to be settled in cash.

The question arises whether the economic incentive for the entity to settle the claim by transferring cash needs to be considered when classifying the claim.

What was discussed?

The staff discussed the arguments that support each view.

Economic incentives should not be considered

This view focuses on the rights and obligations in the contract. The fact that the entity can waive its right to defer payment until liquidation and transfer resources before liquidation is not relevant. What is relevant is whether the entity has an obligation to transfer resources before liquidation. Further, if the entity has a substantive unconditional right to avoid the liability settlement outcome, then it is not relevant if the liability settlement outcome is favourable.

Equity classification does not mean that economic resources would never be transferred to holders of equity claims. The Gamma approach classifies as equity obligations:

- to transfer economic resources only at liquidation; and
- for a residual amount.

A reverse convertible bond would be classified as equity under the Gamma approach if the entity has the substantive unconditional right to settle it by delivering a fixed number of equity instruments. Therefore, the amount of the claim would depend on the availability of the entity's economic resources and the cash settlement transfer can be avoided.

In some cases, an entity's right to settle a claim by delivering a fixed number of ordinary shares is 'structurally' out-of-the-money (i.e. always out-of-the-money, or always unfavourable) – e.g. it can pay cash equal to the fair value of 80 shares or deliver 100 shares. Therefore, in those cases the value of the liability settlement outcome is always less than the value of the equity settlement outcome and there is an indirect obligation to pay cash.

Under the Gamma approach, liability classification arises from either obligations to transfer cash or other financial assets before liquidation or obligations for a specified amount independent of an entity's economic resources. Callable preferred shares with resets (where, if the entity does not redeem the preference shares, the redemption amount increases at an increasing rate over time) would therefore be classified as liabilities under the Gamma approach because the amount of the payment is known, even though the timing of the payment is unknown. This classification is achieved without the need to consider economic incentives.

Economic incentives should be considered

This view considers the likelihood that economic resources would be transferred by the entity regardless of any obligation to do so.

In the Conceptual Framework ED, the Board proposed that an entity has an obligation to transfer an economic resource if the entity has no practical ability to avoid the transfer. This means that:

- the transfer is legally enforceable, or
- any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself.

The basis for conclusions to the Conceptual Framework ED states that economic compulsion may be a factor that reduces the entity's practical ability to avoid

a future transfer, so it would need to be considered in assessing whether that criterion is met. Therefore, the potential significant favourability of the liability settlement outcome compared with the equity settlement outcome might establish a financial liability.

However, because a very broad range of facts and circumstances could affect an entity's choice of settlement, a number of follow-on issues and questions would arise if economic incentives were considered in the classification assessment.

Issue	Question
The economic incentive to exercise the liability settlement option may range from 'marginally favourable' to 'deeply in-the-money'	How significant does an economic incentive need to be for the entity to be 'economically compelled' to transfer economic resources?
Market changes would result in the significance of the economic incentive changing from period to period	Should the assessment of economic compulsion be performed only when classifying the claim at initial recognition or performed continuously to take into account changing facts and circumstances?
Effects on the entity's other economic resources or claims or other business factors may influence an entity's decision to exercise a liability settlement option	Should the assessment of economic compulsion consider economic consequences beyond the alternatives in the contract?
Options that are subject to risk are typically always potentially favourable	Should the assessment be limited to current economic consequences at the assessment date or should possible future economic consequences be considered as well?
A similar counterintuitive result occurs for a typical convertible bond that is highly likely to be converted into shares but is classified as a liability	If the economic incentives are considered for reverse convertible bonds, then should they not also be considered from the perspective of the holder for the classification of typical convertible bonds?

What did the staff recommend?

The staff recommended that economic incentives should not be considered in the classification assessment, although the requirements of IAS 32 regarding indirect obligations should be retained and updated to reflect the Gamma approach. The staff believed that differences between claims with alternative settlement outcomes and other claims against the entity could be communicated through presentation and disclosure requirements.

What did the Board decide?

The Board agreed with the staff's preliminary view that, under the Gamma approach, economic incentives should not be considered in the classification assessment. Therefore, classification would be based on the substantive rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract. Board members acknowledged the

staff's view that additional information could be communicated to users through presentation and disclosure requirements. Some Board members believed that requiring economic incentives to be considered in the classification assessment would be too complex and necessitate reassessment of classification as judgements change.

A Board member argued that the IAS 32 requirements on indirect obligations are different from economic compulsion considerations in that the former requires liability classification if the terms of the instrument establish the obligation from day one, whereas the latter consideration implies that the likelihood of each settlement outcome would have to be anticipated up front. Another Board member questioned the impact on the classification if a settlement alternative has no commercial substance. The staff believed that this consideration was already required under IAS 32 and that it may be easier to draw the line on whether an outcome has an economic impact compared with whether there is economic compulsion to choose an alternative.

KPMG insight

The staff paper noted previous discussions of the IFRS Interpretations Committee and IASB on certain types of claims and whether, in substance, they establish obligations that would meet the definition of liabilities.

One of these instruments was a callable preferred share with resets.² Because this instrument included no contractual obligation ever to pay dividends or to call the instrument, it was concluded that it should be classified as equity under IAS 32. Under the Gamma approach, this instrument would be classified as a liability without the need to consider economic incentives or economic compulsion. Therefore, the classification under the Gamma approach differs from the IAS 32 approach even when both approaches disregard economic incentives.

It is not clear how widely or narrowly the staff interpret the concept of an indirect obligation and how it might arise. Paragraph 20 of IAS 32 refers to the value of the share settlement alternative being such that the entity will settle in cash. However, when the Committee discussed a financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares,³ the Committee noted that judgement would be required to determine whether the issuer's early settlement option is substantive. Various factors would need to be considered, such as the term of the instrument, the width of the range between the cap and the floor and the issuer's share price. Therefore, it is important to consider whether an alternative is substantive when assessing claims with alternative settlement outcomes.

In addition, whether economic incentives should affect the classification of instruments is only one aspect to be considered. There may be other barriers to the entity exercising the liability or equity settlement outcome, such as regulatory or legal requirements. The Board will need to discuss this at a future meeting.

2. [IFRIC Update – November 2006: Classification of a financial instrument as liability or equity.](#)

3. [IFRIC Update – January 2014: IAS 32 Financial Instruments: Presentation](#) – 'A financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares'.

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