IFRS NEWSLETTER
FINANCIAL INSTRUMENTS

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cutting through complexity

“The project has made progress by identifying the relevant features in measuring claims. The next challenge is to explore how these features affect users’ information needs.”

Chris Spall
KPMG’s global IFRS financial instruments leader

The future of IFRS financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in June 2015 on its project on financial instruments with characteristics of equity.

Highlights

After the project on financial instruments with characteristics of equity restarted in earnest last month, the IASB has begun identifying the features of claims that are relevant to distinguishing between liabilities and equity.

As a first step, at its June meeting, the Board discussed features that are relevant in *measuring* claims – namely, the:

- type of economic resource required to settle the claim;
- timing of the transfer of economic resources required to settle the claim;
- amount or quantity of economic resources required to settle the claim;
- priority of the claim relative to other claims; and
- conditions or contingencies attached to the claim.

The next step for the project will be to *analyse* the relevance of the identified features of claims for assessments that users might make using different parts of financial statements.

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

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY – RELEVANT FEATURES

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 *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*.

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.

The Board did not formally revisit the project until May 2015, when it discussed the conceptual and application challenges in distinguishing between liabilities and equity, and said that it would identify the characteristics of claims that create these challenges as a next step in the project.

The staff presented their analysis of the features of claims that are relevant to distinguishing between liabilities and equity.

What's the issue?

The classification of financial instruments as liabilities or equity has a significant impact on their balance sheet presentation, on their measurement, and on how they affect an entity's financial performance. However, the increasing complexity of financial instruments is making it difficult to distinguish between liabilities and equity.

Now that the scope and the challenges of the project have been identified, the next important step is to identify features of claims that are relevant to distinguishing between liabilities and equity.

The staff believe that features are only relevant if they have the potential to affect the prospects for future cash flows on the claim.

What did the staff recommend?

A claim that contains features that could affect the prospects for future cash flows should be measured – through recognition or disclosure – to provide useful information about the claim. Therefore, as a first step, the staff identified the features that are relevant in measuring claims – i.e. those that affect the prospects for future cash flows.

A claim's 'features' refer to the way it specifies the required transfer of economic resources[1] – i.e. the circumstances under which the entity's obligation will be settled. Examples of settlements include:

- fulfilling the obligation;
- transferring economic resources to the holder by repurchasing the claim;
- negotiating a release from the claim; or
- replacing the existing claim with a new claim with different features.

1. Under the proposed Conceptual Framework, an economic resource is a right that has the potential to produce economic benefits.

Different features affect the prospects for future cash flows in different ways, and information about those effects may influence different types of assessment that users make. These differences may require:

- different recognition requirements or measurement bases;
- inclusion of the amounts in different totals and subtotals in the balance sheet, and profit or loss; or
- additional information in the notes to the financial statements.

Relevant features identified by the staff

The staff believe that features are only relevant in measuring the aggregate amount of claims if they have the potential to affect the prospects for future cash flows on the claim. The table below outlines five features that meet this criterion.

Examples of each type of feature	How could the feature affect the prospects for future cash flows?	How is the feature considered under current IFRS?
Type of economic resource required to settle the claim		
Cash or other financial assets. Goods or services. Any economic resources under the control of the entity.	• Allocates different types of economic resource to different claims. • Introduces the risk that the entity will not have the type of economic resource required to settle the claim. • Determines whether any costs incurred to produce, obtain or convert economic resources to settle a claim would flow to other claim holders.	IFRS does not distinguish between liabilities and equity on this basis. However, some IFRS requirements are specific to the type of economic resource to be transferred. For example, IAS 39 *Financial Instruments: Recognition and Measurement* (and IFRS 9 *Financial Instruments*) and IAS 32 apply to "contractual obligations to deliver cash or another financial asset to another entity". In addition, IAS 18 *Revenue* (and IFRS 15 *Revenue from Contracts with Customers*) applies to the sale of goods and the rendering of services.
Timing of the transfer of economic resources required to settle the claim (in full or in part)		
Calendar dates for: • full settlement – e.g. maturity dates; and • part settlement – e.g. coupon payment dates.	• Determines whether the transfer will take place before the entity's liquidation. • Allocates the entity's economic resources to claim holders at different times. • Introduces the risk that the entity will be unable to settle the obligation when required. • Determines whether any costs incurred to produce, obtain or convert economic resource to settle a claim would flow to those claims that are required to be settled at a later time.	The timing of the transfer of economic resources is implicit in the definition of liabilities, as illustrated by the following standards. Under IAS 32, obligations to transfer cash or other financial assets before liquidation are financial liabilities. Under IFRS 2 *Share-based Payment*, obligations to transfer cash or other assets before liquidation are liabilities. Under the proposed Conceptual Framework, obligations to transfer economic resources before liquidation are liabilities. In addition, IAS 1 *Presentation of Financial Statements* requires liabilities to be distinguished between current and non-current (or, if elected, in the order of liquidity if that is most relevant) on the balance sheet.

Examples of each type of feature	How could the feature affect the prospects for future cash flows?	How is the feature considered under current IFRS?
Amount or quantity of economic resources required to be transferred to settle the claim		
Face values, coupons, floors and/or ceilings denominated in units of a selected currency, commodity, financial asset, or a basket or index of assets. These amounts may change over time if: • they are set with reference to market interest rates; or • the economic resource is denominated in units of a selected currency, commodity, financial asset, or a basket or index of assets.	• Identifies whether an obligation exists to transfer a specified amount or quantity of economic resources, other than a pro rata share of the entity's remaining economic resources. • Allocates different quantities or amounts of economic resources to different claims. • Introduces the risk that the entity will not have the amount of economic resource required to settle the claim.	Some IFRS requirements specify the amount of economic resources that are required to settle a claim. IAS 32 states that "obligations to transfer a variable number of equity instruments [equal to a specified amount] are financial liabilities". IAS 33 *Earnings per Share* states that "the amount of the preference dividends for cumulative preference shares required for the period … is deducted from profit or loss". One of the conditions of the puttable exception to the definition of a financial liability in IAS 32 states that "the total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the 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."
Priority of the claim relative to other claims		
Senior secured bonds. Junior bonds. Preference shares. Common shares. Warrants.	• Modifies the prospects for future cash flows depending on the relative ranking of the claims ('pecking order' or 'waterfall').	Under IAS 32, puttable financial instruments that include an obligation to transfer cash or other financial assets before liquidation are classified as equity if certain conditions are met. Under IAS 33, ordinary shares – for which earnings per share is calculated – are defined as an equity instrument that is subordinate to all other classes of equity instrument.
Conditions or contingencies attached to another particular feature – i.e. type, timing or amount – or to the claim as a whole[2]		
Unconditional. Conditional on events within the entity's control. Conditional on events within the claim holder's control. Conditional on events beyond the control of both.	• May lead to an obligation to transfer economic resources: – ceasing to exist in the future; or – being converted into a different type of obligation on the occurrence or non-occurrence of a specified event – e.g. as occurs for written or purchased options to issue claims.	Some IFRS requirements – especially those related to recognition and measurement – are specific to the type of event on which the claim is contingent.

For the purpose of this meeting, the staff analysed the relevant features independently – i.e. without considering their interaction with one another. However, in practice they are analysed for their combined effects on claims.

2. The staff will analyse and discuss conditions and contingencies in further detail in future IASB meetings.

How the staff would analyse claims with identified features

The information that the claim holders are interested in depends on the relevant features of claims – i.e. what affects the future cash flows on the claim.

The holders of claims that contain *all relevant features* – e.g. ordinary bonds – are generally interested in information about the type, timing, amount and uncertainty of future cash flows on the claims. These claim holders will also be interested in features of other claims to the extent that they affect the future cash flows on their claims.

By contrast, the holders of claims that contain *no relevant features* – e.g. ordinary shares – are generally interested in information about the entity's economic resources and about any relevant features of other claims against the entity.

The staff considered some examples of simple claims, and whether they contain all, some or none of the relevant features listed above.

Type of claim	Which relevant features does it contain?	Explanation
Ordinary bonds	All relevant features	The entity has an obligation to transfer an amount of cash, equal to an amount specified in a particular currency, at a specified time before liquidation and senior to all other claims.
Shares redeemable for their fair value	Some relevant features	The entity has an obligation to settle the claim, at fair value, at a specified time before liquidation or on demand of the holder with cash. However, like ordinary shares (see below), they do not specify the amount of economic resources and claims that the entity needs to pay – i.e. the fair value of the ordinary shares reflects the total amount of recognised and unrecognised economic resources and other claims.
Share-settled debt		These claims do not require the entity to settle the claim using economic resources – i.e. the entity uses a variable number of its own ordinary shares instead of cash. Also, these claims are not required to be settled before liquidation of the entity (although conversion to a claim with different features is required before liquidation). However, like ordinary bonds, they specify the amount or rate of change in amount that the entity requires to settle the claims.
Cumulative preference shares		These claims are not required to be settled before liquidation of the entity. However, like ordinary bonds, they specify the amount or rate of change in amount that the entity requires to settle the claims.
Ordinary shares	No relevant features	The entity has no obligation to transfer any amount or any specific type of economic resources to the holders of ordinary shares until the entity's liquidation.

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The notion that ordinary shares do not have relevant features means that the prospects for future cash flows on such instruments are primarily driven by the entity's overall economic resources – i.e. its ability to generate cash flows – and the cash flows that will be required to settle other claims – i.e. claims with relevant features that have a priority over ordinary shares. This appears indicative of ordinary shares representing a residual or equity-like interest.

Features that the staff do not believe are relevant

The staff believe that the following features, which have been suggested as criteria over the years, are not relevant to assessing prospects for future cash flows of the claim (or do so only as a result of features that are relevant).

What is it?	Why is it not relevant?
Rights affecting the entity's economic resources	
This feature may specify voting rights or restrictive rights over the entity's activities – e.g. rights to vote at shareholder meetings, and debt covenants.	Such rights may affect the entity's economic resources and the prospects for their future cash flows. However, they do not affect how those prospects are allocated amongst claims. Information about the nature and amount of economic resources is provided through the recognition and measurement requirements applying to the entity's assets. Furthermore, if claim holders have control over the entity, then they have the power to demand information about the entity and are not the primary users of financial statements.
Risk of returns on claims	
This is a measure of the uncertainty of the prospects for future cash flows on a claim.	This feature may influence different types of assessment that users need to make, and therefore a desired outcome of classification may be to depict claims that have similar risk together. However, to achieve this outcome the features would need to be specified – which is not the case for this measure.
Perspective of financial reporting	
Financial statements are presented from the perspective of the entity, not its capital providers.	This feature is relevant in meeting the objective of financial reporting – i.e. financial statements should provide information that: • is useful to existing and potential investors, lenders and other creditors; and • focuses on these parties' common information needs.

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The staff's argument that the feature relating to voting or restrictive rights over the entity's economic activities is not relevant does not necessarily mean that it is also irrelevant to determining the value of a claim. For example, a debt instrument that is supported by covenants may have more value than one that is not supported by covenants. However, the additional value derives from the interaction of the covenant with the relevant other terms of the instrument – e.g. requirements for payment of principal and interest. Also, shares with voting rights might have a higher market value than shares without voting rights.

What did the IASB discuss?

The Board did not make any decisions during this meeting. However, Board members agreed with the features identified by the staff.

During the discussion, one Board member confirmed with the staff that the features identified relate to the measurement of claims, without considering their allocation between different classes of liabilities and equity.

The member also clarified with the staff that – although the perspective of financial reporting is not a relevant feature for the direct measurement of claims – it is likely to become a relevant feature in considering the assessments made by users.

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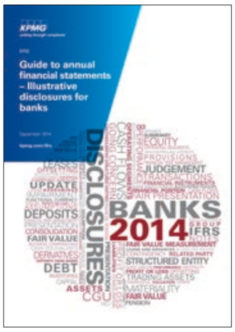

Illustrates one possible format for financial statements based on a fictitious bank and helps to identify which disclosures may be required.

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