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Financial Instruments with Characteristics of Equity Update

Objective

1 The objective of this agenda paper is to discuss with the EFRAG TEG the recent developments undertaken by the IASB with regards to the *Financial Instruments with Characteristics of Equity* ('FICE') project.

Introduction

2 EFRAG Secretariat provided EFRAG TEG members with an update on the IASB's discussions in September 2017. In January 2018, the IASB discussed potential ways to provide useful information about non-derivative instruments with complex payoffs. This agenda paper covers the issues discussed at that meeting and has been divided into two sections:

(a) classification of non-derivative instruments with a complex payoff structure;

(b) additional guidance on the notion of an amount that is independent of the entity's available economic resources.

3 As a short reminder, the Gamma Approach will classify a claim as a liability if it:

(a) requires the transfer of economic resources at a specified time other than at liquidation (the timing feature); or

(b) specifies an amount that is independent of the entity's available economic resources (the amount feature).

Classification of non-derivative instruments with a complex payoff structure

IASB discussion

4 In January 2018 the IASB met to discuss an issue identified during the review of the pre-ballot draft of the FICE Discussion Paper.

5 The issue relates to how the Gamma Approach classifies non-derivative instruments with a complex payoff structure. More specifically, the issue arises when an entity has the option to:

(a) limit the amount of a claim to the entity's available economic resources (e.g. an option to settle a claim by delivering a fixed number of shares); or

(b) settle a claim at an amount that is affected by other variables that are independent of the entity's economic resources (e.g. a foreign currency or commodity index).

6 According to the IASB staff, the issue arise as these instruments are non-derivatives that could be seen as a compound instrument (an equity host and an embedded derivative asset). An example of such an instrument is a share with an embedded call option held by the issuer where the strike price is linked to a gold index ('gold indexed callable share'). In such a case, the entity has the option:

(a) to exercise the option to buy its own equity and pay a strike price linked to the gold index; or

(b) not to exercise the option to buy its own equity and limit the amount of the claim to the entity's available economic resources.

7 Under IAS 32 *Financial Instruments: Presentation*, this non-derivative instrument would be classified as **equity** in its entirety as the entity has the unconditional right to avoid delivering cash. Also, the entity has no contractual obligation to deliver a variable number of its own equity instruments.

8 Under the Gamma approach, this non-derivative instrument would also be classified as **equity** in its entirety as the amount of the claim is limited to the entity's available economic resources because the entity will choose the lowest of the options between paragraphs 6(a)) and 6(b)). Furthermore, while the entity has the right to settle the claim by delivering cash, it has no obligation to do so.

9 However, in the absence of further specific requirements, all non-derivative instruments with an amount that is limited by the entity's available economic resources will be classified as equity in their entirety even if the amount is also affected by variables that are independent of the entity's available economic resources (e.g. foreign currency or commodity index). As a result, information about the variability resulting from such variables (e.g. exchange rate or gold price changes) will not be provided. In paragraphs 36 to 38, we present a number of other instruments with a complex payoff structure where the entity may have the option for the equity or liability settlement.

10 In order to address this lack of information, the IASB discussed three potential approaches:

(a) *enhancing embedded derivative requirements*: to analyse these instruments as an equity host and an embedded derivative asset even if the issuer held the option to settle the claim;

(b) *enhancing indirect obligation requirements*: to help with decisions about distinguishing liability and equity in certain cases, particularly when the equity settlement outcome has no economic substance; or

(c) *expanding the attribution requirements*: to some particular types of non-derivative equity instruments with alternative settlement features.

Enhancing embedded derivative requirements

11 If the embedded derivative requirements are enhanced, then such instruments[1] would be separated and accounted for as an equity host and a derivative financial asset.

12 Thus, for the gold indexed callable shares, an entity would recognise the underlying shares as equity instruments and the right to repurchase the shares for cash as a derivative. As the strike price of the call option is linked to gold price (variable independent of the entity's available economic resources) the derivative would not

[1] I.e. instruments that give an entity the option to limit the amount of a claim to that entity's available economic resources but also, at the same time, the option to settle at an amount that is affected by other variables that are independent of the entity's economic resources.

be classified as an equity instrument. The call option would be accounted for as a derivative asset.

13 One of the consequences of separating embedded derivatives from equity host instruments is that equity instruments and derivative assets would be presented on a gross basis. This alternative would capture the entity's exposure to the embedded derivative through classification, recognition and measurement and would help to achieve consistent accounting between a standalone and an embedded derivative if both are affected by a variable that is independent of the entity's available economic resources.

14 However, such an approach would raise challenges regarding the identification and separation of the host instrument as there are many possible ways of performing the separation. In addition, the IASB staff considered that the degree of the gross-up might also not always best depict the entity's financial position, especially if the equity settlement outcome has no economic substance or is very unfavourable for the entity. Finally, enhancing the embedded derivative requirements may result in a change in practice.

Enhancing indirect obligation requirements

15 If the indirect obligation requirements are enhanced, then the classification of these instruments will depend on whether the equity settlement option is substantive.

16 Under this alternative, a gold indexed callable share that is deep in the money at inception, and expected to remain so throughout the life of the instrument, may be classified as liability in its entirety. Similarly, a reverse convertible bond (please see paragraph 26 below) with a deep out of the money conversion option may be classified as a financial liability in its entirety.

17 Such an approach might help to better represent the economic substance of the instrument[2]. Nonetheless, this would mean that the feature that limits the amount of the claim to the entity's available economic resources will be ignored for the purposes of classification under some circumstances. Further, enhancing the indirect obligation requirements is also likely to give rise to challenges similar to economic compulsion. Finally, it may require a change in practice and there may be consequences on a wider set of financial instruments, particularly those with alternative settlement outcomes where the relative favourability of an alternative settlement outcome could raise questions on the classification

Expanding the attribution requirements.

18 Under the Gamma approach, entities will be required to attribute profit or loss and other comprehensive income to some classes of equity other than the ordinary shares of the parent entity and to update the carrying amount of each subclass of equity to reflect any such attribution.

19 Under this alternative, the attribution requirements could be expanded to cover non-derivative instruments with a complex payoff structure. Expanding the attribution requirements could help providing useful information about non-derivative instruments with a complex payoff structure that are classified as equity in their entirety without the need to separate the embedded derivatives.

20 Disclosure of potential dilution to ordinary shares proposed by the Gamma Approach could also provide some information about these types of instruments as they are/may be settled in own shares.

[2] The IASB has already tentatively decided that the requirements in IAS 32 for indirect obligations should be retained applying the Gamma Approach.

21 However, it would not provide further information about the distribution of returns that could arise from the alternative settlement outcome.

IASB discussion and tentative decisions

22 In January 2018, the IASB tentatively decided:

(a) before proposing any particular accounting requirements, to raise the issue in the Discussion Paper and seek feedback on whether separating embedded derivatives may be a potential solution; and

(b) to raise a question in the Discussion Paper about whether and how the attribution requirements may help provide information about complex payoffs if the embedded derivative is not separated from the equity host contract.

EFRAG Secretariat analysis

23 The DP will raise the issue of whether these financial instruments could be analysed as an equity host and an embedded derivative asset.

24 We note that under IAS 32, if an entity has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of equity. Therefore, enhancing embedded derivative requirements and separating embedded derivatives for non-derivatives with complex payoffs would be a significant change to current requirements, and consequently to current practice.

25 For example, it would change current practice on the accounting for the callable shares (as above) as entities would have to account them as an equity host component and an embedded derivative asset component which represents the right to settle the claim in cash. Under IAS 32, shares callable by the issuer are classified as equity in their entirety and the right to settle by delivering cash does not play a role in classification.

26 Similarly, questions could arise with a reverse convertible bond (e.g. a bond to pay CU100 that is convertible into 100 shares at the issuing entity's option). Such instrument could be seen as:

(a) an equity component that represents the obligation to deliver a fixed number of shares and a derivative component that represent the issuer's right to choose cash payment instead of the fixed number of shares if it is a cheaper alternative (as noted by the IASB Staff in the January 2018 agenda paper); or

(b) an instrument that includes an unconditional right of the entity to settle a claim either by transferring a fixed number of equity instruments (which would be an equity settlement outcome under the Gamma approach), or a specified amount of cash (which would be a liability settlement outcome under the Gamma approach). That is, it would include a liability host and an embedded derivative (i.e. purchased put option on own equity).

27 In addition, EFRAG Secretariat notes that non-derivatives with complex payoffs are often affected by multiple variables (e.g. foreign currency, market price of the shares, etc) and it will be difficult to provide information about all those different features through separation of embedded derivatives and recognition of fair value changes in profit or loss. In addition, such requirements will be costly for preparers.

28 Instead, EFRAG Secretariat considers that if the Gamma approach is to be applied, the IASB should retain the principle that in the case of "an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of equity". That is, under the Gamma approach, a claim would meet the definition of an equity instrument if an entity has both:

(a) an unconditional right to avoid transferring cash or other financial assets to settle the claim until liquidation (time); and

(b) an unconditional right to settle the claim at an amount that is dependent of the entity's economic resources (amount).

29 Finally, EFRAG Secretariat notes that if the IASB decides to use the attribution requirements to help in providing information about complex payoffs, entities will still need to make the separation of the embedded derivative for attribution purposes as the attribution may be based on fair value changes of such embedded derivatives. This would also add costs and complexity to current requirements.

30 EFRAG Secretariat considers that information about the variability resulting from the different features included in non-derivative instruments with complex payoffs could be provided through a better breakdown of equity and improved disclosures on the terms and conditions of such financial instruments.

Questions for EFRAG TEG

31 Does EFRAG TEG consider that separating embedded derivatives may be a potential solution for the issues that arise with the instruments described in paragraph 5 above?

32 Does EFRAG TEG consider that the attribution requirements may help provide information about complex payoffs if the embedded derivative is not separated from the equity host contract?

Amount that is independent of the entity's available economic resources

IASB discussion

33 When discussing the non-derivative instruments with complex payoffs, the IASB staff discussed the notion of a claim for an 'amount that is independent of the entity's available economic resources' and how this notion would be applied in practice. In particular, how the Gamma approach should be applied to instruments that limit the amount of a claim to the entity's available economic resources (e.g. an option to settle a claim by delivering a fixed number of shares) because they contain a cap or a floor that is triggered automatically or at the option of the entity.

34 When explaining the notion of an 'amount that is independent of the entity's available economic resources', the IASB staff clarified that:

(a) the 'available economic resources of the entity' are the total recognised and unrecognised assets of the entity that remain after deducting all other claims against the entity;

(b) the amount of a claim is 'independent of the entity's available economic resources' if changes in the entity's available economic resources do not result in changes in the amount of the claim;

(c) if the amount of the claim is affected by changes in the entity's available economic resources such that it could exceed the available economic resources of the entity, then the amount is also independent of the entity's available economic resources;

(d) conversely, the amount of a claim is dependent on the entity's available economic resources if changes in the entity's available economic resources result in changes in the amount of the claim such that the amount never exceeds the available economic resources of the entity;

(e) a claim might specify the amount of the obligation using the entity's available economic resources as a reference. The entity will still be required to consider whether the amount could exceed the entity's available economic resources

under any possible scenario - based on the contractual terms of the financial instrument at initial recognition. If the amount can exceed the entity's available economic resources in some circumstances, then the amount is considered to be independent of the entity's available economic resources applying the Gamma Approach.

35 Let us consider the following examples:

Mandatorily convertible note with a cap

36 Under the Gamma approach, an instrument that is mandatorily convertible into a variable number of shares equal to a specified amount of cash, subject to a cap for the number of shares to be issued, would be classified in its entirety as equity. The reason for this is that the amount of the claim is limited by the cap specifying a maximum number of shares deliverable by the entity. Therefore, the amount will never exceed the available economic resources of the entity.

37 The Gamma Approach focuses on the amount of the obligation, and in particular, whether that amount is limited to the entity's available economic resources, regardless of how that limit is implemented. Therefore, for the mandatorily convertible note, as long as the entity's obligation is limited to a maximum (ie fixed) number of shares, the classification does not change whether the limit exists as an option right held by the entity, or it operates automatically. In contrast, applying IAS 32, automatic opposed to optional conversion affects the classification.

Share-settled bond with a floor

38 Under the Gamma approach, a share-settled bond that obliges an entity to deliver a variable number of shares equal to a fixed amount (e.g. CU100) subject to a minimum number of shares (e.g. 100 shares) would be accounted for as a compound instrument with a financial liability component and an equity component.

(a) the minimum payoff of CU100, will be classified as a liability component (i.e. claim for an amount independent of the entity's available economic resources);

(b) the additional payoff that arises if the value of 100 shares exceed CU100 will be accounted for as an equity component (i.e. claim for an amount dependent on the entity's available economic resources).

IASB discussion and tentative decision

39 At the meeting, some IASB members raised some concerns on the accounting for mandatorily convertible bonds with a cap. Under the Gamma approach, some members considered that such instruments should be analysed as a liability host and an embedded derivative (rather than being entirely classified as equity). Otherwise, the accounting for such instruments will be subject to structuring opportunities where issuers will include a cap on every instrument to achieve equity classification.

40 Some IASB members also questioned how the notion of an "amount that is independent of the entity's available economic resources" should be applied under the Gamma approach, particularly when considering whether an amount "could exceed the entity's available economic resources".

EFRAG Secretariat analysis

41 Under IAS 32, the classification of a mandatorily convertible note with a cap will depend on whether the cap is triggered automatically or at the option of the issuer.

(a) *Cap is triggered automatically*: In 2014 the IASB discussed the classification of a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor. The IFRS IC noted that that the

instrument meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 because the issuer has a contractual obligation to deliver a variable number of its own equity instruments. The IFRS IC also noted that it is inappropriate to consider that the instrument contains separate conversion features for each scenario where the issuer will deliver a different number of its own equity instruments. That is, IAS 32 does not permit an issuer to divide a single conversion feature into multiple settlement outcomes for the purposes of evaluating the classification requirements in IAS 32. Furthermore, the IFRS IC noted that the cap and the floor are embedded derivative features whose values change in response to the price of the issuer's equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those embedded derivative features from the host liability contract and account for them at fair value through profit or loss in accordance with IFRS 9.

(b) *Cap is triggered at the option of the issuer*: In 2014 the IASB also 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. The discussion was mainly focused on issuer's early settlement option. According to the IFRS IC discussions, if the entity has the option to deliver the fixed number of shares specified by the cap at any time, the entity has no contractual obligation to deliver a variable number of own shares and therefore the instrument is classified as an equity instrument.

42 EFRAG Secretariat has already expressed a preference that if the Gamma is to be applied, then a financial instrument should be classified as equity if the entity has an unconditional right to avoid the liability settlement. Such principle would be aligned to the IFRS IC decisions up to date.

Questions for EFRAG TEG

43 Does EFRAG TEG consider that under the Gamma approach, the classification of a financial instrument should be classified as equity in its entirety just because it has a cap or a floor?