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Financial Instruments with Characteristics of Equity
Issues Paper

Objective

1 The objective of this session 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 and the next steps of the project.

Introduction

2 EFRAG Secretariat provided EFRAG TEG members with an update on the IASB's discussions in February 2017. Since then, the IASB discussed the following topics:

(a) **Topic 1**: how the Gamma approach would apply to the accounting within equity;

(b) **Topic 2**: the scope of contractual rights and obligations to be considered for the classification and presentation requirements under the Gamma approach;

(c) **Topic 3**: application of the Gamma approach to the classification of derivatives on non-controlling interests with an exercise price denominated in a foreign currency;

(d) **Topic 4**: a summary of interactions with other IFRS Standards, IFRIC Interpretations and the Conceptual Framework for Financial Reporting; and

(e) **Topic 5**: Due process and permission to ballot.

Topic 1: Accounting within equity

3 At its meeting in February 2017, the IASB discussed illustrative examples that clarify how its decisions on the Gamma approach apply to accounting within equity, including convertible bonds and put options written on own equity.

4 The IASB discussed the accounting for **convertible bonds** as described below:

Instrument	IAS 32	Gamma
Convertible bond Obligation to deliver, at the option of the holder, a fixed amount of cash or a fixed number of shares.	**COMPOUND INSTRUMENT** Bifurcation into liability and equity components. The **liability component** is measured first and represents the contractual arrangement to deliver cash. The difference between this value and the fair value of the instrument is assigned to	**COMPOUND INSTRUMENT** Bifurcation into liability and equity components. The **liability component** is measured first. The difference between this value and the fair value of the instrument is assigned to the **equity component** (meets the "solely dependent on the residual amount" condition).

Instrument	IAS 32	Gamma
	equity component (meets the "fixed-for-fixed" condition) even when the instrument is out-of-money. The **equity component** is not remeasured. The income and expenses relating to the **liability component** are recognised in profit or loss.	Under the Gamma approach the **equity component** is potentially remeasured over time through an attribution of comprehensive income. The IASB is considering different attribution mechanisms (e.g. based on changes in fair value). The remeasurement is made within equity to help users assess the allocation of the residual returns. At maturity, the carrying amount of the equity component is transferred to ordinary shares. The income and expenses that arise from the **liability component** are recognised in profit or loss. The *Statement of Changes in Equity* will show the wealth transfer between different classes of equity.

5 The IASB also discussed the accounting for **written put options**, which is described below. The accounting for a convertible bond will be similar to the accounting for a written put option on own shares that is issued together with ordinary shares. In both cases, the holder will have the option to either receive cash or shares of the entity.

Instrument	IAS 32	Gamma
Written put option on own shares (gross physical settlement) Requires the purchase of a fixed number of own shares at the option of the holder in exchange for a fixed amount of cash.	**LIABILITY and EQUITY leg** The option feature represents an **equity component** (i.e. premium received) as it meets the fixed-for-fixed condition. An entity's contractual obligation to purchase its own shares gives rise to a **liability component** for the present value of the **redemption amount** (i.e. present value of strike price). This amount is **reclassified from equity**. Changes in the carrying amount of the **liability component** are recognised in profit or loss. The **equity component** is not remeasured over time.	**LIABILITY and EQUITY leg** There is an equity and liability component and reclassification from equity. However, the Gamma approach will provide guidance on initial recognition. In particular: • the **redemption amount** is the present value of the strike price of the option; • the **derecognition from equity** is based on the fair value of the ordinary shares at the date the written put is issued; • the **equity component** is the sum of the premium received and the difference between the two amounts calculated above. The **equity component** is remeasured over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns, and it is a transfer within equity. At maturity, the carrying amount of the **equity component** is transferred to ordinary shares. Changes in the carrying amount of the **liability component** are separately presented in profit or loss. The *Statement of Changes in Equity* will show wealth transfer between different classes of equity.

6 For the particular case of NCI puts, the accounting would be the same as for the written put option on own shares. However, the equity components are replaced with their NCI equivalents.

7 Appendix 1: *Illustrative examples of derivatives on own equity* includes a simplified illustrative example for a convertible bond and a written put option.

EFRAG Secretariat analysis on derivatives on own equity in general

8 EFRAG Secretariat notes that expanding the attribution of profit or loss and OCI to components of equity and updating the respective carrying amounts represents a significant change to existing requirements in IAS 1 *Presentation of Financial Statements*, IAS 32 *Financial Instruments: Presentation* and current Conceptual Framework.

9 Such an approach, while keeping the notion of equity as a residual amount, may have implications for the future Conceptual Framework in respect of addressing the direct remeasurement of the components of equity (senior classes of equity). We also note that in the past EFRAG supported the notion of equity as the element of the financial statements that is not directly measured[1].

10 Further, EFRAG Secretariat notes that an attribution approach will:

(a) increase the complexity and the costs for preparers as entities will have to determine the fair value of their own equity instruments (which will increase the use of IFRS 13 *Fair Value Measurement)*, compute an attribution method and present the results in the statement of financial position;

(b) impact other standards such as IAS 33 *Earning per Share* (see paragraph 48(c) below)*;* and

(c) raise a number of application challenges, including the accounting within equity and the presentation on face of the primary financial statements. For example, how many classes of equity should appear on the face of the financial statements and how should the accounting within equity be done considering the legal requirements impacting equity (e.g. issued capital, share premium and legal reserves)?

11 Nonetheless, in February 2017 EFRAG User Panel members discussed this topic and some considered that the creation of subclasses of equity and direct measurement of the different classes was useful to them to assess the allocation of residual returns and better assess the solvency of entities, particularly financial institutions. EFRAG User Panel will discuss some illustrative examples in a future meeting.

EFRAG Secretariat analysis on derivatives on own equity that represent equity/liability exchanges (e.g. written put options).

12 From the IASB discussions, the Gamma approach seems to change the existing requirements on the "reclassification from equity" and "equity component" of derivatives on own equity that represent equity/liability exchanges (e.g. change to existing requirements on written put options).

(a) **reclassification/derecognition from equity**: in accordance with paragraph 23 of IAS 32, a financial liability is reclassified from equity and is recognised initially at the present value of the redemption amount. Paragraph IE30 of the Illustrative Examples provides an example of how the reclassification should be done. Under the Gamma approach, the derecognition from equity is based on the "fair value of the ordinary shares at the date that the written put is issued" (i.e. not measured on the same basis as the liability which is measured at the "redemption amount"). EFRAG Secretariat assesses that this would represent a significant change to current requirements under IAS 32.

[1] Paragraphs 55 to 65 of EFRAG comment letter on the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting.*

(b) **equity component:** in accordance with paragraph 22 of IAS 32, any consideration received (e.g. premium received for a written option on the entity's own shares) is added directly to equity. Under the Gamma approach, the "equity component" for written put options would be equal to the "premium received adjusted by any differences between the redemption amount and the fair value of the ordinary shares at the date the written put is issued" (i.e. not based simply on the premium). This would represent a change to current requirements and the equity component would be different from the premium received, which is the fair value of the instrument at initial recognition.

EFRAG Secretariat analysis on written puts on non-controlling interest ("NCI puts")

13 In its February 2017 meeting, EFRAG TEG members highlighted the importance of addressing the issues that currently arise with written puts on non-controlling interests.

Initial recognition of NCI puts

14 On initial recognition, paragraph 23 of IAS 32 states that a contract that contains an obligation for an entity to purchase its own instruments for cash or another financial asset gives rise to a financial liability. Yet, this paragraph does not state clearly whether the contra to the liability requires that the NCI be derecognised or whether the general reduction in equity (alongside NCI) is sufficient.

15 Under the Gamma approach a financial liability is recognised initially at the present value of the redemption amount, and is reclassified from NCI shares ("derecognition of the NCI shares on which a written put option is issued"). Similarly, if the put option expires unexercised, then the carrying amount of the redemption amount would be reclassified to NCI shares. This would address the presentation issue on initial recognition.

Subsequent measurement of NCI puts

16 On subsequent measurement, in 2012 the IFRS Interpretations Committee ("IFRS IC") published a draft Interpretation on NCI puts in the parent's consolidated financial statements. The issue was related to the fact that some believe that changes in the measurement of the financial liability that is recognised for the put option should be recognised in profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement /* IFRS 9 *Financial Instruments*, while others believe that those changes should be recognised directly in equity because of the guidance in IFRS 10 *Consolidated Financial Statements*[2] (leading to diversity in practice). The draft Interpretation proposed to clarify that the financial liability that is recognised for an NCI put must be remeasured in accordance with IAS 39 and IFRS 9, which require changes in the measurement to be recognised in profit or loss. Nonetheless, after considering the feedback received, the IASB decided that this issue should be included in the FICE project.

17 Under the Gamma approach, if the redemption amount (i.e. present value of the strike price) is fixed, then changes in the financial liability that is recognised for the put option should not be separately presented in OCI. However if the strike price is, for example, equal to the value of the underlying shares (e.g. fair value written put option) then the changes in the liability will qualify for separate presentation. Thus, under the Gamma approach, the separate presentation within OCI will depend on the characteristics of the strike price. This would be the conceptual solution to what some see as the counter-intuitive accounting in comprehensive income for puttable instruments, including puts on shares held by NCI.

[2] Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Questions for EFRAG TEG members

18 Do EFRAG TEG members have any comments on the IASB's discussions on accounting within equity?

19 Do EFRAG TEG members believe that guidance being developed will solve the issues that you find in practice with written put options, including NCI puts?

Topic 2: Scope of contractual rights and obligations

20 At its meeting in February 2017, the IASB discussed whether the effects of law should be considered for the purposes of classifying financial instruments under the Gamma approach. In particular, whether the Gamma approach should focus only on the contractual terms of a financial instrument (consistently with the existing requirements in IAS 32 and IFRS 9) or whether it should consider both the rights and obligations arising from the contract and the law for classification purposes (consistently with IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*). When discussing this issue, the IASB considered:

(a) **Mandatory tender offers ("MTOs")**: the IFRS IC received in the past a request to address the accounting for purchases of non-controlling interests that arise as a result of business combinations. In particular, whether MTOs required by law should be recognised as a liability. The IFRS IC noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts that are executory (unless they are onerous) and concluded that no liability needed to be recognised for MTOs. However, at a later meeting some members expressed the view that a liability should be recognised in a manner that is consistent with IAS 32 at the date the acquirer obtains control of the acquiree while others were of the view that MTOs are not in the scope of IAS 32 or IAS 37 so no liability should be recognised.

(b) **Contingently convertible bonds ("CoCos")**: the IFRS IC received in the past requests to address the accounting for financial instruments that are contingently convertible into ordinary shares as a result of regulatory requirements. Namely, there were questions on whether laws that impose contingent conversion features on particular types of claims issued by an entity should be considered for classification purposes.

21 **MTOs**: limiting the assessment of classification to contractual terms would result in the entity's obligations that arise from legal requirements to offer to purchase the non-controlling interest not being considered in the classification of MTOs. Therefore, MTOs and written put options, which have similar economic consequences, would not be accounted for similarly.

22 To address this issue, the IASB discussed the possibility of considering the effects of legal requirements in the classification of all instruments. However, there were concerns that:

(a) a fundamental change could have unintended consequences beyond addressing the distinction between liabilities and equity in IAS 32;

(b) additional requirements on classification, recognition and derecognition would have to be developed for the Gamma approach and IFRS 9 as neither IAS 32 nor IFRS 9 were developed to take them into account; and

(c) an entity would need to continually monitor changes in the law and questions may arise on when the effects of law should be considered, i.e. at inception or a under particular circumstances.

23 **CoCos**: limiting the assessment of classification to contractual terms under the Gamma approach implies that any contingent equity conversion feature that results

from the national resolution authority's power derived from legislation should not be considered by the issuer for classification purposes (i.e. an entity would only consider contingencies reflected in the contract). As a result, the instrument would be classified as a liability in its entirety; an equity component would only be recognised if the contingent conversion option is solely dependent on the residual amount.

24 This ensures consistency on contingently convertible bonds that are affected by law on both the asset and liability side (i.e. would be consistent with IFRS 9). This is because, under IFRS 9 the holder does not consider the effect of regulation when assessing whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

25 After discussing these two instruments, the IASB tentatively decided:

(a) to require an entity to apply the Gamma approach to the contractual terms of a financial instrument consistently with IAS 32 and IFRS 9;

(b) to consider whether it should take any action to address the accounting for MTOs, including potential disclosure requirements; and

(c) not to reconsider IFRIC 2, given that it is not aware of any challenges to its application.

EFRAG Secretariat analysis on MTOs

26 In regard to MTOs, the EFRAG Secretariat considers that the tentative decision taken by the IASB indicates that accounting for MTOs will be considered after publication of the DP. However, it is not clear whether, and if so how, this issue will be mentioned in the forthcoming DP.

EFRAG Secretariat analysis on contingently convertible bonds

27 EFRAG FIWG members referred in previous meetings to the issue of financial instruments that are contingently convertible to ordinary shares as a result of regulatory requirements. In particular, members noted that upon a trigger event, the financial instruments may be mandatorily convertible into a variable number of own shares or there may be a mandatory write-down.

28 It was noted that this feature raised difficulties in terms of classification of bail-in instruments. More specifically, members noted that:

(a) mandatory conversion to shares would be consistent with a liability classification while the mandatory write-down would not;

(b) the trigger event and form of resolution (conversion or write-down) could be at the discretion of the regulator and it was not clear in advance which form of resolution the regulator would choose;

(c) these financial instruments raised questions about how to provide transparent information to users, particularly information about write-down features in the contract (resolution regulation) and write-downs recognised in a year;

(d) past discussions on financial instruments that are mandatorily convertible into a variable number of shares upon a contingent non-viability event focused not only on classification but also on measurement of the liability and accounting for any interest paid on the instrument; and

(e) the contingent settlement provisions in paragraph 25 in IAS 32 were important and should be retained.

29 At this stage, the IASB has not specifically addressed the issues related to financial instruments that may be mandatorily written down or the measurement issues that arise with contingently convertible instruments. It is expected that the forthcoming

Discussion Paper will provide sufficient information to permit an understanding of how these instruments will be classified under the Gamma approach.

EFRAG Secretariat analysis on interaction between 'contractual rights and obligations' and 'regulatory and legal' requirements

30 EFRAG FIWG members noted that the interaction between 'contractual rights and obligations' and 'regulatory and legal' requirements was fundamental and considered that IFRS Standards were not consistent, or even contradictory, when dealing with these two concepts. More specifically, they noted that under IFRIC 2 the effects of legislative requirements are considered for classification purposes while in IAS 32 and IFRS 9 they are not.

31 EFRAG Secretariat acknowledges that ideally there should be consistency between the different standards. Nonetheless, if effects of law were to be considered for the purposes of classifying financial instruments this would be a fundamental change to current requirements in IAS 32 and have knock-on consequences in IFRS 9. We also note that when an entity assesses the extent of its obligations based on the terms and conditions of a contract, that contract has to comply with relevant laws and regulations but need not include all specific conditions in laws and regulations because the law makes them a component of the contract.

32 Therefore, EFRAG Secretariat concurs, to some extent, with the IASB tentative decision that under the Gamma approach the classification should be focused on the contractual terms of a financial instrument (consistently with IAS 32 and IFRS 9). In addition, given the narrow fact pattern to which IFRIC 2 applies and the importance of this guidance to cooperative entities, the EFRAG Secretariat supports the tentative decision of the IASB not to reconsider IFRIC 2. Considering the different approaches in IAS 32 and IFRIC 2, the IASB will need to consider whether, and if so how, IFRIC 2 will be integrated in the future revised standard.

33 Nonetheless, EFRAG Secretariat highlights the challenges that arise from the interaction between the contractual rights and obligations and the Banking Recovery and Resolution Directive ("BRRD"). We consider that the IASB should work together with regulators to address the challenges that arise with the new BRRD, particularly when considering the role of the national resolution authorities and the possibility of capital instruments being written down or converted. We also note that a similar approach has been done in IFRS 17 *Insurance Contracts* where specific legal issues are considered in the standard.

Questions for EFRAG TEG members

34 Do EFRAG TEG members have any comments on the IASB's tentative decisions on the scope of contractual rights and obligations?

35 Do EFRAG TEG members believe that the guidance being developed will solve the issues found in practice, particularly with financial instruments that are contingently convertible to ordinary shares as a result of regulatory requirements?

Topic 3: Derivatives on non-controlling interests with an exercise price denominated in a foreign currency

36 The IASB previously discussed the solely dependent on the residual amount condition (i.e. fixed-for-fixed) under the Gamma approach and whether a derivative with particular variables, such as foreign currency variability, would be solely dependent on the residual amount (i.e. would be fixed-for-fixed). The discussion can be summarised as follows:

(a) **foreign currency**: if the exercise price of a derivative on own equity is denominated in a currency other than the functional currency of the entity, the amount of the derivative is exposed to variability other than the residual

amount. Thus, such derivatives would not be a claim for an amount that solely depends on the residual amount and would not be classified as equity under the Gamma approach;

(b) **equity instruments of a subsidiary**: the residual amount of a subsidiary entity, including non-controlling interest, is part of the residual amount of the group. If a derivative solely depends on the residual amount of the subsidiary, then the derivative would also solely depend on the residual amount of the group; and

(c) **foreign currency NCI puts**: the IASB Staff was requested to consider the application of the Gamma approach to the classification of derivatives on non-controlling interests with an exercise price denominated in a foreign currency (e.g. NCI puts where the amount receivable is denominated in the functional currency of the subsidiary which differs from the functional currency of the parent[3]).

37 In March 2017 the IASB discussed the foreign currency NCI puts issue (i.e. the interaction between the variables "foreign currency" and "equity instruments of a subsidiary") and considered that under the Gamma approach a derivative "solely depends on the residual amount" when the only variable affecting the amount of derivative is the value of the equity instrument to be delivered. This is the case when the derivative is a contract that is settled with a fixed amount of the entity's functional currency. This principle would apply even when a stand-alone entity issues a derivative on its own equity in its functional currency but uses another currency as its presentation currency.

38 Further, if a derivative is a promise to deliver equity instruments of a specific entity within the group (e.g. subsidiary), then the relevant functional currency is the functional currency of that entity whose equity instruments are being delivered. This is because the amount of the derivative is comprised of the total of both legs, the amount to be received and the amount to be paid

39 Therefore, under the Gamma approach:

(a) a derivative "solely depends on the residual amount" when it is a contract that is settled with a fixed amount of the entity's functional currency;

(b) a derivative that is a promise to deliver equity instruments of a specific entity within the group (e.g. subsidiary) "solely depends on the residual amount" when it is a contract that is settled with a fixed amount of the functional currency of the entity whose equity instruments are being delivered. Thus, when an entity issues a derivative on equity instruments of another entity, the functional currency of the entity whose equity instruments form the underlying of the derivative should be the reference point in determining whether the derivative is denominated in a foreign currency; and

(c) when an entity issues a derivative on its own equity and functional currency (e.g. parent or its subsidiary), the classification as equity or debt does not change in the consolidated financial statements. This holds even if the consolidated financial statements are presented using another currency.

40 In Appendix 2: *Illustrative examples of derivatives in foreign currency* we include a number of examples to better explain how these principles would apply in practice.

[3] IAS 21 *The Effects of Changes in Foreign Exchange Rates* defines functional currency as the currency of the primary economic environment in which the entity operates and foreign currency as a currency other than the functional currency. IAS 21 also permits the presentation currency to be any currency.

EFRAG Secretariat analysis on derivatives on NCI with an exercise price denominated in a foreign currency

41 The issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency is quite relevant and is directly linked to the discussion on and interpretation of what is a “fixed amount of cash”.

42 Entities often issue financial instruments that are denominated in a currency other than its functional currency. A common example is the issuance of convertible bonds by a parent or subsidiary which are denominated in a currency (e.g. euros) other than its functional currency (e.g. Norwegian krone) to ease the access to investors. Another example, is the acquisition of an entity in a foreign country which has convertible bonds issued in local currency and subsequently the acquirer starts to change the currency practice.

43 As currently IAS 32 does not make a specific reference to this issue, entities have an accounting policy choice which impairs comparability. In addition, in November 2006 the IFRS IC discussed the issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency but did not take the matter onto the agenda. Considering the lack of guidance and clarity on this issue, EFRAG Secretariat welcomes guidance on this topic.

44 EFRAG Secretariat also agrees that under the Gamma approach, a derivative “solely depends on the residual amount” if it is settled with a fixed amount of the entity’s functional currency. This principle seems to be clear and reasonable when applied to the separate/individual financial statements of an entity.

45 Challenges arise when considering consolidated financial statements, including situations where an entity issues derivatives on equity instruments of another entity within the group. Considering the notions of “reporting entity” and “functional currency” that exist in IFRS Standards, ideally the principle in paragraph 44 should also apply to consolidated financial statements (as a single entity). However, we acknowledge that a group does not have a functional currency and such discussion is beyond the scope of this project. Therefore, we agree with the outcome proposed.

46 Finally, we note that the foreign currency variable is also important for the separate presentation requirements of derivatives that have been classified as liabilities. More specifically, it affects the assessment of whether income and expenses that arise from liabilities that are neither completely independent nor solely dependent of the residual amount (e.g. foreign currency denominated written call option).

Questions for EFRAG TEG members

47 Do EFRAG TEG members have any comments on the outcome of paragraph 39 above?

Topic 4: Interactions with other IFRS Standards, IFRIC Interpretations and the Conceptual Framework for Financial Reporting

48 In March 2017 the IASB discussed a summary of the potential implications of the Gamma approach for the Conceptual Framework for Financial Reporting, other IFRS Standards, IFRIC Interpretations and other projects on its agenda. Some of the potential implications include:

(a) **revised Conceptual Framework**: some of the potential differences with the conceptual framework are that the Gamma approach:

(i) considers one additional feature for classification purposes: whether the amount of the obligation is independent of the entity's economic resources; and

(ii) proposes separate presentation requirements for income and expenses that depend on the residual amount (i.e. use of OCI without recycling to profit or loss).

Thus, one possible outcome is a recommendation to propose an amendment to the Conceptual Framework.

(b) **IFRS 2 *Share-based payments***: at present, the distinction between liabilities and equity under IFRS 2 is consistent with the revised Conceptual Framework (but not with IAS 32). If the IASB ultimately proposes changes to the Conceptual Framework as a result of the FICE project, the IASB would need to consider the implications for a future revision of IFRS 2 (e.g. whether the separate presentation and the attribution approach should also be applied to shared-based payment transactions).

(c) **IAS 33**: if the IASB proceeds with an approach that attributes total profit or loss and OCI to derivatives classified as equity and requires separate presentation requirements (i.e. use of OCI), then it may consider the implications of the attributions and separate presentation requirements for the earnings per share calculation (basic and diluted). For example, the additional use of OCI and attribution approach will have impact on the calculation of EPS.

(d) **IAS 1**: the effect of the Gamma approach on the different classes of equity and liabilities and separate presentation requirements may have a significant impact on the presentation of financial statements. In particular, it could have an impact on the Principles of Disclosures project, the Primary Financial Statements project and IAS 1.

(e) **IFRS 9 and IFRS 7**: if the IASB decides to add a project to amend or to replace IAS 32, there will be likely consequential amendments to other IFRS Standards focused on financial instruments such as IFRS 9 and IFRS 7. One area of interaction is the application of the separate presentation requirements to stand-alone and embedded derivative financial liabilities that depend on the residual amount.

(f) **IFRIC 2**: in February 2016, the IASB tentatively decided that it would not reconsider the requirements of IFRIC 2 other than for consequential amendments.

(g) **IFRS 3 *Business Combinations***: questions have arisen in the past about the lack of consistency between the requirements in IFRS 3, IFRS 10 and IAS 32, in particular for NCI puts. The IASB's discussions on the Gamma approach could help clarify the interaction between IAS 32 and these standards.

49 The IASB members were not asked for any decisions. Still, some members considered that the DP should:

(a) clarify how the notion "no practical ability to avoid the transfer of an economic resource" in the revised Conceptual Framework would interact with the classification of financial instruments under the Gamma approach;

(b) explain that the use of the OCI option for equity instruments in IFRS 9 is driven directly from the definition of equity instruments in IAS 32. Thus, any changes to classification will have direct consequences for the use of the OCI option for equity instruments in IFRS 9;

(c) provide examples on whether and how the attribution approach would affect the calculation of basic EPS; and

(d) clarify that the Gamma approach does not change any measurement attributes but has measurement consequences (e.g. compound instruments).

EFRAG Secretariat analysis on interactions with other IFRS Standards

50 EFRAG Secretariat has not made, at this stage, a detailed assessment of the possible consequences for other IFRS Standards, IFRIC Interpretations and the Conceptual Framework for Financial Reporting.

51 Nonetheless, considering the level of changes that the FICE project will propose on the classification, presentation and disclosure requirements for financial instruments, this project is likely to have a pervasive effect on the revised Conceptual Framework, IAS 1, IFRS 2, IFRS 7, IAS 32 and IAS 33.

Questions for EFRAG TEG members

52 Do EFRAG TEG members have any comments on the interactions with other IFRS Standards, IFRIC Interpretations and the Conceptual Framework for Financial Reporting?

Topic 5: Due process and permission to ballot

53 The IASB reviewed the due process steps it has taken to date in developing the DP on FICE. The IASB members confirmed they were satisfied that the IASB has completed all the necessary due process steps on the project to date and instructed the staff to begin drafting and balloting of the DP.

54 The IASB also decided that the DP should allow a comment period of 180 days.

Questions for EFRAG TEG members

55 Do EFRAG TEG members have any comments on the IASB's tentative decisions on the permission to ballot or comment period of 180 days?

Appendix 1: Illustrative examples of derivatives on own equity

56 EFRAG secretariat has prepared a simplified version of the examples provided by the IASB staff in agenda paper 5C of February 2017 meeting.

Example 1: Convertible bond

57 Entity A issues a bond for CU100 in cash, with an option to be exercised by the holder. The holder has the right to elect to receive CU110 in cash two years from date of issuance or to receive 100 ordinary shares of the entity. The value of a similar bond without equity conversion option is CU82. The fair value of the conversion option is CU10 in year 1 and CU15 in year 2.

IAS 32	Gamma
COMPOUND INSTRUMENT Bifurcation into liability and equity components. The **liability component** is measured first. The difference between this value and the fair value of the instrument is assigned to **equity component**. *Initial recognition* Dr: Cash CU100 Cr: Liability component CU82 Cr: Equity component (conversion option) CU18 *Year 1 – accrual of interest* Dr: Interest expense CU13 Cr: Liability component C13 *Year 2 – accrual of interest* Dr: Interest expense C15 Cr: Liability component C15 *Settlement date if the holder elects to receive fixed amount of cash* Dr: Liability component CU110 Cr: Cash CU110 The amount that was previously recognised in equity remains in equity. *Settlement date if the holder elects to receive fixed amount of shares with nominal value of CU1.1* Dr: Liability component CU110 Cr: Equity – Ordinary shareholders CU110 The original equity component remains as equity. The **equity component** is not remeasured and the carrying amount is transferred to ordinary shares. However, currently there is a lack of guidance on subsequence accounting for the equity component, including at maturity date.	**COMPOUND INSTRUMENT** Bifurcation into liability and equity components. The **liability component** is measured first. The difference between this value and the fair value of the instrument is assigned to the **equity component**. *Initial recognition* Dr: Cash CU100 Cr: Liability component CU82 Cr: Equity component (conversion option) CU 18 Under the Gamma approach the **equity component** is potentially remeasured over time through an attribution of comprehensive income. The IASB is considering different attribution mechanisms. In this example we use an attribution based on fair value changes of the conversion option, which fluctuates over time. The remeasurement is made within equity. *Year 1 – accrual of interest and attribution mechanism* Dr: Interest expense CU13 Cr: Liability component C13 Dr: Equity component (conversion option) CU8 Cr: Attribution to conversion option CU8 *Year 2 – accrual of interest and attribution mechanism* Dr: Interest expense CU15 Cr: Liability component CU15 Cr: Equity component (conversion option) CU5 Dr: Attribution to conversion option CU5 *Settlement date if the holder elects to receive fixed amount of cash* Dr: Liability component CU110 Cr: Cash CU110

IAS 32	Gamma
	Settlement date if the holder elects to receive fixed amount of shares Dr: Liability component CU110 Dr: Equity component (conversion option) CU15 Cr: Equity – Ordinary Shares CU125 In both cases, at maturity the carrying amount of the equity component is transferred to ordinary shareholders. The income and expenses that arise from the **liability component** would be recognised in profit or loss. The *Statement of Changes in Equity* will show the wealth transfer between different classes of equity.

Example 2: Written put option

58 Entity A issued 100 ordinary shares for CU0.9 each (CU90) and a written put option on 100 ordinary shares at a strike price of CU1.1 each (CU110). The put option is exercisable in two years. Entity A received CU10 in cash as a premium. The present value of the redemption amount (CU1.1 per share x 100 ordinary shares) is CU82. The fair value of the conversion option is CU 10 in year 1 and CU 15 in year 2.

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LIABILITY and EQUITY leg An entity's contractual obligation to purchase its own shares gives rise to a **liability component** for the present value of the redemption amount (i.e. present value of strike price). This amount is **reclassified from equity**. The option feature represents an **equity component** (i.e. premium received). *Initial recognition* Dr: Cash on shares issued CU90 Cr: Equity – Ordinary Shares issued CU90 Dr: Cash on put option premium CU10 Cr: Equity – Conversion Option CU10 Cr: Liability – Redemption amount CU82 Dr: Equity – Ordinary Shares C82 Changes in the carrying amount of the **liability component** are recognised in profit or loss. The **equity component** is not remeasured over time. *Year 1 – time value of money* Dr: Interest expense C13 Cr: Liability – Redemption amount C13 *Year 2 – time value of money* Dr: Interest expense C15 Cr: Liability – Redemption amount C15 *Settlement date if the holder exercises its option* Dr: Liability – Redemption amount CU 110 Cr: Cash CU110	**LIABILITY and EQUITY leg** The option feature represents an **equity component** (i.e. premium received). The Gamma approach will provide new guidance on initial recognition. In particular: • the **redemption amount** is the present value of the strike price of the option; • the **derecognition from equity** is based on the fair value of the ordinary shares at the date the written put is issued; • the **equity component** is the sum of the premium received and the difference between the two amounts calculated above. *Initial recognition* Dr: Cash on shares issued CU90 Cr: Equity – Ordinary Shares CU90 Cr: Liability – Redemption Obligation CU82 Dr: Equity – Ordinary Shares C90 Dr: Cash on put option premium CU10 Cr: Equity component (conversion option) CU18 The **equity component** is remeasured over time through the attribution of comprehensive income and it is a transfer within equity. *Year 1 – time value of money and attribution mechanism* Dr: Interest expense C13 Cr: Liability – Redemption Obligation C13 Dr: Equity component (conversion option) CU8

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The amount that was previously recognised in equity remains in equity. *Settlement date if the holder elects not to exercise the option* Dr: Liability – Redemption amount CU110 Cr: Equity CU110 The amount that was previously recognised in equity remains in equity.	Cr: Attribution to conversion option CU8 *Year 2 – accrual of interest and attribution mechanism* Dr: Interest expense C15 Cr: Liability – Redemption Obligation C15 Cr: Equity component (conversion option) CU5 Dr: Attribution to conversion option CU5 *Settlement date if the holder exercises its option* Dr: Liability – Redemption Obligation CU110 Cr: Cash CU110 *Settlement date if the holder elects not to exercise the option* Dr: Liability component CU110 Dr: Equity component (conversion option) CU15 Cr: Equity – Ordinary Shares CU125 At maturity, the carrying amount of the **equity component** is transferred to ordinary shares. Changes in the carrying amount of the **liability component** are separately presented in profit or loss. The *Statement of Changes in Equity* will show wealth transfer between different classes of equity.

Appendix 2: Illustrative examples of derivatives in foreign currency

1 **Example 1: A subsidiary entity issues a derivative on its own equity instrument in its own functional currency but the group's presentation currency differs from the subsidiary's functional currency**.

(a) in the financial statements of the subsidiary the derivative could be considered solely dependent on the residual amount applying the Gamma approach and could be classified as an equity instrument; and

(b) the group's choice to use a currency other than a subsidiary's functional currency as it presentation currency would not affect the classification of a derivative issued by the subsidiary in the consolidated financial statements.

2 **Example 2: A parent entity issues a derivative over the subsidiary's equity shares in the parent's functional currency, which differs from that of the subsidiary**. In this case there is a mismatch between the functional currency of the entity whose equity instruments underlie the derivative and the currency that determines the receivable leg of the derivative. Therefore, the derivative does not solely depend of on the residual amount of the entity whose equity instrument affect the amount the amount of the derivative. Thus, under the Gamma approach:

(a) the derivative will not be classified as an equity instrument in the consolidated financial statements; and

(b) the derivative will not be classified as an equity instrument in the separate financial statements of the parent because the derivative is not issued over its own equity.

3 **Example 3**: **A parent entity issues a derivative on its own equity instrument in its own functional currency but the group's presentation currency differs from the parent's functional currency.**

(a) in the separate financial statements of the parent the derivative could be considered solely dependent on the residual amount applying the Gamma approach and could be classified as an equity instrument; and

(b) the group's choice to use a currency other than a parent's functional currency as it presentation currency would not affect the classification of a derivative issued by the parent in the consolidated financial statements.