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Project	**Financial Instruments with Characteristics of Equity (FICE)**		
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Introduction

1. In response to the pre-ballot draft of the FICE Discussion Paper, a question has been raised about how the Gamma Approach applies to particular types of non-derivative instruments with complex payoffs. These particular types of instruments do not oblige the entity to transfer cash or other financial assets, therefore the classification will be determined by how the amount of the claim is specified (ie the pay-off).

2. To date, the Board has considered how complex payoffs (eg payoffs affected by multiple variables) affect the classification of derivative instruments. The Board has also considered how complex payoffs affect the classification of many non-derivatives such as compound instruments and hybrid financial instruments with financial liability hosts.

3. However, there is a limited set of non-derivative instruments that might include complex payoffs that does not fall neatly into the categories of instruments in paragraph 2 that the Board has already discussed. As we show later in this paper, these instruments do not fall neatly into those categories because they are non-derivatives that could be analysed as comprising an equity host and an embedded

derivative asset. This paper considers how the Gamma Approach can provide useful information about these more complex non-derivative instruments.

4. This paper is structured as follows:

   (a) What is the question? (paragraphs 5–10)

   (b) Recap: overview of the Gamma Approach (paragraphs 11–14)

   (c) Application of the Gamma Approach (paragraphs 15–29)

      (i) amount that is independent of the entity's available economic resources

      (ii) classifying financial instruments with complex pay-offs

   (d) Staff Analysis (paragraphs 30–57)

   (e) Summary and recommendation (paragraphs 58–62)

What is the question?

5. The question raised relates to how the Gamma Approach classifies non-derivative instruments with a complex payoff structure. More specifically, the question arises where the amount of the claim is limited by the entity's available economic resources–and hence depends on the available economic resources–but at the same time, is also affected by some other variables that are independent of the entity's economic resources. Such complex payoffs could arise in many forms including derivative instruments and compound instruments.

6. The Board has already discussed the question for derivative instruments. Applying the Gamma Approach, an entity classifies *derivative* instruments as a liability if the net amount of the derivative is affected by any variable that is independent of the entity's available economic resources. On the other hand, the Gamma Approach does not take such a 'variable' approach for non-derivative instruments. Therefore, the question applies only to non-derivative instruments.

7. The Board has also already considered how some non-derivative instruments with complex payoffs should be accounted for when the instrument is a compound instrument with a liability component (See paragraph 20 for further discussion). However, there are some non-derivative instruments that do not contain a liability

component. As mentioned in paragraph 3, such instruments can be analysed as an equity host component and an embedded derivative asset component. For example, a financial instrument may grant the entity the right choose between two settlement options, delivering cash or a fixed number of shares. Although the entity may choose to settle the claim in cash, there is no liability component because the entity does not have a contractual obligation to do so and the amount of the claim is limited by the entity's available economic resources, because of the entity's right to settle by delivering a fixed number of shares. Accordingly, the instrument can be analysed as an equity host component and an embedded derivative which represents the right to settle the claim in cash.

8. 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[1] in their entirety even if the amount is also affected by variables that are independent of the entity's available economic resources. Once classified as equity, information about the variability resulting from such variables will not be provided in a way that information about similar variables that are part of other derivatives and compound instruments will be.

9. In our view, there are three considerations when applying the Gamma Approach to such instruments:

   (a) Does the Gamma Approach require separation of embedded derivative financial assets from equity hosts?

   (b) Do the indirect obligation requirements apply when the embedded derivative financial asset is deeply out of the money?

   (c) If the embedded derivative is not separated and indirect obligation requirements do not result in liability classification, what information could be provided about the equity instrument through presentation or disclosure?

10. These questions do not only arise as a result of applying the Gamma Approach; they also exist when applying IAS 32. However, the instruments that might be

[1] subject to the requirement that it does not require the transfer of economic resources other than at liquidation

affected under the Gamma Approach will have a slightly different set of features compared to IAS 32. We are not aware of the extent of the significance and prevalence of challenges associated with these issues when applying IAS 32. The Gamma Approach may result in changes in classification of some of the instruments for which these issues are relevant. These issues may then become more or less relevant and significant when applying the Gamma Approach. This paper sets out the challenges and outlines some potential solutions if the Board decides to address the issue in the light of input it receives on the Discussion Paper.

Recap: overview of the Gamma Approach

11. The Gamma Approach uses two features to classify an instrument. 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); or

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

12. Both of these features are relevant to assessments of the entity's financial position and financial performance because:

    (a) information about the timing of a transfer of economic will help users assess the extent the entity will have the economic resources required to meet its obligations as and when they fall due.

    (b) information about the amount of claims and how that amount changes over time, will help users assess:

        (i) the extent the entity has sufficient economic resources required to meet its obligations at a point in time.

        (ii) whether the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it.

13. In addition to classification, the Gamma approach will provide additional information through separate presentation, including:

(a) information about the amount of some liabilities through separate presentation of income and expense.

(b) information about equity instruments by attributing income and expenses to some equity instruments other than ordinary shares.

14. The Gamma approach will also provide information about some of the other features of both liabilities and equity through disclosure, including information about the priority on liquidation, potential dilution and terms and conditions.

Application of the Gamma Approach

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

15. As summarised in 11, the Gamma Approach determines classification based on two features, the timing and the amount of financial instruments. A financial instrument is classified as equity only when it contains neither feature that would result in the liability classification. This means that if an instrument does not require the entity to transfer economic resources (such as those settled in equity instruments), then the classification will be determined solely by the amount feature. As mentioned in paragraph 1, the instruments in question do not oblige the entity to transfer cash or other financial assets. They are either required to be settled by delivering equity instruments, or grant the entity a right, but no obligation, to settle by transferring cash. Therefore, the analysis in this paper focuses on the amount feature.

16. The amount of an obligation 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.[2] . If the amount of a claim is independent,

[2] 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 it is also independent of the entity's available economic resources. When assessing whether the amount of a given claim is independent of the available economic resources of the entity, 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.

changes in the entity's economic resources, other claims against the entity, or activities of the entity do not affect the amount of claim[3].

17. 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.

18. 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.

Classifying financial instruments with complex pay-offs

19. In the context of the FICE project, complex payoffs for non-derivative instruments can exist in the following forms:

    (a) compound instruments with a financial liability component and an equity component (paragraph 20);

    (b) non-derivative instruments without a financial liability component, therefore the complex payoff comprises an equity component and an embedded derivative). This type of instruments can be either:

        (i) those with an embedded derivative that would have been classified as equity on its own had the derivative existed as a standalone derivative, eg an issuer option to convert a bond for a fixed amount of cash to a fixed number of shares. (paragraphs 21–23); and

        (ii) those with an embedded derivative that would have been classified as a financial asset (eg due to variability in the amount resulting from factors that are independent of the

[3] Or affect the amount of such claims in a way that the amount could exceed the available economic resources of the entity

available economic resources such as a foreign currency or commodity index (paragraphs 24–29).

20. The Board has already discussed the classification of some compound instruments that include a liability component and an equity component (Agenda Paper 5C, February 2017). For example, a share-settled bond may include a feature such that, at maturity, the entity is obliged to deliver a variable number of shares equal to CU100 subject to *a minimum number* of shares, say 100 shares. The entity is therefore obliged to deliver either CU 100 (in shares) or 100 shares, whichever is worth more; the entity is obliged to deliver at least CU 100 in shares. Applying the Gamma Approach, the instrument would be accounted for as a compound instrument. Similar to a convertible bond, the amount of obligation would be analysed as follows:

(a) the obligation for an amount independent of the entity's available economic resources, ie the minimum payoff of CU100, will be classified as a liability component; and

(b) the obligation for an amount dependent on the entity's available economic resources, ie the additional payoff that arises if the value of 100 shares exceed CU100[4], will be accounted for as an equity component, in particular it would be a derivative equity instrument similar to a conversion option in a convertible bond.

21. The Board has also discussed the application of the Gamma Approach to financial instruments that grant *the entity* the right to choose between settlement outcomes (Agenda Paper 5B, October 2016), one of which would meet the definition of an equity instrument. For example, a bond to pay CU100 that is convertible into 100 shares at the issuing entity's option (a 'reverse' convertible bond). For such obligations, the entity has the choice to settle the claim by either paying a specified amount of cash or delivering a specified number of shares, whichever is cheaper. Effectively, this means that the amount of the entity's obligation is limited to the lower of:

[4] If the amount is affected by some other variable, such as a commodity index, then the conversion option would be classified as a financial liability applying the Gamma Approach.

(a) the value of the specified number of shares; and

(b) the specified amount of cash.

22. Based on the Board's discussion to date, the Gamma Approach will classify such instruments as equity in their entirety. Even if the Board were to explore separation of the embedded derivatives as discussed in this paper, the effect of separating an embedded derivative and accounting for each component separately will be the same as accounting for the entire contract as an equity instrument because the embedded derivative would also be classified as an equity instrument.

23. In addition, the Board also discussed the application of indirect obligation (Agenda Paper 5B, October 2016). In the Board's preliminary view, the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained. Therefore, an indirect obligation would arise if the entity's equity settlement right is structurally out of the money, that is, the amount of the equity settlement outcome always exceeds the liability settlement outcome.

24. Some financial instruments, including the reverse convertible bond described in paragraphs 21 and 22, grant the entity the right to settle the claim by issuing a fixed number of equity instruments, or otherwise limit the entity's obligation to a fixed number of equity instruments. The amount of such financial instruments would depend on the entity's available economic resources because it will never exceed the available economic resources.

25. Some such instruments might also contain other features in addition to the settlement option described in paragraph 25, indexation of the cash settlement amount to a variable, eg commodity index. While the Gamma Approach will consider the amount of the claim to be dependent on the available economic resources of the entity[5], such features mean that the amount is also affected by a variable that is independent of the available economic resources. As described in paragraph 6, if an instrument were a derivative, such an independent variable would result in liability classification of the derivative. The same does not apply to non-derivative instruments. The question then is how best to provide

[5] The amount of the claim depends on the entity's available economic resources because the maximum amount of the claim is a fixed number of shares specified in the contract, which will never exceed the available economic resources.

information about non-derivative instruments that limit the amount of the claim to a fixed number of equity instruments, but that are also affected by some other variable.

26. Let's consider the amount of the claim in the following examples:

(a) **Gold indexed callable share**: consider a share with an embedded call option held by the issuer. The strike price is linked to gold index. Apart from the call option, the share otherwise behaves like ordinary shares, ie no contractual obligation to transfer economic resources other than at liquidation and the amount of obligation is dependent on the entity's available economic resources. Effectively, this means that the amount of the entity's obligation is limited to the lower of:

(i) the fair value of the ordinary shares, if the entity choose not to call the share; and

(ii) the strike price linked to gold index, if the entity chooses to call the share.

(b) **Mandatorily convertible note with a cap**: 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. The entity may or may not have an option to deliver the maximum number of shares specified by a cap at any time. We assume that the cap is a substantive contractual feature. Effectively this means that the amount of the entity's obligation is limited to the lower of:

(i) the fair value of the number of ordinary shares as specified in the cap. The cap will come into effect if the fair value of the shares fall below a particular threshold so that the number of shares to be delivered cannot exceed the cap number; and

(ii) the specified amount of cash.

27. Given the classification requirements of the Gamma Approach as summarised earlier in this paper, and in the absence of further specific requirements, the non-derivative instruments described in paragraph 26 would be classified in their entirety as equity for the following reasons:

(a) **Gold indexed callable share**: the amount of the claim is limited to the entity's available economic resources because the amount will be determined as 'lower of' as described in paragraph 26(a)–in contrast, the amount of the compound financial instrument in paragraph 20 is determined as 'higher of'. Furthermore, while the entity has the right to settle the claim by delivering cash, it has no obligation to do so; and

(b) **Mandatorily convertible note with a cap**: 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.

28. In comparison, when applying IAS 32, the following features are relevant to the classification of the non-derivative instruments described in paragraph 26:

(a) **Gold indexed called share**: Although the entity has the right to settle the claim by delivering cash, the entity has an unconditional right to avoid delivering cash. Also, the entity has no contractual obligation to deliver a variable number of its own equity instruments. The callable shares are therefore classified as equity in their entirety, and the right to settle by delivering cash does not play a role in classification.

(b) **Mandatorily convertible note with a cap**: Applying IAS 32, the classification of the mandatorily convertible note will depend on whether the cap is triggered at the option of the entity (assuming the option is substantive), or triggered automatically once the threshold is reached.

(i) If the entity has *an 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–consistent with a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor, with an issuer option to settle with the maximum number of shares as discussed by the Interpretations Committee in January 2014.

(ii) If the cap is *automatically triggered*, the entity has no unconditional right to avoid settling the claim by delivering a variable number of shares. Therefore, the note is classified as a financial liability–consistent with the case of a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor as discussed by the IC in May 2014.

29. 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, whether or not the limit is a right of the entity, or is automatic, affects the classification. By focusing on the relationship between the amount of the obligation and the available economic resources of the entity, the Gamma Approach achieves greater consistency in the classification of instruments with similar payoffs (Agenda Paper 5C, February 2017). That being said, we note that this is a type of instrument for which providing information about the variability in the amount of claim becomes an issue applying the Gamma Approach when compared with IAS 32 as the instrument would be classified as equity in their entirety under the Gamma Approach. We discuss potential solutions in the next section.

Staff analysis

30. The objective of this paper is to explore potential ways to provide useful information about instruments that limit the amount of the claim to the entity's available economic resources but that are also affected by some other variable such as a commodity index. The staff considered the following potential solutions:

(a) enhancing embedded derivative requirements might help provide useful information when the host instrument would be classified as equity applying the Gamma Approach (paragraphs 32–41);

(b) enhancing indirect obligation requirements might help decisions about distinguishing liability and equity in cases where the limit to the available economic resources is deeply out of the money (paragraphs 42–51); or

(c) expanding attribution requirements might help provide useful information for entire financial instrument classified as an equity instrument without separating embedded derivatives (paragraphs 52–57).

31. All of the above solutions will have different consequences for the information provided through the financial statements:

(a) if embedded derivative requirements are enhanced, then the instrument will be separated and accounted for as an equity host and, if affected by a variable independent of the entity's available economic resources, a derivative financial asset. This will have the effect of 'grossing up' the statement of financial position. For example, the gold-indexed callable share in paragraph 26 would be classified as an equity host without the call option, and a derivative asset representing the entity's right to call the shares in exchange for cash equal to the strike price.

(b) if the indirect obligation requirements are enhanced to address the classification of the non-derivative instruments with complex payoffs, then some such instruments will be classified as a financial liability, and 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. For example, the gold-indexed callable share in paragraph 26 could be classified as a liability for the amount of the strike price, if the equity settlement option is considered lacking an economic effect.

(c) without any separation of embedded derivatives, or enhancement of indirect obligations, the instrument will be classified as an equity instrument in its entirety as a result of the feature that limits the amount of the claim to the entity's available economic resources.

Embedded derivatives

32. Some of the features in the financial instruments in paragraph 26 might meet the definition of an embedded derivative asset, for example an embedded purchased call option. The maximum amount of obligations described in paragraph 26 is limited by the available economic resources of the entity. For that reason, the instruments can be seen as an equity host contract and an embedded derivative which could lower the amount of obligation. For example, a reverse convertible bond grants the entity the right to choose between paying cash and delivering equity. The entity would choose to pay cash only when such an outcome is more favourable (ie cheaper) to the entity. This means that a reverse convertible bond can be analysed as:

    (a) an equity component that represents the obligation to deliver a fixed number of shares; and

    (b) 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. Because the amount of the bond is for a fixed amount, then the derivative would be classified as equity applying the Gamma Approach.

33. Separating the embedded derivative in a fixed-for-fixed reverse convertible bond has no effect on the overall classification, therefore the concerns raised in paragraph 25 do not apply. The gold indexed callable share and mandatorily convertible note in paragraph 26 will be analysed in a similar way as a host equity instrument and an embedded derivative. However, because the embedded derivative in these instruments is affected by a variable that is independent of the available economic resources of the entity, the derivative would be classified as an asset if it were to be classified separately applying the Gamma Approach.

34. The issue also exists today when applying IAS 32. IAS 32 requires the issuer of a non-derivative financial instrument to evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. This compound instrument requirement will remain unchanged applying the Gamma Approach. Unlike compound instruments with a financial liability component, IAS 32 does not provide detailed requirements on whether

and how an entity should separate an embedded derivative asset when the host contract is classified as an equity instrument, resulting in diversity in practice.

Benefits of separating embedded derivatives

35. By separately accounting for the host instrument as equity and the alternative settlement feature as an embedded derivative, information about the variability in the amount of obligation will be provided through recognition and measurement of the embedded derivative. Doing so will also help achieve consistent accounting between a standalone and an embedded derivative if both are affected by a variable that is independent of the entity.

36. If separation were not to be required or permitted, instruments would be classified in their entirety. Many reverse convertible bonds and callable shares (whose amount does not exceed the available economic resources of the entity) could be classified as equity instruments regardless of the effect of other variables. The possible consequences are:

    (a) one of the settlement outcomes may not meet the equity classification requirements had it existed on its own, eg if the entity calls the shares by paying the strike price linked to gold as described in paragraph 26(a). A right or an obligation to deliver cash indexed to gold in exchange for own shares, if existed separately, would be classified as a derivative asset/liability because the net amount is affected by a variable that is independent of the entity's available economic resources, gold price. If such an instrument is classified as equity in their entirety, information about the variability in the amount of obligation resulting from changes in the gold price will not be provided. In contrast, this issue does not exist for a reverse convertible that can be settled by delivering a fixed number of equity instruments because the right to pay a fixed amount of cash for a fixed number of equity instruments has no variable independent of the entity's available economic resources that affect the net amount of the exchange.

    (b) it raises a question as to whether the attribution requirements can provide useful information about the effect of the variables that is not

captured through classification. See paragraphs 52–57 for further discussion.

Potential challenges of separating embedded derivatives from an equity host contract

37. Challenges with the separation requirements include identifying and defining the host instrument, and specifying the order of separation. There are many possible ways of performing the separation, and clarifying these aspects would be required to ensure that similar economic outcomes are classified consistently (ie similar to the objective of the requirements discussed in Section 4 for convertible bonds and written put options). The staff think that the analysis of rights and obligations and the accounting should echo the consistency in accounting between written put options on own shares and convertible bonds.

38. The economic outcomes arising from reverse convertible bonds and the mandatorily convertible notes are very similar to that of callable shares (ie shares that can be repurchased at the entity's option). If separation were to be performed, a reverse convertible and the mandatorily convertible note could be analysed as if they were callable shares. This means that the entity would need to recognise an equity component for the equity settlement outcome (the fixed number of shares), and recognise a derivative representing the alternative settlement outcome as follows:

    (a) for the gold indexed callable shares, the 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 in our example is linked to gold price, a variable independent of the entity's available economic resources, the derivative will not be classified as an equity instrument. The call option will be accounted for as a derivative asset.

    (b) similarly, for the reverse convertible bond, the entity would recognise the equity settlement outcome that would arise on conversion as an equity instrument as if the shares were issued, and the entity's right to pay cash would be recognised as a purchased call option derivative. If the derivative meets the equity classification requirements for

standalone derivatives (eg a fixed-for-fixed call option), the derivative will be classified as equity as well.

(c) The cap (whether automatically triggered or at the entity's option) in the mandatorily convertible note will also be accounted for as an equity instrument as if the maximum number of shares were issued. The possible settlement outcomes where a lower number of shares are delivered (ie the cap is not triggered/exercised) will be accounted for as a derivative.

39. One of the consequences of separating embedded derivatives from equity host instruments is that equity instruments and derivative assets are presented on a gross basis. The effect will be more significant if the equity settlement option (including those that are automatically triggered) is deep out of the money and the embedded derivative is classified as a derivative asset[6]. Let's consider an example where an issuer-held conversion option in a reverse convertible bond is deep out of the money. If the embedded derivative is separated as discussed in paragraphs 38, the entity would recognise an equity instrument as if the shares were issued, and the entity's right to pay cash would be recognised as a purchased call option derivative. A deep out of the money conversion option suggests that the cash settlement option is much cheaper than the equity settlement option, which means the purchased share call option would be deep in the money. Since the call option is highly valuable, in order to reflect the economics, a high value option asset and a high value equity instrument are recognised. The high value of the equity instrument represents the fair value of the shares that would be issued if the issuer exercises the equity conversion option[7]. Separating embedded derivatives from the equity host instrument might capture the effect of any variable that is independent of the entity's available economic resources, however the degree of the gross-up might not always best depict the entity's financial position, especially if the equity settlement option is deep out of the money. Enhancing the indirect

[6] Embedded derivatives would be classified as derivative assets/liabilities when their amount is affected by a variable that is independent of the entity's available economic resources.

[7] The recognition of shares at fair value are consistent with how written put options on own shares are accounted for. On issuance of such written puts, the Gamma Approach requires decognition of equity shares at fair value.

obligation requirements may potentially address this gross up issue. (See related discussion in paragraph 49).

40. As mentioned earlier, these issues do not only apply to the Gamma Approach; they also exist applying IAS 32. We are not aware of the extent of the significance and prevalence of challenges associated with these issues. Requiring separation of embedded derivative from an equity host instrument, albeit for a limited set of instruments, may result in a change in practice.

41. In view of limited information we have at this stage about the significance and prevalence of these types of instruments and associated challenges, and the complexity of the potential solutions, the staff think that the Board should raise this issue in the Discussion Paper to seek feedback from the respondents before discussing further and proposing any particular accounting requirements.

Indirect obligations

42. In some extreme cases, the feature that limits the amount of the non-derivative to the available economic resources of the entity may be deeply out of the money. If such a feature lacks an economic effect, then it could be argued that the feature should be ignored for the purposes of determining classification.

43. For example, if an issuer-held conversion option in a reverse convertible bond is deep out of the money at issuance and is expected to remain as such until the option expiry date, the issuer is unlikely to exercise the conversion option. Does this mean that there is an indirect obligation on the issuer to choose the liability settlement outcome (eg cash payment)?

44. In October 2016, the Board discussed how the economic compulsion and indirect obligation affect the classification applying the Gamma Approach (Agenda Paper 5B). In the Board's preliminary view, economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a claim as either a liability or equity. The reasons included that considering economic compulsion in classifying financial instrument is not consistent with existing accounting requirements for financial instruments (such as IFRS 9) that are based on the rights and obligation in the contract, not the likelihood that economic resources would be transferred by the entity.

45. In forming the preliminary view above, the Board observed that sometimes the entity's stated right to choose an equity outcome may be 'structurally' out of the money (ie designed to be always out of the money, or always unfavourable). The Board tentatively decided that the requirements in IAS 32 for indirect obligations should be retained applying the Gamma Approach. This means that such contractual right may not be considered substantive and be excluded in determining the classification.

46. In our example of a reverse convertible bond and other instruments that grant the entity rights to alternative settlement outcome, the equity conversion option could be so far out of the money–and be expected to remain as such–that it may have little economic effect. The questions are:

    (a) whether some contractual terms should be excluded when determining the classification of a financial instrument even when the contractual terms are *not* 'structurally' out of the money[8]; and

    (b) if so, what factors or guidance should be applied when determining whether to exclude such features.

47. The IFRS Interpretations Committee has considered some aspects of these questions in applying IAS 32, including:

    (a) instruments that can be converted to a fixed number of ordinary shares at the issuer's option (a type of this instrument was considered by the Interpretations Committee in 2013).

    (b) instruments that are mandatorily convertible into a variable number of shares, subject to a cap and floor, and which the entity has a right to settle at any time by transferring the maximum number of shares (a type of this instrument was considered by the Interpretations Committee in 2014).

48. When the Interpretations Committee discussed the issues in paragraph 47(b), it noted that the definitions of financial asset, financial liability and equity instrument in IAS 32 are based on the financial instrument's contractual rights and

[8] Contractual terms are ignored if they are structurally out of the money, which is when they are out of the money under all possible scenarios.

contractual obligations. However, paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the Interpretations Committee noted that if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument. When discussing this issue, the Interpretations Committee noted that:

(a) the issuer cannot assume that a financial instrument (or its components) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of its own equity instruments (the early settlement option);

(b) judgement will be required to determine whether the issuer's early settlement option is substantive and thus should be considered in determining how to classify the instrument. If the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument;

(c) the guidance in paragraph 20(b) of IAS 32 is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment. Specifically, the example in that paragraph describes an instrument that the issuer will settle by delivering either cash or its own shares and states that one of the settlement alternatives should be excluded from the classification assessment in some circumstances; and

(d) to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. In making that assessment, the issuer could consider, along with other factors, whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms. The Interpretations Committee also noted that factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share

price could be relevant to the assessment of whether the issuer's early settlement option is substantive. For example, the early settlement option may be less likely to have substance—especially if the instrument is short-lived—if the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor (ie the minimum). That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity.

49. As discussed in paragraph 39, separating embedded derivatives from the equity host instrument might capture the effect of any variability introduced by variable that is independent of the entity's available economic resources, however the degree of the gross-up might not always best depict the entity's financial position, if the equity conversion option is deep out of the money. The indirect obligation requirements may be enhanced such that deep out of the money equity settlement option is excluded from determining the classification of the instrument. This means that a reverse convertible bond with a deep out of the money conversion option may be classified as a financial liability in its entirety.

50. The question is whether a contractual term is substantive and thus relevant for the classification assessment when it has little or no economic effect. Possible challenges to making that decision are similar to economic compulsion and may arise unless the contractual term is 'structurally' out of the money. They could include:

    (a) The liability or equity settlement option may range from marginally unfavourable to deeply out of the money. How significantly out-of-the money does a settlement option need to be for a contractual term to be considered no longer substantive?

    (b) Market changes will result in the value of the settlement option changing from period to period. Therefore, should the entity assess whether a contractual term is substantive only when classifying the claim at initial recognition, or would the assessment need to be performed continuously to take into consideration changing facts and circumstances?

(c) Effects on the entity's other economic resources (eg from change of control provisions), or claims (eg additional interest on other debt or covenant breaches), or other business factors may influence an entity's decision to exercise a liability or an equity settlement option. Should an entity consider economic consequences beyond the alternatives in the contract in determining whether a contractual term is substantive or not.

(d) Options that are subject to risk are typically always *potentially* favourable[9]. Therefore, should the assessment be limited to the current economic consequences at the assessment date (ie an 'intrinsic value' assessment)? Alternatively, should the possible future economic consequences from a possible future settlement be considered in the assessment as well (for example, volatility)?

(e) Furthermore, if some contractual terms are considered as non-substantive for reverse convertible bonds, should the same apply from the perspective of the holder for the classification of typical convertible bonds?

51. Further, enhancing the indirect obligation requirements may have wider consequences beyond the particular set of non-derivative instruments that are in scope of this paper. To achieve consistent accounting, it may require a significant change in practice for many financial instruments, including those that would have otherwise been classified as financial liabilities as well as the 'equity-host' instruments. Compared with the embedded derivative solution, the staff think that the scoping may be more challenging if the issue is addressed through enhancing indirect obligation requirements. Given the challenges identified, the staff think that enhancing embedded derivative requirements is a preferable potential solution.

Providing useful information if equity classified

52. During its deliberation, the Board has decided on presentation and disclosure requirements that would help communicate differences between claims with the

[9] Apart from those that are always structurally in or out of the money.

amount that depends on the available economic resources of the entity and the claims with the 'independent' amount. This includes requirements to attribute amounts within equity to classes of equity other than ordinary shares. If alternative settlement features are not depicted through classification (eg separation of embedded derivative), the staff think it should be captured through presentation or disclosure.

53. Applying the Gamma Approach, the Board's current view is that entities should continue to apply the requirements in IAS 33 *Earnings per Share* to non-derivative instruments while enhancing information provided for equity-classified derivatives through attribution requirements. If embedded derivatives arising from alternative settlement outcomes are not separated, and the entire non-derivative instrument may be classified as an equity instrument. The staff considered whether the existing requirements in IAS 33 in combination with the proposals under the Gamma Approach would result in provision of useful information about such types of instruments.

54. Disclosure of potential dilution to ordinary shares proposed by the Gamma Approach may provide some information about these types of instruments as they are/may be settled in own shares. It would not however provide further information about distribution of returns that are possible to arise from the alternative settlement outcome.

55. The information provided by IAS 33 about various equity claims against the entity is limited because entities are not required to disclose the effect of options or warrants that are antidilutive. Some written options that are out of the money, and all purchased options, are antidilutive. The objective of the attribution requirements set out in this Discussion Paper is to help provide information about the distribution of total comprehensive income amongst all equity claims. The Board's view is that it would be useful to provide information about the distribution of returns amongst all equity instruments, regardless of whether those instruments are currently dilutive or antidilutive. To achieve this objective, there may be a merit in extending attribution to some particular types of non-derivative equity instruments with alternative settlement features.

56. The Discussion Paper will discuss more than one method of attributing total comprehensive income within equity, eg full fair value and modified fair value. One of the options discussed is not to require any attribution beyond the existing requirements in IAS 33. The Board has not formed a preliminary view as to whether to require any attribution and if so, which method to use. The Board's decision on attribution subsequent to receiving feedback on the discussion paper would affect how much information is provided about equity instruments through presentation. If those information is not provided through presentation, it will raise a question whether those information should be provided through classification or disclosure. It will therefore influence the relevance of the application of 'indirect obligation' and 'embedded derivatives' requirements to the specific non-derivative financial instruments discussed in this paper.

57. As set out in paragraph 52, the question of how to use attribution and that of whether to account for the embedded derivative separately are related. Consequently, the staff think that the Board should raise this issue in the Discussion Paper to seek feedback before discussing further and proposing any particular accounting requirements.

Summary and questions for the Board

58. The questions raised in this paper may be addressed through enhancing embedded derivative requirements, enhancing the indirect obligation requirements, or through the attribution requirements if the instrument is equity classified in its entirety.

59. In the staff's view, clarifying the embedded derivative requirements would come with the following benefits and challenges:

    (a) more information would be provided through classification–recognition and measurement of the embedded derivative. Doing so lessens the pressure on providing the same information through the presentation and disclosure requirements. It would also enhance consistency of classification between different arrangements with similar economic outcomes;

(b) on the other hand, as described in paragraphs 37–39, challenges with the separating embedded derivatives from equity instruments include identifying and defining the host instrument, and specifying the order of separation. There are many possible ways of performing the separation, and clarifying these aspects would be required to ensure that similar economic outcomes are classified consistently (similar to compound instruments and redemption obligation). We also note that separating embedded derivatives will lead to a gross up of assets and equity in the statements of financial position and that effect will be more significant for deep out of the money options. In addition, enhancing the requirement may result in a change in practice.

60. Enhancing the indirect obligation requirements would have the following benefits and challenges:

(a) it might help the classification to better represent the economic substance of the instrument. Further guidance might help identify when a feature is sufficiently lacking in economic effect to be ignored for the purpose of classifying the instrument as a liability or an equity instrument.

(b) on the other hand, as described in paragraphs 50–51, enhancing the indirect obligation requirement is likely to give rise to challenges similar to economic compulsion. It may require a change in practice and there may be consequences on a wider set of financial instruments. Compared with the embedded derivative solution, defining the scope may be more challenging.

61. Presentation, attribution of income and expense, in particular, may be another way to address the issue. As discussed in paragraph 52, how much information is provided through attribution will influence how much needs to be provided through other means, ie classification or disclosure. Depending on the Board's decision on the attribution approach after considering the feedback on the Discussion Paper, the application of embedded derivative requirements and indirect obligation may become more or less relevant to addressing the issue discussed in this paper.

62. On balance, the staff think that clarifying the embedded derivative requirements would be a preferable potential solution as it will help depict the variability in the amount of claims through the recognition and measurement of derivatives. At the same time, we are aware of potential challenges that come with it, including the gross-up as discussed in paragraph 39. Consequently, given limited information that we have about the extent of the significance and prevalence of challenges associated with these issues, the staff think that it is worth raising these issues in the Discussion Paper and seeking feedback. Subsequent to receiving feedback on the Discussion Paper, the staff could bring further analysis for the Board to assess the significance and prevalence of the issues and decide whether to address these issues and if so, how.

Question

1. Does the Board agree with the staff recommendation to:

(a) discuss the issue and raise a question in the Discussion Paper regarding separation of the embedded derivative as described in paragraphs 32–39 to seek feedback from the respondents before discussing further and proposing any particular accounting requirements; and

(b) raise a question in the Discussion Paper about whether and how the attribution requirements may help provide information about the alternative settlement features as described in paragraphs 52–56?