

## STAFF PAPER

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<b>Project</b>	<b>Financial Instruments with Characteristics of Equity</b>		
<b>Paper topic</b>	<b>Derivatives on ‘own equity’</b>		
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## Introduction

1. The objective of this paper is to:
  - (a) provide summary of the characteristics of derivatives on ‘own equity’;
  - (b) provide a summary of the Gamma approach to classification and presentation that is relevant to derivatives on ‘own equity’; and
  - (c) discuss the challenges of applying the Gamma approach to derivatives on ‘own equity’ with a particular focus on the unit of account.
2. This paper is structured as follows:
  - (a) What are derivatives on ‘own equity’? (paragraphs 3–6);
  - (b) What are the different types of derivatives on ‘own equity’? (paragraphs 7–12);
  - (c) The Gamma approach (paragraphs 13–17);
  - (d) Applying the Gamma approach to derivatives on ‘own equity’ (paragraphs 18–41)
  - (e) Summary and questions for the Board (paragraphs 42–46)
  - (f) Appendix A—Types of derivatives

## What are derivatives on ‘own equity’?

3. Derivative financial instruments contain contractual rights and obligations to exchange underlying financial assets or liabilities with another party.<sup>1</sup> Consequently, such contracts can also be considered as exchange contracts with two ‘legs’ with each leg representing one side of the exchange. For example, a typical warrant contains an obligation of the issuer to deliver ordinary shares in exchange for the receipt of cash.
4. If both of the legs meet the definition of either an asset or liability and the exchange contract meets the definition of a derivative<sup>2</sup>, then an entity is required to account for it as a derivative asset or derivative liability under IFRS 9 *Financial Instruments*.
5. The characteristic of derivatives on ‘own equity’ that distinguishes them from other derivatives is that, by definition, one of the underlying financial instruments of the exchange meets the definition of equity (the equity ‘leg’). The other underlying financial instrument of the exchange could be either a financial asset (the asset ‘leg’) or a financial liability (the liability ‘leg’). As a result, the financial reporting consequences of the equity ‘leg’ are different to those of the asset or liability ‘leg’. For example, changes in the non-equity ‘leg’ meet the definition of income and expense, while changes in the equity ‘leg’ do not. However, IFRS Standards typically do not account for the legs of the underlying exchange separately.
6. Therefore, regardless of what drives the distinction between liabilities and equity, challenges arise simply because derivatives on ‘own equity’ combine ‘a leg’ that would, in isolation, meet the definition of equity with one that does not.

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<sup>1</sup> Paragraphs AG15–AG19 of the Application Guidance of IAS 32 *Financial Instruments: Presentation*.

<sup>2</sup> Appendix A of IFRS 9 defines a derivative as ‘a financial instrument or other contract ... with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate... or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date.

## What are the different types of derivatives on 'own equity'?

7. There are two basic types of exchanges:
  - (a) receive a financial asset in exchange for delivering 'own equity' (an 'asset/equity exchange'); and
  - (b) extinguish a financial liability (or equity) in exchange for delivering 'own equity' (or liability) (a 'liability/equity exchange').
8. Whilst the above two exchanges may look similar there is an important difference:
  - (a) For asset/equity exchanges, both of the underlying financial asset to be received, and the underlying equity to be delivered, are not existing financial assets or equity of the entity. Thus, when the contract is settled it results in an increase in the assets of the entity and an increase in the equity of the entity. These derivatives are discussed further in **Agenda Paper 5C – Applying Gamma to asset/equity exchange derivatives**.
  - (b) For liability/equity exchanges, the financial liability or equity that is to be extinguished when the contract is settled must be, by definition, an existing financial liability or equity of the entity. Because of this relationship, derivatives that are liability/equity exchanges need to be considered together with the underlying claim that will be, or might be, extinguished. These derivatives are discussed further in **Agenda Paper 5D – Applying Gamma to liability/equity exchange derivatives**.
9. Under IAS 32, the differences between the two types of exchanges mean that different requirements apply to them.
10. In addition to the two basic types of exchanges of underlying financial instruments, a derivative on own equity might also be conditional on future events.
11. For the purposes of this meeting, we limit our discussion to unconditional contracts (ie forward contracts) and contracts that are conditional on events within the control of the counterparty (ie written options).

12. We intend to discuss contracts that are conditional on events within the control of the issuer, and contingent events, at a future Board meeting. This is because the issue of economic compulsion is also relevant for these contracts.

### The Gamma approach

13. Whether a claim meets the definition of a financial liability or of equity will depend on whether it has the relevant features.
14. Approach Gamma focuses the distinction between liabilities and equity on both
- (a) the **timing** of required settlement. Information about this feature is relevant for assessing the extent to which the entity is expected to have the economic resources to meet its obligations as and when they fall due; and
  - (b) the **amount** of the obligation. Information about this feature is relevant for assessing:
    - (i) the extent to which the entity has sufficient economic resources to satisfy the total claims against it if they were all to be settled at a point in time; and
    - (ii) the extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it.
15. Consequently, under approach Gamma, a liability includes an obligation:
- (a) to transfer economic resources at particular points in time other than at liquidation; or
  - (b) for a specified amount independent of the economic resources of the entity.

All other claims will be classified as equity.

16. Furthermore, we have already discussed presentation requirements that will provide additional information about the relevant features. These include separate presentation requirements for:

- (a) liabilities, including standalone and embedded derivatives, that depend on the residual amount (ie that are not independent of the entity's economic resources); and
  - (b) classes of equity, including derivatives classified as equity, other than ordinary shares.
17. For more details, refer **Agenda Paper 5B – Summary of discussions to date**.

### **Applying the Gamma approach to derivatives on own equity**

18. When the IASB last discussed derivatives on own equity in October 2015, the Board acknowledged that any approach to classifying derivatives on own equity will require a compromise between faithfully reflecting the underlying exchange of equity and non-equity instruments and the complexity of doing so.
19. In developing the approaches to the distinction between liabilities and equity, the IASB directed the staff to:
- (a) consider how the existing requirements for classifying the derivatives on 'own equity' in IAS 32 would fit with the underlying rationale of Gamma; and
  - (b) identify potential areas in which the existing requirements might be improved.
20. The Gamma approach will, as developed to date, will determine if one of the underlying 'legs' of the exchange meets the definition of equity. This would be the case if the delivery leg of the contract includes an obligation that both:
- (a) **does not** require the entity to transfer economic resources at a date other than liquidation; and
  - (b) **does not** promise a return that is independent of the economic resources of the entity.
21. So, for example, we have already established under the Gamma approach that:
- (a) an obligation to deliver cash (regardless of the amount) would be a liability (see Appendix B of Agenda Paper 5A);

- (b) an obligation to deliver a variable number of ordinary shares equal to an amount independent of the entity would be a liability (see Appendix B of Agenda Paper 5A); and
  - (c) an obligation to deliver a fixed number of ordinary shares would be equity (see Appendix B of Agenda Paper 5A).<sup>3</sup>
22. If the obligations in 21(a) and (b) are combined in a contract with a right to receive cash, it would be like any other derivative asset or derivative liability under the Gamma approach.
23. However, if the obligation in 21(c) is combined in a contract with a right to receive cash, then it would be a derivative that has an underlying leg that would meet the definition of ‘equity’ and another leg that meets the definition of an asset.
24. So Gamma, as developed to date, tells us whether the underlying legs might be equity or not. However, Gamma does not tell us whether we should be classifying the entire contract, or classifying the underlying ‘legs’ separately. This is a question of the unit of account for classification.
25. If Gamma is applied to both legs of the derivative as one single unit of account, the second challenge is deciding how to classify the combined contract.
26. Classifying a contract that contains a combination of non-equity and equity legs in its entirety will result in inconsistencies between the classification of the underlying legs of the contract and other elements in the financial statements. This is because classifying a contract in its entirety would classify:
- (a) some contracts that contain non-equity legs as equity; and
  - (b) some contracts that contain equity legs as assets or liabilities.
27. Therefore, additional requirements would be needed to address some of these challenges.
28. In the staff’s view, the alternatives to classifying derivatives can be summarised as:

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<sup>3</sup> Assuming the entity has the ability to settle by delivering its own equity instruments.

- (a) Require a detailed componentisation of derivatives. This would result in all equity legs being bifurcated and classified as equity.
  - (b) Require all derivatives to be classified as assets or liabilities. This would result in all derivatives with ‘equity legs’ being classified as assets or liabilities.
  - (c) Classify standalone derivatives in their entirety as either equity or not equity, using classification criteria based on both legs.
29. Under IAS 32 (and for financial instruments in general under IFRS 9), the unit of account is the contract in its entirety. IAS 32 avoids the complications of detailed componentisation by:
- (a) using the fixed-for-fixed condition to classify standalone derivative contracts (eg warrants) in their entirety as either equity or not equity;
  - (b) having additional requirements that identify liability and equity components:
    - (i) for compound instruments (eg convertible bonds); and
    - (ii) for obligations to redeem equity instruments (eg written puts on own equity).
30. Before we explore classifying derivatives using the same unit of account as IAS 32, we first consider whether the objectives of the Gamma approach might be better achieved by:
- (a) requiring a more detailed componentisation (paragraphs 31–36); or
  - (b) requiring all derivatives on own equity to be classified as assets or liabilities (paragraphs 37–41).

### ***A more detailed componentisation approach***

31. Gamma as developed to date could be applied by requiring the detailed componentisation of derivatives down to their constituent equity and non-equity legs.
32. In the predecessor joint project led by the FASB, the FASB and the Board considered an approach to the distinction between liabilities and equity that would

have separated out different components of derivatives. That approach, the Reassessed-Expected-Outcomes approach (REO), required sophisticated option pricing techniques to separate and measure each component.

33. But the REO approach, or any approach that requires detailed componentisation, has many challenges:

- (a) conceptual challenges because of doubts whether the resulting components may meet the definitions of assets, liabilities and equity given the interdependence of the rights and obligations of the contract.<sup>4</sup>
- (b) operational complexity that comes from the requirement to perform a detailed componentisation. In the case of a simple forward contract, detailed componentisation might appear to be straightforward because forwards contain both rights and obligations. However, in case of options and more complex contracts, that approach becomes practically challenging and also raises the question of whether the benefits exceed the costs.

34. To illustrate the above challenges, consider a written warrant to issue a fixed number of own ordinary shares in exchange for receiving a fixed amount of cash. Such a contract imposes an obligation on the entity to perform the exchange at the option of the holder of the warrant. If such an exchange was componentised into the constituent legs of the exchange, it would result in an asset component and an equity component. However:

- (a) there would be doubts whether the asset component would, in fact, meet the definition of an asset, given that it is contingent on the counterparty exercising the contract<sup>5</sup>. In other words, while it is possible to split the value of the warrant in a variety of ways, the critical question is whether the resulting components represent rights and obligations that meets the definition of assets and liabilities.

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<sup>4</sup> As noted in the recent Conceptual Framework Exposure Draft published in 2015, executory contracts give rise to a right and/or obligation *to the exchange*. The rights and/or obligations *to the exchange* meet the definitions of assets or liabilities, not the future rights and obligations that may result from the exchange. Componentising down to the individual legs of the exchange will treat each leg as an independent asset, liability or equity component.

<sup>5</sup> The entity cannot demand the exchange occur and the only recourse to the entity if the exchange does not occur is that its ordinary shares will not be issued.

- (b) it could result in the inflation of the statement of financial position with assets that the entity does not control and equity that is contingent on the counterparty exercising its right to the exchange. This would arguably not be consistent with the underlying rationale of the Gamma approach, which intends to depict whether the entity has sufficient economic resources to meet the timing and amount of its obligations.
  - (c) it would be difficult to measure the individual legs of the warrant in isolation. This is because the value of the warrant as a whole depends on the interaction of both legs (because of their interdependence). This is also why derivatives assets and liabilities are not further bifurcated in IFRS Standards such as in IFRS 9.<sup>6</sup>
35. There is nothing particular about the Gamma approach that would indicate that a different unit of account should be used compared to that used in IAS 32. In other words, a more detailed componentisation could have been performed on the basis of the existing definitions (excluding the clauses for derivatives) in IAS 32. But IAS 32 does not require such a componentisation.
36. However, the requirements of IAS 32 introduce other challenges. For example, classifying the instrument in its entirety results in either:
- (a) some contracts with underlying equity 'legs' accounted for as financial assets or financial liabilities (because they do not meet the fixed-for-fixed condition); or
  - (b) some contracts with underlying asset 'legs' accounted for as equity instruments (eg if they meet the foreign currency rights issue exception to the fixed-for-fixed condition).

### ***Classify all derivatives as assets or liabilities***

37. Because there appears to be no approach to the unit of account that does not resolve all these challenges completely, many have in the past advocated simply classifying all derivatives on 'own equity' as assets or liabilities. While such an

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<sup>6</sup> Componentisation, if performed for derivatives on own equity, would have to be performed for all derivatives, otherwise there would be a loss of comparability.

approach might appear to be more practical than classifying some derivatives as equity, this too raises challenges:

- (a) it will amplify the issue of recognising changes relating to the underlying equity 'leg' as income or expense.
- (b) it would be inconsistent with the classification of standalone obligations to issue a fixed number of ordinary shares as equity, including conversion options that typically exist in non-cumulative preference shares and other multiple share class structures.

38. In the predecessor project, all of these challenges led both the FASB and the Board to prefer a narrow equity approach.<sup>7</sup>
39. However, classifying all derivatives on own equity as assets or liabilities would not meet the objectives of the Gamma approach. This is because doing so would not differentiate between claims with the relevant features for users to make various assessments of financial position and financial performance. Of course, one way to mitigate that problem is to require additional separate presentation requirements to capture claims that have the relevant features of the Gamma approach.
40. Therefore, the challenges are not eliminated by classifying all derivatives as liabilities and assets. They are simply transferred from the context of classification, to the context of presentation within liabilities and the income statement. Classifying all derivatives on own equity as assets or liabilities would simply require additional classes for separate presentation.
41. Based on the above, in the staff's view, classifying all derivatives on own equity as assets or liabilities does not have any advantages compared to the existing IAS 32 approach of classifying some contracts in their entirety as equity .

## **Summary and questions for the Board**

42. In the staff's view:

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<sup>7</sup> The basic ownership approach was proposed in the predecessor project.

- (a) the Board should not explore a detailed componentisation approach.

This is because of:

- (i) the conceptual issues regarding whether the components would meet the definitions of the elements given their interdependence.
- (ii) the operational complexity imposed by such an approach.

- (b) the Board should not classify all derivatives on own equity as liabilities or assets because doing so will not provide the most relevant information to assess the entity's financial position and financial performance.

43. Instead, the Gamma approach should continue to classify derivatives in their entirety as either equity, or as assets or liabilities. This would be consistent with the existing approach in IAS 32, hence consistent with the objective of not starting with a blank sheet of paper.

44. As noted in paragraph 26, doing so will inevitably result in some additional challenges that will need to be addressed, including:

- (a) the classification of some contracts with equity legs as assets or liabilities, or some contracts with asset legs being classified as equity.
- (b) requirements for liability/equity exchanges (including convertible bonds and written puts).

45. We have also established, under the Gamma approach separate presentation requirements for particular types of obligations classified as liabilities, including those that depend on the residual amount. For example, income and expense arising from an obligation to transfer an amount of cash equal to the fair value of an entity's ordinary shares (for example, shares redeemable at fair value), would be presented separately. These separate presentation requirements may help address some of the challenges that we identify.

46. We consider how the Gamma approach could be applied to derivatives on own equity, and ways of reducing or mitigating the some of the challenges that arise, in:

- (a) Agenda Paper 5C – Applying Gamma to asset/equity exchange derivatives; and
- (b) Agenda Paper 5D – Applying Gamma to liability/equity exchange derivatives.

**Questions for the Board**

Do you agree with the staff that full componentisation of derivatives should not be explored further, and that derivatives should be classified in their entirety?

Do you agree with the staff to not require all derivatives on own equity to be classified as assets or liabilities?

## Appendix A—Types of derivatives

	<b>Unconditional</b>	<b>Counterparty option</b>	<b>Entity option</b>	<b>Contingent</b>
<b>asset/equity exchanges</b>	Forward contract to deliver equity	Written option to sell equity  (eg warrant, typical stock option)	Purchased option to sell equity	Contingent sale of equity
<b>equity/liability exchanges</b>	Forward contract to repurchase own shares  (mandatory redeemable shares)	Written option to repurchase own shares  (eg NCI puts)	Purchased option to repurchase own shares	Repurchase of own shares contingent on some event
<b>liability/equity exchanges</b>	Forward contract to convert financial liability to equity	Written option to convert financial liability to equity  (eg option in a convertible bond)	Purchased option to convert financial liability to equity	Contingent conversion of financial liability to equity

A1. All of the exchange contracts above can be either:

- (c) for a fixed amount of one for a fixed amount of the other;
- (d) for a variable amount of one for a fixed amount of the other; or
- (e) for a variable amount of one for a variable amount of the other

A2. All of the exchange contracts can also be either:

- (a) settled with a physical exchange (gross-settled);
- (b) net-settled in equity instruments; or
- (c) net-settled in cash.