

## STAFF PAPER

February 2017

## IASB Meeting

Project	Financial Instruments with Characteristics of Equity research project		
Paper topic	Contractual terms		
CONTACT(S)	Manuel Kapsis	<a href="mailto:mkapsis@ifrs.org">mkapsis@ifrs.org</a>	+44(0) 20 72466459

*This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® Update.*

**Introduction**

1. This paper discusses the scope of contractual rights and obligations that an entity should consider when applying the Gamma Approach to a financial instrument. The objective of this paper is to set out a discussion to be included in the forthcoming Discussion Paper.
2. This paper includes:
  - (a) Background (paragraphs 3–9)
  - (b) What is the current scope of IAS 32? (paragraphs 10–14)
  - (c) What are the challenges? (paragraphs 15–19)
  - (d) Staff analysis (paragraphs 20–47)
  - (e) Summary and conclusion (paragraphs 48–49)

**Background**

3. In October 2014 the IASB decided that the Financial Instruments with Characteristics of Equity project should investigate potential improvements to the classification of liabilities and equity in IAS 32 *Financial Instruments: Presentation*. The Board decided that the starting point should be the requirements of IAS 32, the objective was not to undertake a fundamental review.

4. Over the past year, the Board has developed the Gamma approach to address the challenges identified with the classification of financial liabilities and equity. Once an entity has identified the rights and obligations of a financial instrument, then it would apply the Gamma approach to classify that claim based on the features of those rights and obligations.
5. To date, the Board has considered how the Gamma approach would address a number of challenges identified<sup>1</sup>, including the classification and presentation of:
  - (a) obligations to deliver a variable number of shares equal to an amount independent of the entity's economic resources.
  - (b) derivatives that are settled in or are indexed to the entity's equity instruments (eg written options and contingent contracts).
  - (c) contracts which grant the issuer the right to choose between a liability and equity settlement outcome (eg purchased options).
  - (d) contracts that oblige the entity to redeem its own equity instruments (eg written put options)
6. The scope of IAS 32 is limited to financial instruments. Furthermore, the definitions that set the scope of IAS 32 are also applied to set the scope of the financial instruments literature in IFRS Standards in general. This includes the recently issued IFRS 9 *Financial Instruments*.
7. One of the defining aspects of all financial instruments is that the rights and obligations need to be *contractual*. However, there are some particular transactions for which the rights and obligations in a contract are affected by the law (including statutes, legislation, regulation or any other legal instrument issued by an authority in a particular jurisdiction).
8. Such transactions include (explained in further detail in paragraphs 23–30):
  - (a) Mandatory tender offers
  - (b) Some varieties of contingent convertible bonds
9. An entity applies the Gamma approach to a contract for the purposes of classifying a financial instrument as a financial liability or equity. The question is

---

<sup>1</sup> For further details, see Agenda Paper 5A *Summary of discussions to date*

whether, for such transactions, the contract is limited to the contractual terms, or includes other rights and obligations arising from the effect of law.

### What is the current scope of IAS 32?

10. The main principle is that IAS 32 applies to all financial instruments. If a right or obligation is not a financial instrument, then another IFRS Standard applies. For liabilities, the most relevant of these would be IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
11. A financial instrument is defined as “any contract that gives rise to a financial asset of one entity and a financial liability or equity instruments of another entity”<sup>2</sup>.
12. One of the defining aspects of all financial instruments is that the rights and obligations need to be *contractual*. All of the definitions of financial instruments, including financial assets, financial liabilities and equity instruments refer to rights or obligations arising from contracts.
13. IAS 32 paragraph 13 states that:

In this Standard, ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.
14. Hence, assets and liabilities that are not contractual, for example those rights and obligations that arise from statutory requirements imposed by government are not financial liabilities or financial assets (for example, income taxes). Paragraph AG 12 of IAS 32:

Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial

---

<sup>2</sup> Paragraph 11 of IAS 32

liabilities or financial assets. Accounting for income taxes is dealt with in IAS 21 *Income Taxes*. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

### ***The Board's recent conclusions***

15. In IFRS 9, the Board acknowledged that, as the result of legislation, some governments or other authorities have the power in particular circumstances to impose losses on the holders of some financial instruments.
16. The Board noted that IFRS 9 requires the holder to analyse the *contractual terms* of a financial asset to determine whether the asset gives rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. In other words, the holder would not consider the payments that arise only as a result of the government's or other authority's legislative power as cash flows in its analysis. That is because that power and the related payments are not contractual terms of the financial instrument.<sup>3</sup>

### ***Members shares in co-operatives***

17. IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* is an interpretation of IAS 32 that applies to equity instruments that grant the holder a right to *request* redemption, but include or are subject to limits on whether the entity is required to redeem such instruments.
18. Paragraph 5 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* states that:

The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as

---

<sup>3</sup> Paragraph BC4.191 of IFRS 9

a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

19. IFRIC 2 addresses issues that arise in a very narrow fact pattern. We are not aware of any challenges with the application of IFRIC 2. Therefore, we do not think a review of IFRIC 2 is necessary beyond any consequential amendments.

### **What are the challenges?**

20. It is reasonably clear that entities should *not* apply IAS 32 to rights and obligations that arise independently from contracts, such as from law (including statutes, legislation, regulation or any other legal instrument issued by an authority in a particular jurisdiction).
21. However, if the law affects the rights and obligations of an existing contract (other than just their enforceability), then the question is whether the contract is limited to the contractual terms, or includes the effect of law, for the purposes of classifying financial instruments under the Gamma approach.
22. Two transactions that we are aware of that demonstrate the challenges include:
  - (a) bonds that are contingently convertible to ordinary shares as a result of regulatory requirements (paragraphs 23–25); and
  - (b) mandatory tender offers (paragraphs 26–30).

### ***Contingently convertible bonds***

23. Questions have been raised about whether laws that impose contingent conversion features on particular types of claims issued by an entity should be considered as part of the classification of such instruments as liabilities or equity.
24. Some of these questions have arisen because paragraph B4.1.13 of IFRS 9 *Financial Instruments* Appendix B includes an example illustrating contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. In that example, the effect of the regulations is not

considered when assessing whether the contractual cash-flows are solely payments of principal and interest on the principal amount outstanding.

25. If the law has no effect on a contingent convertible (ie it is contractually contingent convertible), then applying the Gamma approach would result in it being classified as a financial liability. As discussed in December 2016, an equity component would only be recognised if the contingent conversion option is solely dependent on the residual amount.

### ***Mandatory tender offers***

26. The Interpretations Committee received a request to address the accounting for mandatory purchases of non-controlling interests that arise as a result of business combinations. One of the questions asked in the submission was whether mandatory tender offers (MTOs) required by law should be recognised as a liability.
27. The Interpretations Committee discussed whether a liability should be recognised for the MTO at the date the acquirer obtains control of the acquiree. The Interpretations Committee noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts that are executory in nature and concluded that no liability needed to be recognised for the MTO. The Interpretations Committee tentatively decided to recommend to the IASB that it should not amend IFRS 3.
28. At a later meeting, the Interpretations Committee continued to discuss whether a liability should be recognised for the MTO. A small majority of Interpretations Committee members expressed the view that a liability should be recognised for the MTO in a manner that is consistent with IAS 32 *Financial Instruments: Presentation* at the date that the acquirer obtains control of the acquiree. Other Interpretations Committee members expressed the view that an MTO is not within the scope of IAS 32 or IAS 37 and that a liability should therefore not be recognised.
29. The Interpretations Committee directed the staff to report its views to the IASB and noted that the IASB could address this issue as part of its Post-Implementation Review of IFRS 3.

30. The IASB noted that at its March 2013 meeting it tentatively decided to re-consider the measurement requirements in paragraph 23 of IAS 32<sup>4</sup>, including whether all or particular put options and forward contracts written on an entity's own equity should be measured on a net basis at fair value. Because an MTO is economically similar to a put option written on a non-controlling interest, IASB members expressed the view that the accounting for those items should be considered at the same time. Hence this issue is now being considered as part of the FICE project.

### Staff analysis

31. Once the rights and obligations of a financial instrument are identified, then the Gamma approach would classify that claim based on the features of those rights and obligations.
32. If laws affect the rights and obligations in a contract, then there are clearly economic consequences for the entity. If those economic consequences are similar to those that would arise if the rights and obligations were contractually agreed, then ideally they would be accounted for similarly. Hence, for example, it might be desirable for MTOs to be accounted for similarly to written put options, given their similar economic consequences.
33. There are many assets and liabilities that share similar characteristics. However, different IFRS Standards apply different accounting requirements to different populations of assets and liabilities. Various transactions might have similarities, however, they would be accounted for differently applying different IFRS Standards.
34. The financial instrument literature has been developed to account for rights and obligations that arise from contract. For example, applying IFRS 9, an entity recognises a financial asset or financial liability when it becomes a party to the contractual provisions of the instrument. Likewise, when assessing whether a financial asset gives rise to cash flows that are solely payments of principal and

---

<sup>4</sup> Paragraph 23 of IAS 32 sets out the requirements when an entity has an obligation to redeem its own equity instruments, including requiring the entity to recognise the present value of the redemption amount.

interest on the principal amount outstanding, IFRS 9 requires the entity to analyse the contractual terms.

35. The financial instrument literature was not developed to account for rights and obligations that arise from law. Both IAS 32 and IFRS 9 do not contain requirements that would address matters that could arise as a result of considering the effect of law. These matters could include additional recognition, derecognition and reclassification requirements to address the possibility of legislation being introduced, repealed, or amended or becoming applicable based on some event or activity of the entity. IFRS 9 has a mixed measurement model for financial assets, requiring either amortised cost or fair value measurement. Under IFRS 9 the contractual terms of an instrument are assessed at initial recognition when the entity enters into a contract and are not subsequently reassessed unless and until a modification of the terms leads to derecognition. In order to ensure such a model provides useful information, IFRS 9 prohibits reclassifications from one category to the other except for changes in the business model which are expected to be infrequent.
36. If the effect of law is taken in to account then additional requirements will need to be developed under the Gamma approach, and potentially IFRS 9, for the classification, reclassification, recognition and derecognition of financial instruments. Simply limiting the consideration of the effects of the law to only the initial classification decision may not provide useful information under all circumstances.
37. Law making authorities always have the power to take unilateral action that changes the rights and obligations of an entity or a contractual arrangement. However, for a typical contract between parties, to change the rights and obligations in the contract they would need to undertake a transaction or mutually agree to the same. IAS 32 and IFRS 9 include requirements that address the latter, but not the former.

#### *Limiting the assessment to contractual terms*

38. If the Board applies the Gamma approach consistently with IAS 32 (and IFRS 9), then an entity would classify financial liabilities and equity instruments based on the *contractual terms*.



39. For the particular contingent convertible bonds that might be affected by the law, the contractual terms considered would be consistent with the treatment for the equivalent financial asset. That is, any contingent equity conversion feature that is only a result of the national resolving authority's power derived from legislation would not be considered for the purposes of classifying the instrument. This would result in the instrument being classified as a liability in its entirety.
40. However, for the MTO, the entity's obligation under the law to offer to repurchase the non-controlling interests would not be considered in classifying the claim. This would be the case even though the economic consequences of the obligation are similar to a written put option and would apply until the entity entered into a contract that established its obligation<sup>5</sup>.
41. If the effect of the law creates an obligation that meets the definition of a liability, and it is beyond the scope of IAS 32, then it might fall within the scope of another IFRS Standard, such as IAS 37. However, other IFRS Standards are not designed to address matters related to the classification of liabilities and equity. For example, IAS 37 does not currently address the accounting for non-financial liabilities to redeem equity instruments.
42. Issues regarding accounting for MTOs are typically transitory, since the obligation expires after a limited period of time. However, the amount of the obligation could be significant and will be relevant if the transaction straddles the end of a reporting period. If the Board decides to limit the assessment of classification to the contractual terms, consistently with IAS 32 and IFRS 9 today, then it could consider the best way to address the diversity in practice following responses to the Discussion Paper.
43. In any event, the Board could consider, and as part of this project, disclosure requirements to address the circumstances around MTOs.

*Considering the effect of law on existing contracts*

44. If the effect of law is considered in the classification of all financial instruments as liabilities or equity, then requirements will need to be developed to address

---

<sup>5</sup> A unilateral offer would not be enough because it could be withdrawn. There would need to be an offer and an acceptance of the obligation establishing the contract. One such example would be a written put.

particular aspects that we have identified in paragraphs 35–35. Such an approach has been applied in IFRIC 2, however that Interpretation has been restricted to a narrow fact pattern.

45. If the effect of law on contracts is considered, then a follow-up question is *when* they should be considered. In some cases, this would be straightforward, because the effect of the law would apply from inception of a particular contract. In other cases, the effect might only apply under particular circumstances.
46. However, such a distinction may not always be clear. For example, Mandatory Tender Offer requirements apply to all particular types of qualifying instruments, however, the effect of the law on the acquirer is triggered by a particular transaction, the acquisition of the majority of the shares.
47. In addition, because the definitions of financial instruments are used in IFRS 9, then there could be consequences of making such a fundamental change in the scope of the financial instruments literature. In particular an entity would be required to continually monitor changes in law, or the application of law, that might be required to be reflected in the recognition, derecognition and classification of financial instruments.

### **Summary and conclusion**

48. In summary:
  - (a) The Financial Instrument accounting requirement in IFRS Standards have been developed around the concept of a contract. This includes the recognition, classification and measurement, and derecognition requirements. They have not been designed to account for rights and obligations arising from law (except for IFRIC 2).
  - (b) Limiting the assessment of classification to contractual terms consistently with IFRS 9 would ensure consistent consideration of contingent convertible bonds that are affected by law on the asset side and the liability side.

- (c) However, doing so would result in the obligations that arise in MTOs, which have similar consequences to written put options, would not be considered for the purposes of classification.
- (d) Other IFRS Standards might be better designed to account for rights and obligations arising from law (such as IAS 37). However, other IFRS Standards were not designed to address classification of liabilities and equity.
- (e) The alternative of considering rights and obligations that arise from law as equivalent to contractual terms might result in MTOs being accounted for consistently with written put options, however such a fundamental change could have unintended consequences beyond addressing the distinction between liabilities and equity in IAS 32.

49. Based on the above, the staff propose that:

- (a) The Gamma approach should apply to the contractual terms of a financial instrument consistently with IAS 32 and IFRS 9 today.
- (b) The Board does not reconsider IFRIC 2 given that we are not aware of any challenges with its application.
- (c) The Board considers the best course of action with respect to addressing diversity in practice in accounting for MTOs following input received on the Discussion Paper, including potential disclosure requirements as part of this project.

<b>Question</b>
Does the Board agree with the staff proposals in paragraph 49?