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Introduction

1. One of the objectives of the Financial Instruments with Characteristics of Equity project is to improve the consistency, completeness and clarity of the requirements in IAS 32 in order to address some of the practical challenges, in particular with the accounting within equity related to written puts.
2. This paper proposes application guidance and illustrative examples that will help clarify how the Gamma approach would apply to the accounting within equity.
3. This paper is structured as follows:
 - (a) Background (paragraphs 4–9)
 - (b) Staff analysis (paragraphs 10–14)
 - (c) Example 1—Convertible bond (paragraphs 15–33)
 - (d) Example 2—Written put option (paragraphs 34–55)
 - (e) Summary and conclusion (paragraph 56)

Background

4. The Board has previously decided that an entity should provide more information about subclasses of equity, which will provide users with relevant information about the variety of claims against the entity regardless of their classification.

5. One important aspect of this information that the Board has discussed was through attribution of profit or loss and other comprehensive income to some or all subclasses of equity other than ordinary shares. Further information about the Board's discussion of attribution within equity can be found in Agenda Paper 5A *Summary of discussions to date*.
6. This paper completes the discussion of subclasses of equity by illustrating how *other changes* in the carrying amounts would be accounted for under the Gamma approach to address some of the practical challenges identified, in particular for put options written on own equity.

The practical challenges identified in IAS 32 today

7. Although IAS 32 contains initial recognition requirements for equity instruments, it does not contain much guidance on the subsequent accounting. For example, in dealing with the conversion of a convertible bond at maturity, paragraph AG32 of IAS 32 only suggests that the originally recognized equity component may be transferred from one line item within equity to another. The illustrative examples accompanying IAS 32 also do not provide much guidance regarding the equity accounts since all journal entries that affect equity are posted to a generic 'Equity' account.
8. One transaction which exemplifies the challenges that arise is the written put option on non-controlling interests (NCI puts). In 2013, the Interpretations Committee published a draft interpretation that addressed the recognition of changes in the measurement of the liability.¹ However, respondents to that draft interpretation suggested that the IASB should address the accounting for NCI puts more comprehensively. They pointed out that other aspects of the accounting for NCI puts have resulted in diversity in practice. These aspects included:
 - (a) When applying the redemption obligation requirement and reclassifying the present value of the redemption amount from equity, in what account should the debit be recognised? For puts on non-controlling

¹ The redemption obligation requirements will be carried forward under the Gamma approach. The Gamma approach's separate presentation requirements address the recognition of changes in the measurement of such liabilities

interests in particular, the question is whether the non-controlling interest is derecognised, or a contra-equity account is recognised within the parent equity.

- (b) How to account within equity for the premium received for an NCI put, and the for the expiration or exercise of the NCI put.

9. Answering these questions for the NCI puts will have additional consequences for recognition of related transactions, such as dividends or other distributions, and whether a portion of the subsidiary's profit or loss should continue to be attributed to the NCI as required by paragraph B94 of IFRS 10 *Consolidated Financial Statements* after an NCI put is written. It could also have implications for the calculation of earnings per share.²

Staff analysis

10. The approach we have taken in this paper is to illustrate the application of the Gamma approach, and to provide guidance on the mechanics within equity, using a set of examples. We consider the benefits of the additional information provided through the statement of changes in equity in each example.
11. The examples we have used are a convertible bond, and a written put option on own equity. We have used these examples because they provide the best overview of the complete requirements of the Gamma approach.
12. In addition to the accounting within equity, the examples help illustrate the following other aspects of the Gamma approach³:
- (a) Bifurcation of compound instruments into liability and equity components. The accounting for compound instruments is a consequence of the Board's decisions regarding derivatives that extinguish liabilities in exchange for equity. It is consistent with the existing requirements of IAS 32.

² To the extent that the requirements of IAS 33 refer to the classification requirements of IAS 32

³ Further details about the decisions are in Agenda Paper 5A *Summary of discussions to date*

- (b) The redemption obligation requirements, and the associated accounting within equity that is required in order to achieve consistent accounting for similar liability/equity settlement outcomes. We illustrate this by using similar terms for both the convertible bond and written put.
 - (c) Recognition of changes in the measurement of the liability.
 - (d) Attribution of profit or loss and other comprehensive income to derivative equity instruments. For convenience we illustrate the full fair value approach (ie. Approach B) primarily and footnote the required journal entries if there was no attribution (ie Approach A).
 - (e) Accounting for the settlement outcomes within equity. We illustrate the accounting when the entity settles the instruments:
 - (i) by delivering cash or another financial asset (Scenario 1); or
 - (ii) by delivering equity instruments (Scenario 2);
13. The discussion in this paper is not intended to explain the application of the classification requirements of IAS 32.
14. We have illustrated a simplified statement of changes in equity when we have applied the Gamma approach to the examples, however we have not illustrated other categories of equity that might be relevant for regulatory or other purposes. It is not the intention of this paper, or the Gamma approach, to *prescribe* the detailed presentation requirements for the statement of changes in equity which are in IAS 1 *Presentation of Financial Statements*. The main focus of this paper is clarifying some of the ‘mechanics’ needed to apply the Gamma approach, not the presentation of the statement of changes in equity itself.

Example 1—Convertible bond

Facts

15. The entity issues a bond for CU100 in cash, with two settlement options to be exercised by the holder. Either the entity is required to pay CU110 in cash two years from date of issuance, or the holder has the right to elect to receive 100 ordinary shares of the entity. The holder must choose one or the other option.

16. Assume that the present value of CU110 payable in two years is CU82.
17. In our simple example the claim does not have any interest payments and the claim is not convertible, or redeemable by the counterparty or the entity prior to two years.
18. We consider two scenarios which have the same facts except for the share price at the end of year two:
- (a) Scenario 1—The holder exercises the option to require the entity to pay CU110 in cash at the end of year two. Assume in this scenario, the entity's ordinary share price and fair value of the conversion option are as follows:

Scenario 1	Date of Issuance	End of Year One	End of Year Two
Ordinary share price	CU0.9 per share	CU0.8 per share	CU1.0 per share
Fair value of conversion option	CU18	CU10	0

- (b) Scenario 2—The holder exercises the option to receive 100 ordinary shares of the entity, immediately after the end of year two. Assume in this scenario, the entity's ordinary share price and fair value of the conversion option are as follows:

Scenario 2	Date of Issuance	End of Year One	End of Year Two
Ordinary share price	CU0.9 per share	CU0.8 per share	CU1.25 per share
Fair value of conversion option	CU18	CU10	CU15

Application of the Gamma approach

19. Under the Gamma approach, the entity analyses the convertible bond to determine whether there is a conversion option that solely depends on the residual amount (eg it is for the exchange of an obligation for a fixed amount for the issuance of a fixed number of ordinary shares). If so, then on initial recognition of a compound instrument, an entity recognises separately a liability component, and an equity component for the option to convert it into an equity instrument of the entity.
20. On initial recognition, the carrying amount of the liability component is determined for an equivalent instrument without the equity conversion feature. The difference between that value and the fair value of the convertible bond is assigned to the equity component.⁴ These requirements are similar to paragraphs 28-32 of IAS 32 which contain requirements for the accounting for compound instruments.
21. However, under IAS 32, there are no further requirements for the derecognition or reclassification of the initially recognised equity component, even if the compound instrument is finally settled by transferring cash or other financial resources, extinguishing the obligation for the issuing entity to deliver equity instruments. IAS 32 paragraph AG32 notes that the equity component may be transferred from one line item within equity to another.
22. The Gamma approach would not change the basic requirements of IAS 32 relating to convertible bonds. However, it will potentially require attribution within equity, which will require some additional guidance for other changes to the carrying value, such as when the conversion option expires, or when equity instruments are issued to settle an equity classified derivative.
23. Under Gamma, one approach is to attribute the profit or loss and other comprehensive income to classes of derivative equity claims other than ordinary shares. For purpose of this paper, we only consider the approach of attribution that is done on the basis of changes in fair value of the conversion option (ie. Approach B). As a result, the equity component initially recognised for the

⁴ The fair value of the convertible bond is assumed to be the transaction price.

conversion option will be updated to its fair value at the end of each reporting period.

24. Another approach is not to attribute any profit or loss or other comprehensive income to classes of derivative equity claims. As we illustrate the journal entries below for the attribution approach, the difference arising from not doing any attribution is explained in footnotes.

Journal entries under both scenarios

25. On initial recognition:

Dr: Cash	CU100
Cr: Financial liability	CU82
Cr: Equity – Conversion option	CU18

To recognise the cash received and the liability and equity components

26. In year one:

Dr: Interest Expense	CU13
Cr: Financial liability	CU13

Accrual of interest in year one

Dr: Equity – Conversion option	CU8
Cr: Attribution to conversion option	CU8

Attribution of profit or loss to the conversion option in year one⁵ [CU10 (fair value at end of year one) – CU18 (fair value at start of year one)]

Scenario 1— Journal entries for Liability settlement

27. In year two:

Dr: Interest Expense	CU15
Cr: Financial liability	CU15

Accrual of interest in year two

⁵ If the Board does not proceed with attribution within equity, then there would be no such entry at this point.

Dr: Equity – Conversion option CU10

Cr: Attribution to conversion option CU10

[0 (fair value at end of year two) – CU10 (fair value at start of year two)]

Attribution of profit or loss to the conversion option in year two (balance of conversion option is nil after this entry, consistent with the fact that the conversion option does not have value at that time for the instrument holder to exercise it.)⁶

28. At the end of year two, on settlement of the convertible bond by transferring cash:

Dr: Financial liability CU110

Cr: Cash CU110

Recognise the transfer of cash on settlement

Scenario 2—Journal entries for settlement through issue of 100 ordinary shares

29. Initial recognition and year 1 entries are in paragraphs 25–26.

30. In year two:

Dr: Interest Expense CU15

Cr: Financial liability CU15

Accrual of interest in year two (same as Scenario 1)

Dr: Attribution to conversion option CU5

Cr: Equity – Conversion option CU5

Attribution of profit or loss to the conversion option in year two (balance of conversion option is CU15)⁷

⁶ If the Board does not proceed with attribution within equity, then there would be no such entry at this point. However, at the end of year 2, on settlement by transferring cash, the carrying amount for the conversion option would be required to be transferred to the ordinary shares.

⁷ If the Board does not proceed with attribution within equity, then there would be no such entry at this point. However, at the end of year 2, on settlement by issuing shares, the carrying amount for the conversion option which has not been updated for attribution (ie the CU18) would be required to be transferred to the ordinary shares instead of the CU15 illustrated..

31. At the end of year two, on settlement of the convertible bond by issuing shares:

Dr: Financial liability	CU110
Dr: Equity – Conversion option	CU15
Cr: Equity – Ordinary Shares	CU125

To recognise settlement of the convertible bond through the issuance of ordinary shares.

32. The amount recognised for the ordinary shares issued is equal to their fair value at the date of issuance (ie CU1.25 x 100 shares). This is the result of updating the carrying value of the conversion option to its fair value through attribution, and the fact that the shares are issued in exchange for settling both the financial liability (CU110) and the equity (CU15) components of the convertible bond.

Scenario 1—statement of changes in equity⁸

In Currency Units (CU)	Conversion option	Ordinary shares	Total equity
Start of Year One	-	100	100
Convertible bond issued	18	-	18
Attribution of total comprehensive income	(8)	135	127
End of Year One	10	235	245
Attribution of total comprehensive income	(10)	95	85
End of Year Two	-	330	330

⁸ The statements of changes in equity tables presented in this paper are a simplified illustration. The attribution of total comprehensive income row would be typically further disaggregated and there would be additional categories within equity such as retained earnings for ordinary shares. The classes are illustrative only.

Scenario 2—statement of changes in equity

In Currency Units (CU)	Conversion option	Ordinary shares	Total equity
Start of Year One	-	100	100
Convertible bond issued	18	-	18
Attribution of total comprehensive income	(8)	135	127
End of Year One	10	235	245
Attribution of total comprehensive income	5	95	100
Settlement of convertible bond through issuance of shares	(15)	125	110
End of Year Two	0	455	455

33. The statements of changes in equity under both scenarios show two things which would be relevant to users:
- (a) Firstly, all of the changes affecting the conversion option are shown separately from the changes in the ordinary shares.
 - (b) Secondly, the attribution requirements show the difference in the distribution of returns between the conversion option and the ordinary shares. In Scenario 1, the facts result in the distribution of returns favouring the ordinary shareholders more than the conversion option holders, whereas in Scenario 2 it is the other way around. Even if the Board ultimately decides that there should be no attribution required to the conversion option, it would be useful to show that the carrying value is transferred to the ordinary shareholders at expiry of the conversion option.

Example 2—Written put option

Facts

34. The entity issued 100 ordinary shares for CU0.9 each. Simultaneously, the entity issued a written put option on 100 ordinary shares at a strike price of CU1.1 each. The put option is exercisable in two years and in return the entity received CU10 in cash as a premium. The present value of the redemption amount (CU1.1 per share x 100 ordinary shares) is CU82.
35. We consider two scenarios:
- (a) Scenario 1—The holder exercises the put option on ordinary shares, requiring the entity to pay CU110 in cash at the end of year two. Assume in this scenario, the entity's ordinary share price and fair value of the conversion option are as follows:

Scenario 1	Date of Issuance	End of Year One	End of Year Two
Ordinary share price	CU0.9 per share	CU0.8 per share	CU1.0 per share
Fair value of put option	CU10	CU13	CU10 ⁹
Fair value of equivalent conversion option	CU18	CU10	0 ¹⁰

- (b) Scenario 2—The holder does not exercise the put option. Assume in this scenario, the entity's ordinary share price and fair value of the conversion option are as follows:

⁹ Represents the redemption amount (CU110) less the value of the underlying shares (CU100).

¹⁰ Nil because the value of the underlying shares is less than the redemption amount.

Scenario 2	Date of Issuance	End of Year One	End of Year Two
Ordinary share price	CU0.9 per share	CU0.8 per share	CU1.25 per share
Fair value of put option	CU10	CU13	0 ¹¹
Fair value of equivalent conversion option	CU18	CU10	CU15 ¹²

Application of the Gamma approach

36. In July 2016, the Board tentatively decided in the Gamma approach an entity should apply a requirement similar to the existing redemption obligation requirement in paragraph 23 of IAS 32 to ensure that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured.
37. Paragraph 23 of IAS 32 states that if a contract contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset, then the contract gives rise to a financial liability for the present value of the redemption amount (‘redemption obligation requirements’). Paragraph 23 states that this amount is reclassified from equity, however it does not detail exactly how this is accomplished. Paragraph IE 30 of IAS 32 illustrates the accounting for the transaction by both (a) crediting the put option premium, and (b) debiting the reclassification of the redemption amount, to the same generic ‘Equity’ account.
38. The lack of clarity regarding which account within equity should be affected by the transaction has led to challenges in practice when accounting for written put options. As identified in paragraph 8, these challenges are particularly acute for

¹¹ Nil because the value of the redemption amount is less than the underlying shares.

¹² Represents the value of the underlying shares (CU125) less the redemption amount (CU110)

the accounting for NCI because entities are required to separately present NCI when applying existing IFRS requirements (ie NCI).

39. Furthermore, the Board decided that the Gamma approach needs to reconcile the interaction of the redemption obligation requirement with the requirement that fixed-for-fixed derivatives that exchange a liability for equity instruments are classified as equity.
40. The cumulative effects of the Board's decisions under the Gamma approach are that a written put issued on ordinary shares, together with the ordinary shares, should be accounted for consistently as a convertible bond, as both have similar liability and equity outcomes. This would require:
- (a) derecognition of the ordinary shares on which a written put option is issued;
 - (b) recognition of a liability component reflecting the puttable obligation at redemption amount; and
 - (c) recognition of an equity component that is equivalent to the conversion option in a convertible bond.
41. The rest of this section includes:
- (a) What happens at initial recognition? (paragraphs 42–43)
 - (b) Why does the entity need to reclassify the fair value of the shares? (paragraphs 44–49)
 - (c) What happens subsequently? (paragraphs 50–51)
 - (d) How does this address the problems with NCI puts? (paragraphs 52–55)

What happens at initial recognition?

42. To determine the amounts to recognise and derecognise, an entity would be required to apply the following steps on initial recognition:
- (a) recognise an amount which equals the **present value of the redemption amount** as a liability. The treatment is consistent with the redemption obligation requirement in paragraph 23 of IAS 32, as this component is equivalent to the liability component of the convertible bond in Example 1.

- (b) derecognise the **fair value of the ordinary shares** on which a written put is issued from the ordinary shares subclass of equity (see further discussion about why this should be at fair value in paragraphs 44-49).
- (c) recognise a new equity component representing the holder's option to choose the equity settlement outcome over the liability settlement outcome. This equity component is equivalent to the conversion option of the convertible bond in Example 1.

43. Based on the facts in the example, the entries, on initial recognition of the shares and the written put:

Dr: Cash	CU90
Cr: Share Capital – Ordinary Shares	CU90

On initial recognition of 100 ordinary shares @ CU0.9 per share

Dr: Equity – Ordinary Shares	CU90
Dr: Cash	CU10
Cr: Liability – Redemption obligation	CU82
Cr: Equity – Conversion option	CU18

The entity would derecognise the ordinary shares at fair value at the date the written put is issued. This would create a new class of equity that is similar to the conversion option in a convertible bond.

Why does the entity need to reclassify the fair value of the shares?

44. The Gamma approach requires the recognition of the redemption obligation, which is the present value of the strike price of the written put option. However, accounting for just the liability, as is the current practice, does not provide a complete and faithful representation of the economic consequences of the arrangement. This is because it ignores the optionality which is a feature of the contract. The written put option grants the holder the right either to demand payment of the liability component by exercising the put, or to allow the put to expire, converting that liability component to equity. These outcomes are exactly the same as the convertible bond. Consequently we need to recognise this

optionality in the contract as we do in the case of the convertible bonds in Example 1.

45. The standalone written put option contract represents an obligation to redeem the underlying shares, in exchange for payment of the exercise price, at the option of the holder. The underlying shares are existing shares of the entity and have been previously recognised as equity.¹³ However, because one part of the written put option contract, the strike price, is recognised as a liability applying the Gamma approach, then the holder's option to choose the underlying shares instead of the liability needs to be recognised. To accomplish this, the underlying shares need to be derecognised at fair value, as demonstrated in the example. After recognition of the present value of the redemption amount, and derecognition of the underlying shares at fair value, the remaining claim against the entity would represent the holder's option to convert the recognised liability component to ordinary shares (instead of their option in the standalone written put to convert the originally recognised ordinary shares to a liability).
46. As the redemption amount is recognised as a liability as required under the Gamma approach, which represents the minimum outflow possible under the contract, then continuing to recognise the standalone written put option as it is (ie the holder's right to convert the equity to a liability) would be inappropriate because it would lead to double counting.¹⁴
47. Accounting for the written put option as outlined above would achieve consistency with the accounting for the convertible bond. In our examples, both arrangements result in the entity receiving CU100 in cash, and result in giving the holder the option of choosing after 2 years:
- (a) A cash payment of CU110; or
 - (b) 100 ordinary shares

¹³ For convenience, and to illustrate the similar outcomes with the convertible bonds, in our example the entity has issued the ordinary shares simultaneously with the written put, however this need not be the case for the analysis to apply.

¹⁴ The easiest way to illustrate this is to think about what happens to the value of the put if the share price approaches zero at maturity. The value of the put in such a scenario would be the present value of the redemption amount, which has already been accounted for by recognising a liability for the same amount. Unlike the put option, the conversion option recognised in its place would be worth nothing if the value of the ordinary shares was less than the present value of the redemption amount at maturity.

48. It follows from the above that a written put option with a strike price equal to the fair value of the shares would result in the entire fair value of the shares being allocated to the liability component. As a result there would be no equity component.
49. Accounting for written put options in this way results in the correct and consistent application of the Board's tentative decisions and achievement of the objectives of the Gamma approach.

What happens subsequently?

50. One of the advantages of accounting for the components of written puts and convertible bonds consistently from initial recognition is that the subsequent accounting will simply be the same as the convertible bond. Thus, the subsequent accounting for Example 2 will be the same as Example 1. For example, if the put option expires unexercised, then it would be as if the holder had converted the liability to equity in Example 1, Scenario 2.

Scenario 1—statement of changes in equity

In Currency Units (CU)	Conversion Option	Ordinary Shares	Total
Start of Year One	-	100	100
Issuance of ordinary shares	-	90	90
Issuance of written put option	18	(90)	(72)
Attribution of total comprehensive income	(8)	135	127
End of Year One	10	235	245
Attribution of total comprehensive income	(10)	95	85
End of Year Two	-	330	330

Scenario 2—statement of changes in equity

In Currency Units (CU)	Conversion Option	Ordinary Shares	Total
Start of Year One	0	100	100
Issuance of ordinary shares	-	90	90
Issuance of written put option	18	(90)	(72)
Attribution of total comprehensive income	(CU8)	135	127
End of Year One	10	235	245
Attribution of total comprehensive income	5	95	100
Expiry of put option	(15)	125	110
End of Year Two	0	455	455

51. Similar to the statement of changes in equity for Example 1, the statements show separately the different classes of equity and the effects of changes in the carrying value due to the distribution of returns which differs under the two scenarios. In addition, for the written put, the statement of changes in equity show clearly the reclassification of ordinary shares which are subject to the put, and the establishment of the conversion option, representing the holder's right to choose ordinary shares at a future period.

How does this address the problems with NCI puts?

52. For the particular case of NCI puts, the accounting would be the same, however the equity instruments as illustrated in Example 2 are substituted with their NCI equivalents. This would require:
- (a) derecognition of the NCI shares on which a written put option is issued;

- (b) recognition of a liability component reflecting the puttable obligation at redemption amount; and
 - (c) recognition of an equity component that is equivalent to a conversion option in a convertible bond in the subsidiary.
53. If the NCI put is a fair value put, then the NCI equity component will be nil, and all of the returns on the claim will be captured by the liability component. If the amount of the claim solely depends on the residual amount, then the separate presentation requirements will also apply to the gains and losses.
54. Similar entries would be required for the expiry or exercise of the NCI put as illustrated in Example 1 and 2, except instead of ordinary shares being issued in Scenario 2, the entity issues NCI shares.
55. Consistently with the requirements of IAS 32 today, subsequent changes to the liability components are recognized as income and expense, and subsequent changes to the equity components are recognized in the statement of changes in equity.

Summary and question for the Board

56. In this paper we illustrated the accounting for equity components that arises from convertible bonds and written put options. We illustrated how the similar liability and equity outcomes could be accounted for consistently under the Gamma approach. This paper also illustrated how the underlying rationale of the Gamma approach could help clarify the accounting within equity, in particular for written put options. As demonstrated through this paper, the staff is of the view that the Gamma approach will improve the consistency, completeness and clarity of the requirements.

Question

Does the Board agree with the application of the Gamma approach as set out in this paper?