

STAFF PAPER

February 2017

IASB Meeting

Project	Financial instruments with characteristics of equity		
Paper topic	Application of the Gamma approach to derivatives on 'own equity' – derivatives in foreign currency		
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Objective of this paper

1. In December 2016, the Board discussed how the Gamma approach addresses some common practice issues that arise when applying IAS 32 *Financial Instruments: Presentation* to classification of derivatives on 'own equity' ([Agenda Paper 5B](#)). At that meeting, the Board asked the staff to consider the interaction between foreign currency and derivatives on subsidiaries' equity instruments; specifically, the derivatives on the equity instruments of a subsidiary where the amount receivable (eg the exercise price of an option) is denominated in the functional currency of the subsidiary, which differs from the functional currency of the parent. Accordingly, the focus of this paper is how the Gamma approach classifies such derivatives.

Structure of this paper

2. This paper is structured as follows:
 - (a) Background (paragraph 3);
 - (b) Requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates* (paragraphs 4-7);
 - (c) Classification of a derivative on consolidation (paragraphs 8-13);

- (d) Is it the functional currency of the issuer of derivative or the issuer of the underlying equity instrument? (paragraphs 14-17); and
- (e) Summary and question for the Board (paragraphs 18-20).

Background

3. When the Board discussed the application of the Gamma approach to the classification of derivatives on ‘own equity’ in December 2016 ([Agenda Paper 5B](#)), the Board focussed on a single type of variable at a time, rather than considering their combined effect. As requested by the Board at that meeting, this paper considers the interaction between two of the variables that were discussed separately, foreign currency and the equity instruments of a subsidiary entity. The discussions at the December 2016 meeting on the two variables can be summarised as follows:
 - (a) If the exercise price of a derivative on ‘own equity’ is denominated in a currency other than the functional currency of the entity, the amount of the derivative is exposed to variability other than the residual amount. The derivative is not a claim whose amount solely depends on the residual amount and for that reason, such derivatives would not be classified as an equity instrument applying the Gamma approach.
 - (b) The residual amount of a subsidiary entity, including non-controlling interest, is part of the residual amount of the group. If a derivative solely depends on the residual amount of the subsidiary, then the derivative would also solely depend on the residual amount of the group.

Requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*

4. IAS 21 defines functional currency as the currency of the primary economic environment in which the entity operates and foreign currency as a currency other than the functional currency. In addition, IAS 21 permits the presentation currency to be any currency. Accordingly, an entity may have the same currency as its functional currency and the presentation currency, or may have a presentation currency that is different from its functional currency.

5. The definition of functional currency is the currency of the primary economic environment in which *the entity* operates, however the functional currency is determined for each individual entity rather than at a group level. IAS 21 does not define the functional currency *of a group*; there is a presentation currency for a group. A group may contain individual entities with different functional currencies, whose results and financial positions would be translated into the presentation currency of the group.
6. In the following sections, we discuss two questions based on the Gamma approach:
 - (a) a subsidiary entity issues a derivative *on its own equity* and in its own functional currency that is classified as equity in its own financial statements. Does the classification change on consolidation when the parent's functional currency is different to the subsidiary's? (paragraphs 8-13); and
 - (b) if one entity in a group (eg a parent) issues a derivative *on equity instruments of another group entity* (eg a subsidiary), then which entity's functional currency should be the reference point in determining whether the derivative is denominated in *a foreign currency* when the group prepares the consolidated financial statements? (paragraphs 14-17).
7. Please note that the following sections discuss the application of the Gamma approach; we are not providing interpretation of the requirements in IAS 32 *Financial Instruments: Presentation*.

Classification of a derivative on own equity on consolidation

8. If a stand-alone entity issues a derivative on its 'own equity' in its functional currency and the entity uses another currency as its presentation currency, the derivative could still be classified as an equity instrument applying the Gamma

approach¹. The fact that its financial statements are presented in another currency does not preclude the equity classification of the derivative.

9. Consider a subsidiary entity that issues a derivative on its own equity instrument, in its own functional currency. In the separate financial statements of the subsidiary, the derivative could be considered solely dependent on the residual amount applying the Gamma approach and could be classified as an equity instrument.

10. The question is whether it should matter if the group's presentation currency differs from the subsidiary's. For example, let's assume the parent's functional currency is CCY1, the subsidiary's functional currency is CCY2 and the group's presentation currency is CCY3 (that is, the group's presentation currency is different to the functional currency of the subsidiary and the parent). Then:
 - (a) Following from paragraph 8, if the parent issues a derivative on own equity in CCY1, the fact the functional currency differs from the group's presentation currency, CCY3, does not preclude the equity classification of the derivative.

 - (b) If the subsidiary issues a derivative on its own equity in CCY2, following the same rationale, the fact that the functional currency differs from the presentation currency should not preclude the equity classification.

11. The staff think that the application should be consistent between the parent and the subsidiary, ie if a subsidiary entity issues a derivative on 'own equity' in its own functional currency, CCY2, it would be inconsistent if the subsidiary were required to classify it as a liability purely because the group prepares the consolidated financial statements using a different presentation currency. If a standalone entity's choice to use another currency other than its functional currency as the presentation currency does not affect the debt vs equity classification of a derivative, the group's choice to use a currency other than a subsidiary's functional currency as its presentation currency would not affect the classification of a derivative issued by the subsidiary. This would be the case even if the presentation currency of the group is the same as

¹ Subject to meeting the other conditions of the Gamma approach. Throughout this paper, when we say that a derivative could be classified as an equity instrument, we assume that the derivative does not have any other feature that precludes equity classification applying the Gamma approach.

the functional currency of the parent. We also note that this consistency exists within IAS 21 when translating an entity's results and financial position into the presentation currency. IAS 21 requires the same method of translation for:

- (a) when the financial statements of a standalone entity are translated from its functional currency to the a different presentation currency in its standalone financial statements; and
- (b) when the financial statements of a foreign operation (eg a subsidiary) are translated from its functional currency to a different presentation currency that is used for the group in the group's consolidated financial statements.

12. Under the Gamma approach, whether a derivative solely depends on the residual amount is determined by reference to the variability in the amount of the receivable-leg and the payable-leg of the derivative. A derivative is said to be solely dependent on the residual amount where the only variable affecting the amount of derivative is the value of the equity instruments to be delivered. This would be the case if the derivative is a contract to receive cash or other financial assets equal to a fixed amount of the entity's functional currency and to deliver a fixed number of 'own equity' instruments. The residual amount of an entity (as with all other items in the financial statements) are measured in the entity's functional currency. If a derivative is to deliver a claim on the residual amount of a specific entity, then the exposure to a currency other than the functional currency of that specific entity is a variable that does not solely depend on the residual amount (ie the residual amount that is *relevant* to the derivative).
13. In summary, if a derivative is classified as an equity instrument at a specific entity level, the use of another currency as the presentation currency (whether by the choice of the entity itself or the group) will not change the classification of the derivative.

Is it the functional currency of the derivative issuer or the underlying equity instruments issuer?

14. In some cases, the issuing entity of a derivative and the entity whose equity instrument forms the underlying of the derivative may differ. For example, a parent entity may issue a derivative over the subsidiary's equity shares. A question has

arisen in the past when applying IAS 32² - whose functional currency should be the reference point in determining whether the derivative is denominated in a foreign currency—in determining whether the derivative solely depends on the residual amount when applying the Gamma approach.

15. As discussed in paragraph 12 above, if a derivative is a promise to deliver equity instruments of a specific entity within a group, then the relevant functional currency is the functional currency of that entity whose equity instruments are being delivered. This is because the amount of the derivative is comprised of the total of both legs, the amount to be received and the amount to be paid. When applying the Gamma approach, for a derivative on ‘own equity’ to be solely dependent on the residual amount, the functional currency of the receivable leg must match the functional currency of the payable leg, ie:
- (a) the receivable-leg, ie the currency in which the amount of cash or other financial assets to be received is defined; and
 - (b) the payable-leg, ie the functional currency of the entity whose equity instruments (that represent a claim on the residual amount of that specific entity) underlie the derivative.
16. Accordingly, if a parent entity issues a derivative over the subsidiary’s equity instruments in the subsidiary’s own functional currency, the derivative could be classified as an equity instrument in the consolidated financial statements³. From a group perspective, this would be the same treatment regardless of whether the subsidiary issued the derivative or the parent. Similarly, if a subsidiary issues a derivative on its parent’s equity instruments, the functional currency of the parent becomes the references point for determining whether the derivative is exposed to ‘foreign currency’, which would preclude the equity classification.

² This question was discussed by the IFRS Interpretations Committee (the Interpretations Committee) in 2006. The Interpretations Committee then noted that a group does not have a functional currency and discussed whether it should add a project to its agenda to address which currency should be the reference point. In the end, it decided not to take the issue onto its agenda because it believed that the issue was sufficiently narrow that it is not expected to be widespread in practice.

³ In the separate financial statements of the parent, the derivative is not classified as an equity instrument because the derivative is not issued over its own equity. In the separate financial statements of the subsidiary, the derivative is not recognised as the subsidiary is not a party to the contract.

17. Consider another case where the parent entity issues a derivative over the subsidiary's equity shares in the parent's functional currency, which differs from that of the subsidiary. In this case there is a mismatch between the functional currency of the entity whose equity instruments underlie the derivative (ie the subsidiary's functional currency), and the currency that determines the receivable-leg of the derivative. The derivative does not solely depend on the residual amount of the entity whose equity instrument affect the amount of the derivative. As such, the derivative will not be classified as an equity instrument applying the Gamma approach.

Summary and question for the Board

18. The Staff is of the view that the application of the Gamma approach will improve consistency of the application of the classification requirements by clarifying the principle of classification. In this paper we considered how that principle applies to derivatives on subsidiaries' equity instruments with a strike price denominated in the functional currency of the subsidiary which differs from the functional currency of the parent.
19. As demonstrated in this paper, the following would be the case when applying the Gamma approach to such derivatives:
- (a) where an entity issues a derivative *on its own equity* and in own functional currency, the classification as equity or debt would not change on consolidation. This holds even if the consolidated group financial statements are presented using another currency, which might be the same as the functional currency of the parent; and
 - (b) where an entity issues a derivative *on equity instruments of another entity*, the functional currency of the entity whose equity instruments form the underlying of the derivative should be the reference point in determining whether the derivative is denominated in a foreign currency.

20. Our understanding is that the application of the Gamma approach in 19(a) would not result in a change in practice, however 19(b) provides clarification to the question that arose when applying IAS 32⁴.

Question – application of the Gamma approach to foreign currency and subsidiaries

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

⁴ The question was discussed by the IFRS Interpretations Committee in 2006. See footnote 2 for further information.