STAFF PAPER

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IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Summary of feedback—Classification of derivative financial instruments

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Objective

1. This paper summarises the feedback on the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP). More specifically, this paper focuses on feedback from comment letters and outreach on the Board's preferred approach to classification of derivative financial instruments as set out in Section 4 of the DP.

2. Many although not all respondents provided feedback on this section of the DP. In this paper, when describing the extent to which particular feedback was shared by respondents (eg most, many), we refer to the proportion of the respondents out of those who have provided responses to that specific question.

Structure of paper

3. The remainder of this paper is structured as follows:

   (a) Background—the proposals in the DP (paragraphs 4–7);

   (b) Key messages from the feedback (paragraphs 8–11);

   (c) Classifying a derivative on own equity in its entirety (paragraphs 12–14);

(d) Classifying a derivative on own equity as an equity instrument, a financial asset or a financial liability (paragraphs 15–17);

(e) Applying the timing and amount features of the Board's preferred approach to classification of derivatives on own equity (paragraphs 18–58);

(f) Alternative classification approaches suggested (paragraphs 59–65); and

(g) Removal of the FX rights issue exception (paragraphs 66–71).

Background—the proposals in the DP

4. The Board's preferred approach for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—is as follows:

   (a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability—the individual legs of the exchange would not be separately classified; and

   (b) a derivative on own equity is classified as a financial asset or a financial liability if:

      (i) it is net-cash settled—the derivative could require the entity to transfer cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation (*the timing feature*); and/or

      (ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources (*the amount feature*).

5. In the DP, it is proposed that the Board's preferred approach applies to all derivatives on own equity, without retaining the exception in IAS 32 which applies to particular derivatives on own equity that involve foreign currency (FX rights issue exception).

6. The DP refers to *asset/equity exchanges*—contracts to receive cash or another financial asset in exchange for delivering own equity instruments; and to *liability/equity exchanges*—contracts to extinguish a financial liability in exchange for delivering own equity instruments and contracts to extinguish own equity

instruments in exchange for another obligation that has one or both features of a financial liability.

7. Section 4 of the DP—Classification of derivative financial instruments, discusses the application of the Board’s preferred approach to both asset/equity derivatives and liability/equity derivatives, except derivatives that include an obligation to extinguish an entity’s own equity instruments for which the discussion is set out in Section 5 of the DP—Compound instruments and redemption obligation arrangements. Agenda Paper 5D for this meeting summarises feedback on this section of the DP.

Key messages

8. **Do respondents agree with the challenges set out in the DP on classifying derivatives on own equity?** Most respondents agreed with the challenges identified by the Board, noting that a vast majority of practice challenges with IAS 32 relate to classification of derivatives on own equity, more specifically, the application of the fixed for-fixed condition in IAS 32 is particularly challenging.

9. **Should derivatives on own equity be classified in their entirety?** Almost all respondents who provided responses to this question, supported the Board’s proposal for a derivative on own equity to be classified in its entirety.

10. **Should derivatives on own equity be classified as equity instruments, financial assets or financial liabilities?** Many agreed with the Board that derivatives on own equity should be classified as *equity instruments*, *financial assets or financial liabilities* (rather than all as financial assets or financial liabilities). However, few respondents expressed the view that derivative instruments should not be classified as equity because they think that the future delivery or receipt of own equity should not be considered as part of an entity’s equity prior to the actual delivery or receipt of the equity instruments.

11. **Do respondents support the application of the timing and amount features to classification of derivatives on own equity?** Many respondents were not supportive of the Board’s preferred approach to classification of derivatives on own equity, in particular due to the concerns arising from the application of the amount feature. However, some of these respondents consider that several existing

application challenges with the fixed-for-fixed condition in IAS 32 would be addressed if the Board further develops some of the proposals described in the DP.

Classifying a derivative on own equity in its entirety[1]

12. Almost all respondents agreed that a derivative on own equity should continue to be classified in its entirety ie the individual legs of the exchange should not be separately classified. The arguments in support of this view included:

    (a) doing otherwise, ie separately classifying the individual legs of the exchange, would represent a fundamental change compared to IAS 32 and IFRS 9 and it would reduce comparability to other derivatives that have a non-equity underlying. In addition, it would:

        (i) represent a significant operational challenge given the interdependence of rights and obligations in the contract—overall the usefulness of the additional information from separating derivatives into components was considered not to justify the efforts in providing such information.

        (ii) result in grossing-up of the statement of financial position, with assets that the entity may not control and equity that has not yet been issued (eg the receipt of assets and issuance of equity that is contingent on the holder exercising an option).

    (b) the proposed approach is consistent with paragraph 4.57 of the *Conceptual Framework for Financial Reporting* (the Conceptual Framework), which states that an executory contract establishes a combined right and obligation to the exchange. The right and obligation are interdependent and *cannot be separated*. Hence, the combined right and obligation constitute a single asset or liability.

13. In contrast, a very small number of respondents expressed their preference for separate classification of the individual legs of the exchange, because in their view,

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[1] As described in paragraph 7 of this paper, Section 4 of the Discussion Paper (DP)—Classification of derivative financial instruments—discusses the application of the Board's preferred approach to both asset/equity derivatives and liability/equity derivatives, except derivatives that include an obligation to extinguish an entity's own equity instruments for which the discussion is set out in Section 5 of the DP—Compound instruments and redemption obligation arrangements. Agenda Paper 5D for this meeting summarises feedback on this section of the DP.

doing so would limit diversity in practice or because to their knowledge, some investors already do such separate classification—suggesting the costs of providing such information may not outweigh the benefits.

14. A few respondents also questioned why the DP classifies in its entirety an asset/equity exchange derivative, but not a liability/equity exchange derivative that includes an obligation to extinguish own equity instruments (eg written put on own shares). Some of them expressed the view that a consistent approach should be applied whereby in both cases, the derivative instrument should be classified in its entirety.

Classifying a derivative on own equity as an equity instrument, a financial asset or a financial liability

15. Many respondents agreed with the Board's proposal that a derivative on own equity should be classified in its entirety as *an equity instrument*, *a financial asset* or *a financial liability*, on the grounds that this approach better depicts the economic characteristics of the financial instrument, thus leading to useful information for the users of the financial statements.

16. Additional arguments provided by respondents in support of this view focused on the inherent limitations of applying an approach which would classify all derivatives on own equity as financial assets or financial liabilities—most notably that it would exacerbate the issue of recognising changes relating to the equity leg as income or expense, because more derivatives on own equity would then be classified as financial assets or financial liabilities.

17. However, few respondents disagreed with classifying derivatives on own equity as *equity instruments* because in their view, those financial instruments represent a right or obligation to receive or deliver equity instruments in the *future*—they are therefore executory contracts and not funded instruments, ie the issuer has *not yet* received consideration or given the holder of the derivative instrument a residual right in the entity. These respondents suggested alternative approaches, whereby all derivatives on own equity would be classified as either financial assets or financial liabilities—refer to paragraphs 62–64 for further details on such approaches.

Applying the timing and amount features of the Board's preferred approach to classification of derivatives on own equity

18. As described in paragraph 4(b), applying the Board's preferred approach, a derivative on own equity is classified as a financial asset or a financial liability if it contains the timing feature and/or the amount feature as described in the DP. It then follows that an entity would classify a derivative on own equity as an equity instrument if it does not contain either of these features.

19. Many were not supportive of the Board's preferred approach to classification of derivatives on own equity. These respondents consider that such an approach is complex and will require more judgement compared to the existing requirements in IAS 32, primarily with respect to the application of the amount feature. Further details provided by these respondents are summarised in paragraphs 22–51.

20. Acknowledging the challenges and widespread diversity in practice arising from the application of the fixed-for-fixed condition in IAS 32, few of these respondents suggest that the Board should seek to make improvements to this requirement rather than pursuing the Board's preferred approach (described in paragraphs 60–61). Few other respondents suggested other alternative approaches on classification of derivatives on own equity (described in paragraphs 62–65).

21. However, some respondents agreed with the Board's preferred approach for the following reasons:

    (a) it addresses some of the challenges associated with fixed-for-fixed condition in IAS 32;

    (b) it ensures consistent classification outcomes for gross physically settled derivatives and net-share settled derivatives;

    (c) to a large extent it retains the classification outcomes of existing requirements in IAS 32; and

    (d) it articulates the classification principle consistently with the Board's preferred approach for classifying non-derivative financial instruments—by reference to the timing and amount features.

The amount feature

22. As described in paragraph 4(b)(ii), a derivative on own equity would be classified as a financial asset or a financial liability if its net amount is affected by a variable that is independent of the entity's available economic resources.

23. In response to this proposal, many respondents disagreed and/or expressed the following concerns:

    (a) Increased implementation costs due to the use of new terminology—the Board's preferred approach uses new terminology which will require interpretation and may lead to changes in the existing classification of derivative instruments. This combined with the need for significant judgement as described below would require additional implementation cost.

    (b) Potential new interpretation issues and wider diversity in practice—determining whether a variable is independent of the entity's available economic resources is considered to be complex and could require significant judgement, which may lead to new interpretation issues and wider diversity in practise.

24. Some respondents added that the amount feature might not represent a significant improvement compared to the existing requirements in IAS 32 due to the concerns listed above.

New terminology

25. Similar to their feedback about the classification approach for non-derivative financial instruments, many respondents raised concerns about new terminology and questioned the need for it. These include terms such as: 'independent' or 'dependent', 'an entity's available economic resources', 'the net amount of a derivative'. Agenda Paper 5A for this meeting includes further details on these comments.

26. These respondents expressed concerns that the new terminology may lead to increased implementation costs for preparers and auditors—the need for review of all relevant contracts to assess the implications from the Board's preferred approach and could lead to an increase in the diversity in practice. Given that the

classification outcomes are expected to remain largely similar to those applying the existing requirements of IAS 32, these respondents highlighted that costs may outweigh benefits.

27. In response to the distinction that the DP makes between asset/equity exchange and liability/equity exchange derivatives as described in paragraph 6, few respondents expressed the view that this distinction adds another layer of complexity to the Board’s preferred approach. These respondents requested further clarity on the rationale and questioned the need for such distinction.

Variables that affect the net amount of derivatives on own equity

28. Most respondents who disagreed and/or raised concerns with the application of the amount feature to classification of derivatives on own equity, cited assessing whether or not the net amount is affected by a variable that is independent of the entity's available economic resources to be their main concern.

29. This is because, in their view, such an assessment, could be challenging to apply in practice, and they anticipate that significant judgement will be required due the complex nature of derivative contracts which are affected by multiple variables. These respondents highlight that it would often be difficult to determine whether such variables are independent or not.

30. Providing further details on the argument described above, a representative body of preparers, highlighted that many derivatives on own equity include price adjustments that cause the settlement amount to vary with:

(a) changes in dividends paid on the underlying shares;

(b) changes in withholding tax rates for one or both parties to the contract;

(c) changes in hedging costs for the derivative counterparty;

(d) changes in borrowing costs for the derivative counterparty;

(e) market disruption clauses which require adjustment for hedging costs;

(f) the adjustment of terms of the derivative financial instrument to offset the net gain or loss resulting from a merger announcement, tender offer or a similar event.

31. This respondent suggests the Board clarify whether the variables listed in paragraph 30 would be considered as ‘independent variables’ and consequently preclude the equity classification of derivatives that contain one or more of such variables. If so, according to this respondent, only few derivative instruments that are currently classified as equity would continue to be classified as such when applying the Board’s preferred approach, hence leading to a change in classification outcomes—suggesting that at least some of the above features do not preclude the equity classification applying the ‘fixed-for-fixed’ condition in IAS 32.

32. The DP discussed how the Board’s preferred approach would apply to a number of variables that affect the net amount of derivatives on own equity, for example, currency, time value of money, adjustments for dilution, the presence of contingency, etc.

33. Many respondents found this guidance to be useful, but some respondents suggest that the Board further clarify the proposals and provide additional guidance. In particular, the questions and anticipated challenges summarised in paragraphs 34–47 were highlighted.

Currency

34. Many respondents disagreed with the DP’s explanation that a currency other than the entity’s functional currency is always an ‘independent’ variable. The following reasons were provided:

    (a) The foreign currency denomination should not result in the liability classification. Respondents did not support classifying a derivative on own equity solely because of an exercise price denominated in a foreign currency and viewed it as inconsistent with the equity classification of ordinary shares whose price is quoted in a foreign currency. Their rationale included:

        (i) multinational group entities may consist of entities with different functional currencies and the parent may decide which entity within the group should be issuing the financial instrument based on administrative convenience, cost and relative market liquidity.

(ii) for some issuers in smaller jurisdictions, the decision to raise funds in a currency other than the functional currency is purely due to the lack of liquidity in their markets.

(iii) the determination of a functional currency may also be judgmental and change over time.

(b) where financial instruments are issued in a foreign currency, determining their classification should be performed from the perspective of the currency that the financial instruments are issued, rather than the entity's functional currency—this approach would have been consistent with the assessment whether contractual cash flows are solely payments of principal and interest in IFRS 9.[2]

(c) foreign currency features in identical financial instruments could lead to different classification outcomes depending on the issuer entity's functional currency, therefore reducing comparability and in respondents' view not representing the economic substance of the instrument. In some cases, this could lead to accounting driving business decisions.

(d) the foreign currency issue is further complicated if the foreign currency exposure is hedged such that economically the exposure arising from the financial instrument and the hedge is equivalent to a functional currency issuance. A question was raised as to why such hedged issuances should be classified differently from issuances in the functional currency of the issuer.

35. These respondents often illustrate the concerns described above by providing examples of financial instruments denominated in foreign currencies (for example, Additional Tier 1 issued by banks). Please refer to Agenda Paper 5B for this meeting for further details.

36. Focusing on the concern described in paragraph 34(a), a respondent suggested the Board consider the following alternatives to provide exceptions for:

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[2] Paragraph B4.1.8 in IFRS 9 states that an entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.'

(a) all variability arising from foreign exchange to be considered as a 'dependent variable'.

(b) a foreign currency variable in a derivative on own equity to be considered as a 'dependent variable' on the condition that the same currency is the functional currency of any entity within the group.

(c) use the criteria for separate presentation of a derivative on own equity with a foreign currency variable, which is articulated in paragraph 6.34[3] of the DP in order to determine when a foreign currency denomination would not preclude an equity classification.

37. Without disagreeing with the Board's preferred approach, some respondents noted that this is one of the areas with significant application challenges, hence the Board should provide additional application guidance accompanied with illustrative examples, in particular, in the context of the consolidated group financial statements when an entity enters into a derivative contract on equity instruments of another entity within the same group. Some respondents also said that there is no functional currency that applies to a group (at the group level) in the consolidated financial statements.

38. Furthermore, these respondents suggested the Board clarify what happens when an entity changes its functional currency, ie does this lead to a reclassification of the respective derivative instruments. This is an example of a broader question, described in paragraph 51(a), as to whether the liability or equity classification needs to be reassessed if circumstances change.

Time value of money

39. Paragraph 4.53 of the DP explains that the time value of money is an inherent component for derivatives because the definition of a derivative includes the requirement to be settled at a future date and therefore, a variable that reflects

[3] Paragraph 6.34 of the DP proposes that an entity should include all income and expenses arising from a partly independent derivative in the amounts presented separately, if all of the following criteria are met: (a) the derivative has a net amount that otherwise is unaffected by any other independent variable; the only independent variable is a currency other than the entity's functional currency; (b) the foreign currency exposure is not leveraged; (c) the foreign currency exposure does not contain an option feature; and (d) the denomination in the foreign currency is imposed by an external factor.

compensation for the time value of money that is relevant to the derivative would not preclude an equity classification. The DP adds that, if a variable that represents the time value of money is leveraged or is unrelated to the derivative instrument (eg the benchmark interest rate of an unrelated currency), such a variable is an independent variable and could change the net amount of a derivative independently of the entity's available economic resources.

40. Few respondents suggested the Board provide additional guidance on time value of money, in particular, what variables that represent the time value of money are considered leveraged or unrelated to the derivative instrument, for the purpose of assessing whether they are independent of the entity's available economic resources.

41. Referring to the example included in paragraph 4.54[4] of the DP, a respondent suggested the Board clarify, when the strike price of a derivative or the number of shares to be delivered is adjusted to a predetermined price or number for the time value of money, whether such an adjustment represents an 'independent' variable. In their view, when regarded as a single contract, it would appear that such an adjustment to the settlement amount would represent an 'independent' variable. On the other hand, if the contract is regarded as a series of option contracts that would each be separately evaluated—each individual option would be settled by delivering a fixed number of its own shares for a fixed amount of cash—and therefore, there would be no 'independent' variables.

Dilution

42. In response to the discussion about anti-dilution feature set out in the DP, the following feedback was received:

(a) some respondents welcomed this clarification, citing that it will help reduce application challenges. A respondent from Canada noted that this

[4] Paragraph 4.54 of the DP provides the following example: a written call option on own shares may have multiple exercise dates and a strike price that increases based solely on a relevant interest rate (in the entity's functional currency) at each exercise date. In a contract such as this, the strike price is specified in terms of the present value. Other contracts may specify the strike price as a fixed amount, in terms of the future value to be transferred at a future date of exercise. Both approaches to specifying the fixed amount can result in a dependent variable.

is also useful because in the respondent's view it brings more consistency with the US GAAP requirements.

(b) few respondents considered that the clarity of this guidance should be improved, and that it would be useful if the Board provide additional guidance and illustrative examples, in particular to explain:

(i) the effect of 'down round' features.[5]

(ii) whether it matters for classification which party an anti-dilution feature is designed to protect? For example, some anti-dilution features seek to protect the derivative holder at the expense of the existing shareholders. An auditor observes that practice has developed so that variability in the number of equity instruments to be delivered does not necessarily preclude meeting the fixed-for-fixed condition in IAS 32, provided that some conditions are met. Such conditions include: the financial instrument would otherwise meet the fixed-for-fixed condition; and the effect of the anti-dilution provision is only to maintain the relative rights of the shareholders and derivative holders.

Contingencies

43. As discussed in the DP, the exercise of derivatives on own equity can be optional or non-optional. The exercise of non-option derivatives such as a forward contract is certain to occur whereas the exercise of option derivatives will be conditional upon the *contingencies* specified in the contract. The exercise may be at the option of the holder of the instrument or the issuer, or contingent on an uncertain future event beyond the control of both the holder and the issuer.

44. Paragraph 4.64 of the DP states that if an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial asset or a financial liability, the derivative in its entirety would be classified as such regardless of whether its exercise is contingent on the holder or on an uncertain future event

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[5] 'Down round' features require the downward adjustment of the strike price of a convertible bond if new shares are issued at a price lower than the conversion price. This protects the holders of the convertible instrument from the dilution risk which is suffered by the ordinary shareholders and therefore puts them in a better position than the shareholders

that is beyond the control of both the holder and the entity. A settlement outcome is considered avoidable only if its avoidance is within the control of the entity.

45. Generally, respondents agree that a distinction should be made between settlement outcomes that are within the control of the issuer, and those that are outside its control. However, few respondents suggest the Board further clarify:

    (a) the guidance in paragraph 4.64 of the DP, reproduced in paragraph 44, to explain whether down round features would lead to classification as a financial asset or financial liability when the future issuance of equity is within the control of the issuer.

    (b) the application of this approach to contingencies with multiple settlement alternatives.

46. Few respondents disagreed with classifying a financial instrument as a financial asset or a financial liability due to a settlement outcome that has a remote likelihood of occurrence.

47. Few respondents observed that the discussion set out in the contingencies section of the DP would mean the requirement in paragraph 26 of IAS 32[6] will not be retained and welcomed this change. That is because they consider, this requirement often leads to diversity in practice for derivatives that give the entity the choice over how it is settled. Some of these respondents added that the Board's preferred approach will improve the consistency between how settlement options are treated in a non-derivative and a derivative instrument. Few respondents suggested the Board further clarify the impact in the classification outcome if the entity has the right to elect the settlement option, including to choose net-share settled or gross-share settled and if the counterparty can require the issuer to settle net in cash.

Partly independent derivative financial instruments

48. Applying the proposals in the DP, an entity would classify a derivative on own equity as an equity instrument—if affected by dependent variables only—or as a

[6] Paragraph 26 of IAS 32 states that when a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

financial asset or a financial liability—if affected by independent variables only. However, the net amount of many derivatives on own equity will be affected by both types of variables—the DP refers to these types of derivatives as '*partly independent derivatives*'. Applying the Board's preferred approach, such partly independent derivatives would be classified as derivative financial assets or financial liabilities.

49. Few respondents recommended the Board provide further guidance for determining whether the net amount of the derivative is independent or partly independent of the entity's available economic resources, in particular, when there are multiple variables that determine the conversion price, which was highlighted as a common fact pattern.[7]

50. The remaining comments on partly independent derivatives were concentrated on their proposed presentation requirements, which the staff will summarise in conjunction with the feedback summary on proposals set out in Section 6 of the DP and present at future board meetings.

Other clarifications suggested

51. Furthermore, few respondents asked for clarity on:

    (a) the frequency of the assessment—if the assessment, whether or not the net amount is affected by a variable that is independent of the entity's available economic resources, is a point in time assessment or it is ongoing? This is because, some variables may lapse after a certain point in time, raising the question, whether the classification of the financial instrument classification should be reassessed.

    (b) application of the Board's preferred approach to options to buy options—how would the proposals in the DP apply to financial instruments that contain options for the holder to acquire further options (the so-called 'piggyback options').

[7] For example, when a financial instrument is convertible at the value equal to the weighted average price of the entity's ordinary shares 30 days prior to conversion date or at the lowest value over 5-day weighted average price over a period of 30 days.

Timing feature—Net-share settled derivative financial instruments

52. Most respondents agreed with the timing feature of the Board's preferred approach to classifying derivatives on own equity. However, few respondents disagreed with the proposals in the DP with respect to derivatives on own equity that are net-share settled.

53. Net-share settled derivatives to deliver a fixed number of an entity's own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount of the entity's functional currency, are classified as financial assets or financial liabilities under IAS 32, but would be classified as equity instruments under the Board's preferred approach.

54. Whilst acknowledging that this change would likely have a limited impact in the derivatives market, because most derivative contracts are either gross physically settled or net-cash settled, few respondents suggested the Board clarify whether this change is intended to address known widespread application challenges and how the proposed classification outcome would result in better accounting outcomes, especially when considered together with additional presentation and disclosure requirements. This comment was raised in the light of the additional presentation and disclosure requirements introduced by the Board's preferred approach for equity instruments[8]. The Staff intend to provide the feedback summary on the proposals in the DP on presentation and disclosure at future board meetings.

55. Additionally, at least two respondents expressed concerns over the inconsistency in classification between net-share settled derivatives (classified as equity) and net-cash settled derivatives (classified as derivative financial assets or liabilities) that would result from the Board's preferred approach. These respondents consider transactions settled net in shares have similar economic characteristics to transactions settled net in cash because own shares in such transactions are used as a 'currency'.

[8] Section 6—*Presentation* of the DP sets out the Board's preliminary view that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to non-derivative and derivative equity instruments other than ordinary shares.

56. Disagreeing with the proposal for classifying net-share settled derivatives as equity instruments, a respondent expressed the view that, equity classification should be limited only to those transactions which are either exclusively gross physically settled or where the issuer has the right to gross physically settle.

57. Paragraph 4.42(a) of the DP states that, a net-share settled derivative to deliver a fixed number of an entity's own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount of the entity's functional currency, would be classified as an equity instrument under the Board's preferred approach, but the reverse—derivatives to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares are considered redemption obligation arrangements,[9] because the derivatives result in extinguishment of a fixed number of own equity instruments'.[10]

58. In response to the above proposal, few respondents consider that this approach would lead to an inconsistent classification outcome, because the net result of both instruments is that the entity either receives or delivers shares depending on the movement of the share price. They suggest the Board clarify why the reverse of such derivatives should be classified as a redemption obligation arrangement, as in their view, they are just as likely to lead to own shares being received.

Suggested classification approaches—alternative to the Board's preferred approach to classification of derivative financial instruments

59. Few respondents suggested the following classification approaches for the Board to consider as alternatives to the Board's preferred approach to classification of derivatives financial instruments.

Retain fixed-for-fixed condition in IAS 32

60. Some respondents suggested that the Board retain the fixed-for-fixed condition in IAS 32 but accompanies it with additional application guidance. For example, some

[9] Paragraph 5.11(b) of the DP defines redemption obligation arrangements as arrangements that contain a non-derivative equity instrument and a standalone derivative to extinguish that equity instrument.

[10] Footnote to paragraph 4.42(a) of the DP states that 'derivatives to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares are discussed in Section 5— Compound instruments and redemption obligation arrangements, because the derivatives result in extinguishment of a fixed number of own equity instruments'.

of the guidance provided in paragraphs 4.49–4.66 of the DP was found to be useful also for the purpose of applying the fixed-for-fixed condition in IAS 32.

61. These respondents consider that the issues raised in paragraphs 34–47 in response to the proposals in the DP for variables that affect the net amount of derivatives on own equity, would equally apply in the context of determining whether those derivatives meet the fixed-for-fixed condition in IAS 32, hence addressing such issues would also be beneficial for this approach.

Derivatives on own equity are financial assets or financial liabilities

62. Few respondents suggested the Board consider an approach that would classify all derivatives on own equity as financial liabilities and measure them at fair value through profit or loss. Such derivative instruments would be classified as equity only when settled ie when they are effectively providing funding for the issuer.

63. The merits to such an approach would include: simplifying the requirements in IAS 32 regarding derivatives on own equity; avoiding the need to use the amount feature of the Board's preferred approach which concerns most respondents; and avoiding structuring opportunities that have been observed, in particular, on the application of the current fixed-for-fixed requirements for both stand-alone derivatives and compound financial instruments.

64. Nonetheless, the same respondents acknowledged that applying their suggested approach, all standalone and embedded derivatives, currently classified as equity, would be reclassified into financial liabilities and measured at fair value through profit or loss, in accordance with IFRS 9. This would represent a fundamental change compared to IAS 32 and consequently not be aligned with the objective of the DP to limit unnecessary changes to classification outcomes of IAS 32.

Other alternative approaches

65. Other alternative approaches suggested by respondents included:

    (a) an approach where all derivative instruments that are settled in equity are classified as equity instruments, regardless whether it is for fixed or variable number of the entity's own equity instruments.

    (b) an approach that would classify as financial assets or financial liabilities all derivatives if:

(i) the issuance of or dealing with derivatives on own equity are part of the normal course of an entity's business regardless of whether these derivative instruments are settled in cash or by receiving or delivering shares;

(ii) equity instruments are used to settle liabilities to third parties (ie not a transaction with the owner of the entity); and

(iii) the number of entity's own shares to be delivered or received represents a fixed notional amount regardless of the currency it is denominated.

(c) an approach that would contain only disclosure requirements to provide information on the potential settlement outcomes from all derivatives on entity's own equity.

Removal of the FX rights issue exemption

66. As described in paragraph 5, derivatives on own equity that apply the FX rights issue exception in IAS 32 would be classified as financial assets or financial liabilities applying the Board's preferred approach.

67. The Board's preferred approach also includes separate presentation requirements for foreign currency derivatives on own equity including presentation of their returns in other comprehensive income (OCI), if specified criteria are met (these criteria are described in the footnote to paragraph 36(c)). The presentation requirements are discussed in Section 6 of the DP for which the staff intend to provide the feedback summary at a future board meeting.

68. About one third of the respondents who provided feedback on Section 4 of the DP were not supportive of the removal of FX rights issue exception because they consider such proposal to remove the exception:

(a) *lacks clear rationale*—it is not clear how the Board's preferred approach addresses the concerns that led to the introduction of such an exception in IAS 32 and how the proposed classification better depicts the substance of these transactions. These respondents refer to paragraph BC4F[11] of the

[11] The Basis for Conclusions BC4F in IAS 32 states 'The Board agreed with the International Financial

Basis for Conclusions to IAS 32, which sets out the Board's consideration that classifying rights as derivative liabilities was not consistent with the substance of these transactions because rights issues partially resemble dividends paid in shares.

(b) *is inconsistent with the retention of puttable exception*—the Board's decision to retain the puttable exception in IAS 32 was rationalised on the grounds that the concerns that led to puttable exception have not been resolved by the Board's preferred approach.

(c) *has limited application in practice but its impact is significant to those applying it*—this exception, as set out in IAS 32, is narrowly defined hence its application is not widespread[12]. However, it is important, and the effects are often material for entities applying the exception. This is because, some entities operate in multiple jurisdictions and are required, by law or regulation, to raise funds in a currency other than their functional currency for the purpose of meeting their regulatory requirements. The respondents argue that given the choice, entities would be likely to raise funds in the best available currency with the deepest market liquidity. Consequently, the proposal to withdraw this exception, would have significant impact on entities which operate outside the largest currency zones (eg USD, EUR) and do not have deep and liquid markets in their domestic currencies.

(d) *replaces classification exception with a presentation exception*—in the views of these respondents, the proposed separate presentation for some foreign currency derivatives on own shares, which would be relevant to FX rights issues, represents an exception to the principle behind the

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Reporting Interpretations Committee (IFRIC)'s 2005 conclusion that a contract with an exercise price denominated in a foreign currency would not result in the entity receiving a fixed amount of cash. However, the Board also agreed with the IFRIC that classifying rights as derivative liabilities was not consistent with the substance of the transaction. Rights issues are issued only to existing shareholders on the basis of the number of shares they already own. In this respect they partially resemble dividends paid in shares'.

[12] For example, the standard-setter in Canada described that the FX rights issue exception is not widely used in their jurisdiction.

overall separate presentation proposals in the DP.[13] Accordingly, these respondents do not see a merit of removing a classification exception if it would add an exception to another area of accounting, in this case presentation. Additionally, they commented that the proposed presentation would increase the number of items presented in OCI, which these respondents consider lacks a conceptual definition.

(e) *is less effective in representing the economic characteristics*—few respondents noted that the Board's proposed separate presentation suggests some derivatives in foreign currency have distinguished characteristics. They believe that their economic substance is better depicted through classification as equity rather than as financial assets or financial liabilities.

69. On the other hand, few respondents supported the removal of this exception, based on the conceptual merits of a principle-based approach that would have limited or no exceptions.

70. Paragraph 4.42(b) of the DP explained that, classifying foreign currency rights issues as financial assets or financial liabilities would be consistent with derivatives on own equity whose net amount is affected by other independent variables, including an embedded conversion option in a foreign currency convertible bond.

71. Acknowledging that a foreign currency rights issue and the embedded conversion option in a foreign currency convertible bond could share similar economic characteristics and that they should therefore be classified consistently, respondents expressed mixed views about which classification outcome is more appropriate:

(a) some argued that both, FX rights issue and an embedded option in a foreign currency convertible bond, should be classified as equity instruments, suggesting extension of the FX rights issue exception to

[13] In the views of these respondents, the principle behind separate presentation requirements in the Board's preferred approach is to present separately income and expenses from derivative financial assets and liabilities that have net amounts unaffected by any independent variable but are classified as financial assets or financial liabilities due to their timing feature (such as net-cash settled derivatives on own equity) rather than separate presentation for derivative instruments that have net amounts affected by independent variables ie foreign currency variable (such as FX rights issue).

embedded conversion options in foreign currency convertible bonds in addition to retaining the exception for FX rights issues.

(b) few other respondents supported classifying both these types of financial instruments as financial liabilities, because they expose the entity to fluctuations on the exchange rate between the foreign currency and the entity's functional currency and it would be useful for users of the financial statements to get information on those fluctuations. By classifying them as such, foreign currency gains and losses could be easily observed through movements in profit or loss—these respondents oppose separate presentation of income and expenses from these instruments in OCI.

(c) a standard setter disagreed with the removal of the exception and suggested the Board consider bifurcating the foreign currency element in these financial instruments from the host using the embedded derivative requirements in IFRS 9 and classifying the foreign currency element as a derivative asset or a derivative liability. This respondent notes that, to their knowledge, some financial analysts are already applying this approach for the purpose of their liability-equity analysis.