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Financial Instruments with Characteristics of Equity – Summary of the IASB discussions	EFRAG Secretariat Comments
Financial reporting challenges identified (reasons for amending / replacing IAS 32)	
In **May 2015** the IASB discussed the: • **conceptual challenges** related to identifying the underlying rationale of, and approach to, the distinction between liabilities and equity in IAS 32 *Financial Instruments: Presentation* and in the Conceptual Framework; • **application challenges** which are related to the consistency, completeness and clarity of the requirements in IAS 32, in particular when those requirements are applied to particular types of transactions in practice; • need to identify, confirm (or correct) and reinforce the underlying rationale of the distinction between liabilities and equity in IAS 32 before attempting to improve the consistency, completeness and clarity of the requirements; and • need to identify other relevant distinctions between claims that need to be communicated by means other than the distinction between liabilities and equity.	In the past, the IFRS Interpretations Committee ("IFRS IC") received several submissions related to the **application challenges** of IAS 32 and in many cases it was unable to reach a conclusion. The IFRS IC referred these issues to the IASB because the challenges identified required consideration of fundamental concepts in IFRS. The IASB has also tried to address the **conceptual challenges** related to the distinction between equity and liability within the Conceptual Framework project. However, given that the challenges are both practical and conceptual, the IASB decided to address these issues within a research project, *Financial Instruments with Characteristics of Equity* (FICE), where both the conceptual and application issues can be addressed together. Therefore, EFRAG Secretariat welcomes the *Financial Instruments with Characteristics of Equity* (FICE) research project and the IASB's efforts to identify the underlying rationale of the distinction between liabilities and equity, improve financial reporting and solve the existing deficiencies in IAS 32. EFRAG secretariat notes that EFRAG gave high priority to this project in its response to the 2015 IASB Agenda Consultation.

Objective and scope of the project	
In **October 2014** the IASB discussed the scope and next steps of the research project on *Financial Instruments with Characteristics of Equity*. The IASB decided to pursue the following two overlapping streams of work: • *Classification* - investigating potential improvements to the classification of liabilities and equity in IAS 32. This stream would also include an investigation of potential amendments to the definitions of liabilities and equity in the Conceptual Framework; and • *Presentation and Disclosures* - investigating potential improvements to the presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.	The current binary classification is in general supported. Most respondents to and participants in the outreach meetings on the EFRAG Discussion Paper *Classification of Claims* considered that the current binary classification model in IFRS should be retained with a refinement of the liability definition. Thus, EFRAG Secretariat continues to support explicitly splitting the claims side of the statement of financial position between liabilities and equity. EFRAG Secretariat acknowledges that a binary classification may not convey all of the similarities and differences between the different financial instruments, thus classifying claims as liabilities or equity may not provide satisfactory information to users. In addition, an approach based on a single distinction has resulted in various differences in disclosure and presentation requirements in IFRSs. Thus, EFRAG Secretariat welcomes the IASB's efforts to make improvements to the presentation and disclosure requirements to address the challenges that arise from a binary approach, particularly on the equity side.
Features of claims and various assessments that users might make using information about the identified features	

In **June 2015** the IASB discussed:
• the features of claims against an entity and their relevance to users. The features identified by the IASB as being relevant were:
  ○ the **type** of economic resource required to be transferred to settle the claim (e.g. cash, goods or services etc.);
  ○ the **timing** of the transfer of economic resources required to settle the claim (e.g. specified dates, on demand or at liquidation);
  ○ the **amount** (or quantity) of economic resources required to be transferred (e.g. currency units, commodity units, formulas or rates of change, or a share of the net assets of the entity); and
  ○ the **priority** (or seniority/rank) of the claim relative to other claims (e.g. senior, junior or most subordinate).
• how information about relevant features is provided in IFRS financial statements through classification, recognition, measurement and disclosure;
	EFRAG Secretariat considers that the features identified by the IASB are relevant as these are useful for users to assess prospects for future cash flows and they are broadly aligned with current guidance in the Conceptual Framework.
	For example, paragraph OB13 of the current Conceptual Framework states that information about the **nature** and **amounts** of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. It also states that information about **priorities** and **payment requirements** of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.
	In paragraph OB3 it is also stated that investors', lenders' and other creditors' expectations about returns depend on their assessment of the **amount**, **timing** and **uncertainty** of future net cash inflows to the entity.
	Nonetheless, it is worth noting that equity investors often look for information about the nature and extent of any significant **restrictions of**

• which features of claims against the entity are currently used to distinguish between classes of claims in the conceptual framework, IAS 32 *Financial Instruments: Presentation* and other relevant IFRS.	**the entity's ability to transfer funds** to its shareholders in the form of cash dividends. Such restrictions might be related to legal requirements, bank covenants, a dividends policy, borrowing arrangements, regulatory requirements or contractual arrangements. Information about significant restrictions is also important to help users determine the maximum amount that can be distributed as dividend. Capital providers and other creditors also look for information about the nature and extent of any **significant restrictions of the entity's ability to repay debt**. Such restrictions might be related to other borrowing arrangements, regulatory requirements or contractual arrangements. Thus, the constraints and uncertainties associated to the claims can also be considered a relevant feature.
Assessments that users might make using information about the identified features	

In **July 2015** the IASB discussed the relevance of the features of claims to the various assessments that users might make when using the statement of financial position and the statement of financial performance. In particular:
 	
• assessments of financial position:
  ○ The extent to which the entity is expected to have the **economic resources required to meet its obligations as and when they fall due**. For this assessment, users need information about the timing of required settlement of claims. If that **timing** is prior to liquidation (e.g. specified dates), then the amount and type of economic resources that the claim requires the entity to transfer will also be relevant.
  ○ The extent to which **an entity has sufficient economic resources to satisfy the total claims against the entity at a point in time (e.g. reporting date) and how any potential shortfall will be distributed amongst claims**. For this assessment, users need information about the **amount of economic resources** required to settle the claim at that point in time. They will also need information about the **priority** of the claim on liquidation.
 	
• assessments of financial performance:
  ○ whether the entity has **produced a sufficient return** on its economic resources to satisfy the promised return on claims against it. To make that assessment, users need information about the promised return on claims. A promised return may exceed the return on the entity's economic resources if the specified **amount** of the claim changes over time independently of the changes in the entity's available economic resources. They will also need information about the **priority** of the claim
	EFRAG Secretariat agrees that the assessments identified by the IASB as they are broadly aligned with the Conceptual Framework and how investors analyse financial statements.
	
	For example, paragraph OB3 states that decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the **returns that they expect from an investment** in those instruments, for example dividends, principal and interest payments or market price increases.
	
	In paragraph OB4 it is also stated that to assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the **resources of the entity**, **claims against the entity**, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
	
	EFRAG Secretariat observes that the assessments described on the left are mainly related to the notion of solvency/loss absorbing capacity, liquidity and on how investors analyse financial statements in general. Nonetheless, we note that primary users' assessments are often far more complex, particularly within the financial industry where there may exist significant **restrictions of the entity's ability to transfer funds** to primary users due to legal and regulation requirements (e.g. Banking Recovery and Resolution Directive).

on liquidation to assess how any potential shortfall, or excess, of returns will be distributed amongst claims.	
Potential improvements to the classification of liabilities and equity: Approaches Alpha, Beta and Gamma.	
In **September 2015** the IASB analysed the existing definitions and other related requirements in IAS 32 and considered: • to what extent the requirements in IAS 32 capture the features of claims that are relevant for users to make assessments about an entity's financial position and financial performance; and • whether there are exceptions, inconsistencies, and gaps in the existing definitions and other related requirements in IAS 32. The IASB identified three possible approaches for improvements which would be developed further as the project progresses: • **Approach Alpha** - classifies as liabilities obligations to transfer economic resources prior to liquidation; all other claims will be classified as equity. The distinction between liabilities and equity is focused on the **timing** of required settlement. • **Approach Beta** - classifies as liabilities obligations for an **amount** independent of the entity's economic resources (e.g. a specified amount of currency units); all other claims will be classified as equity. The distinction between liabilities and equity is focused on the amount of economic resources required to settle the claim (which is relevant to Assessments B and Y described above). • **Approach Gamma** - classifies as a liability obligations to transfer economic resources prior to liquidation or for an amount independent of the entity's economic resources. The distinction between liabilities and equity is focused on both the **timing** of required settlement **and** the **amount** of economic resources required to settle the claim. Thus, approach Gamma will only classify as equity claims that require the transfer of economic resources only at liquidation; and the amount of economic resources required to be transferred at liquidation is not independent of the entity's economic resources. This approach is the most consistent with IAS 32. In **September 2016** the IASB discussed and agreed that the classification of derivatives on 'own equity' that are neither completely independent nor solely dependent on the residual amount (conversion option embedded in a foreign currency convertible bond) would be classified as liabilities under the Gamma approach. Further details can found in the next section. .	*IASB's approach to the project on classification*: EFRAG Secretariat notes that even though a new set of principles for the distinction between equity and liability (Alpha, Beta and Gamma approaches) is intended to bring consistency and remedy any identified deficiency in IAS 32, the approaches are not free from the challenges that typically arise in a "fresh start approach". For example: • many consider that IAS 32 is not fundamentally broken and that the IASB should address the existing challenges, focus on the current application questions that have arisen in relation to IAS 32 and clarify the principles of IAS 32 in the process. At this stage, it is difficult to assess the extent of the changes that the IASB will need to make in order to reflect the new concepts in IAS 32; and • even if the new set of principles is broadly similar to the requirements in IAS 32, the new approaches may affect the accounting for some financial instruments for which there are no concerns. Therefore, EFRAG Secretariat highlights the importance of testing extensively whether the new approaches solve the issues that currently arise in practice and apply them to a variety of financial instruments to avoid unintended consequences. *Definition of economic resources:* Share-settled bonds are classified as a liability under approach Beta as an entity has an obligation for a specified amount independent of the entity's economic resources. In this case, the **type** of economic resource required to be transferred to settle the claim on maturity date is a share. Thus, it seems that the entity's own shares are considered as an economic resource. *The use of new terminology:* The different approaches rely on the notions of a claim an amount: • "independent of the economic resources of the entity", • "independent of the residual amount" • "solely dependent on the residual amount"

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- “completely independent nor solely dependent on the residual amount”

when determining whether a claim is a liability or equity and which subclass they belong to. Such concepts may involve significant judgement, generate confusion on which one should be used for presentation and classification purposes and may pose challenges if/when included in the Conceptual Framework (e.g. whether a claim that only arises in the case of liquidation and be dependent on the value of a property should be considered as equity).

Obligations that arise only on liquidation: the approaches Alpha and Gamma take into account whether there is an obligation to transfer economic resources before liquidation. However, it is worth noting that under the approaches Beta and Gamma it would be possible to classify obligations that arise only on liquidation as liabilities if the claim is of a fixed amount that is independent of entity’s economic resources (e.g. non-redeemable cumulative preference shares). EFRAG Secretariat also notes that for regulated financial entities, the issues are more related to “resolution” rather than “liquidation”. From this perspective, the concept of resolution may be needed to be taken into account for classification of some financial instruments (e.g. additional tier 1 instruments).

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<tr><td colspan="2">Potential improvements to presentation: subclasses of financial liabilities</td></tr>
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In **February, April and September 2016** the IASB discussed the use of **sub-classes of financial liabilities** to provide additional information that a single distinction between liabilities and equity cannot convey. In particular:

- **Scope of separate presentation:** In **April 2016** the IASB discussed the scope of the separate presentation requirements for liabilities that depend on the residual. Previous discussions had been focused on ordinary shares redeemable by the holder at fair value. However, shares redeemable at fair value are not the only types of financial liabilities that depend on a residual amount. Thus, in **April 2016** the IASB focused on standalone derivatives and hybrid instruments containing embedded derivatives. The IASB indicated that it would improve comparability to apply the separate presentation requirements to stand-alone and embedded derivatives that depend on the residual amount. However, the IASB members noted that IFRS 9 *Financial Instruments* permits entities to classify financial liabilities that include embedded derivatives in their entirety as measured at fair value through profit or loss. Consequently, the future Discussion Paper is expected to include an analysis of the interaction of the separate presentation requirements with the fair value option in IFRS 9.

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The creation of subclasses of liabilities and their separate presentation within the statement of financial position and financial performance represents a significant change to existing requirements in IAS 1 and IAS 32.

In terms of the **statement of financial position**, there would be three different types of liabilities that would be presented separately: those that depend on the residual; those that are completely independent of the residual and those that are neither completely independent nor solely dependent on the residual amount. However, EFRAG Secretariat highlights that it is not clear at this stage how separate presentation would be reflected on the face of the financial statements, particularly whether these will be, for example, reflected as subtotals within total liabilities or specific line items.

In terms of the **statement of financial performance**, the income and expenses related to changes in the carrying amount of the liabilities would

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• **Statement of financial position**: In **February 2016** the IASB discussed the presentation of liabilities with different features on the face of the statement of financial position and indicated that, under the Gamma Approach (as with the Alpha approach) it would be useful to present separately liabilities that depend on a residual amount (e.g. shares redeemable at fair value) from those liabilities that do not. Making such a distinction could help users assess the extent to which its liabilities respond to changes in its economic resources and show how resilient the entity's capital structure is to reductions in value of its economic resources. In **September 2016** the IASB discussed whether derivatives that are neither completely independent nor solely dependent on the residual amount should be presented as a separate class that would enable users to distinguish such derivatives from those that are fully independent and those that are solely dependent on the residual amount. As referred above, such derivatives would be classified as liabilities under the Gamma approach. • **Statement of financial performance:** In **February 2016** the IASB discussed the presentation of income and expense that arises from liabilities with different features. The IASB indicated that, under the Gamma approach (as with the Alpha approach), it would be useful to distinguish between income or expense that arises from liabilities for a specified amount income and expense that arises from liabilities that depend on a residual amount (e.g. shares redeemable at fair value). In **September 2016** the IASB tentatively decided that income and expenses arising from financial instruments that meet the separate presentation requirements should be presented under other comprehensive income **(OCI)**. The IASB tentatively decided that the Discussion Paper should include a preliminary view that, if the derivatives on 'own equity' that are neither completely independent nor solely dependent on the residual amount meet a particular criteria (subject to drafting but the application of the separate presentation requirements should be limited to specific types of derivatives with foreign currency exposure and only under certain circumstances), then entities should apply the separate presentation requirements to the total income and expenses arising from such derivatives. For example, income and expenses arising from fair value changes of forwards or written options on own equity with an exercise price denominated in a foreign currency (which would be classified as a liability under the Gamma approach) would be presented in OCI if such derivatives would meet certain criteria. It will also analyse an alternative approach applying the separate presentation requirements only to the portion of income and expenses that depends on the residual amount ("disaggregation approach").	be presented separately either within profit or loss or within other comprehensive income. Recognising changes in the carrying amount of a liability in OCI would solve the issue related to the counterintuitive accounting that when an entity performs well, a loss is recognised in profit or loss (e.g. shares redeemable at fair value). Nonetheless, this approach leads to creation of additional categories within OCI and the IASB will have to assess whether adding additional categories to OCI would be in line with the latest thinking developed in the Conceptual Framework. It also raises the question of whether there should be recycling or creation of a new separate components within equity for the OCI items. EFRAG Secretariat also notes that FICE project is closely linked to the Primary Financial Statements project and it is important to ensure coherence between these two projects.

Potential improvements to presentation: subclasses of equity and attribution of profit or loss and OCI to subclasses of equity	
In **February 2016** the IASB also discussed how **subclasses of equity** could help in providing additional information about the features the IASB identified as relevant. For that purpose, the IASB discussed: • whether subclasses of equity should include "ordinary shares" (the most residual claim that requires the entity to transfer economic resources only at liquidation at an amount equal to a pro-rata share of the entity's net assets on liquidation) and "senior classes of equity" or "other than the ordinary shares" (any other claim that reduces the claim of ordinary shares to the entity's net assets and is not a liability). It would include, for example, equity components of compound instruments, derivatives on own equity and non-cumulative preference shares; • whether the attribution of profit or loss and OCI should be expanded to classes of equity other than "ordinary shares" of the parent[1] to help users assess the allocation of returns amongst different classes of equity. For example, non-cumulative preference shares, derivatives on own equity and equity components of compound instruments; and • whether the carrying amount of each subclass of equity should be also updated to reflect the attribution. In that meeting the IASB members indicated that it would be useful to: • require entities to attribute profit or loss and other comprehensive income to some classes of equity other than the ordinary shares of the parent entity; and • update the carrying amount of each subclass of equity to reflect any such attribution. The IASB also observed that some of the claims that would be classified as liabilities under the Gamma approach would be classified as equity under the Alpha (e.g. share-settled debt) and Beta approaches (e.g. shares redeemable at fair value). Because of this difference, the IASB members asked the staff to explore ways to present the attribution of amounts to these classes of equity more prominently than other classes of equity. In **April and May 2016** the IASB continued to explore potential ways of providing information about classes of equity claims "other than the ordinary shares" through the attribution of profit or loss and OCI. More specifically, it discussed the attribution mechanisms for "non-derivative equity claims" (e.g. non-cumulative preference shares and participating equity instruments) and "derivative equity claims". • For **non-derivative equity claims**, the IASB discussed whether the attribution of total profit or loss and OCI to non-cumulative preference shares and participating equity	EFRAG Secretariat notes that expanding the attribution of profit or loss and OCI to classes of equity other than "ordinary shares" of the parent and updating the respective carrying amounts represents a significant change to existing requirements in IAS 1 and IAS 32 and current Conceptual Framework. *Carrying amount of each subclass of equity updated to reflect the attribution:* The IASB discussed how **subclasses of equity** could help in providing additional information about the features identified as relevant. It also discussed whether subclasses of equity should include "ordinary shares" and "senior classes of equity". These discussions are aligned with EFRAG's previous position that primary and secondary equity claims are fundamentally different. Even so, EFRAG Secretariat notes that the introduction of subclasses is not free of challenges. For example, it will create the need for new definitions and may blur the distinction between equity and liabilities. In terms of whether the attribution of profit or loss and OCI should be expanded to other subclasses of equity, EFRAG Secretariat has observed mixed views on the usefulness of attributing net income to potential ordinary shareholders (where conversion has not been exercised) and calculation of basic earnings per share. Alternatively, to help users to better assess the allocation of returns amongst different classes of equity, it was suggested that the IASB could start by improving the requirements in IAS 33 *Earnings per Share* and aligning them with the requirements in IAS 32. In terms of updating the carrying amount of these other subclasses of equity based on the attribution, in the past EFRAG supported the notion of equity as the element of the financial statements that is not directly measured. The approaches B, C and D imply that the carrying amount of senior classes of equity would be updated to reflect attribution of comprehensive income. Such an approach, while keeping the notion of equity as a residual amount, may have implications for the future Conceptual Framework in respect of addressing the direct remeasurement of the components of equity (senior classes of equity).

[1] Existing IFRS already require the attribution of profit or loss and OCI between non-controlling interests and parent equity interests.

instruments should follow the existing requirements in IAS 33 *Earnings per Share*. For non-derivative equity claims other than ordinary shares (such as non-cumulative preference shares), the IASB indicated that it would be useful, and impose little additional cost, to attribute amounts based on the existing requirements for such instruments in IAS 33 *Earnings per Share*. IAS 33 includes requirements for the adjustment of the numerator of the earnings per share calculation for the effect of distributions and participation features of such instruments. • For **derivative equity claims**, the IASB discussed four approaches (considering a simple warrant): o *No attribution for derivative equity claims* **(Approach A):** Currently profit or loss and OCI for the period are only attributable to non-controlling interests and owners of the parent. With Approach A, current requirements would be maintained and information about the effect of derivative equity claims would continue to be given through diluted earnings per share and other disclosures; o *Full fair value approach* **(Approach B):** The attribution of profit or loss and OCI to derivative equity claims would be based on changes in their fair value; o *Modified fair value approach* **(Approach C):** The attribution would be based on changes on components of recognised equity that would be calculated based on the relative fair value of derivative equity claims and other classes of equity; and o *Ordinary share equivalents approach* **(Approach D):** The attribution would be based on applying the relative average fair values of equity claims to the total profit or loss and OCI of the year. At the meeting, the IASB indicated that it would be useful for entities to provide additional information to reflect differences between derivatives classified as equity and other classes of equity through attribution. The IASB decided to include a discussion of the various approaches in a future discussion paper to obtain input regarding the potential costs and benefits of each approach.	There is also the question related to obtaining a relevant measure requirement for senior classes of equity while also reaching a meaningful attribution of comprehensive income to subclasses of equity. It seems that equity items might potentially have different measurement basis, however it is still not clear at this stage which (if any) measurement basis will be used. There is also the question related to presentation of the changes in the carrying amount of senior classes of equity. The attribution mechanism developed thus far would allocate comprehensive income to subclasses of equity. This does not mean that their remeasurement will be through comprehensive income. Furthermore, if such approaches were to be followed, the IASB would have to consider extending the scope of the project to include amendments to the requirements of IAS 33 and IAS 1 *Financial Statements Presentation.* It is however, too early to fully understand what would have to be changed in IAS 32 *Financial Instruments: Presentation* and other standards. Finally, when approaches B, C and D are applied a number of practical challenges could arise. For example, approaches C and D would be complex and costly to apply as the entity would have, for example, to calculate the fair value of its own equity instruments. On the other hand, how many classes of instruments should appear on the face of the income statement? If the approach B is applied and the change in the fair value of the warrants is higher than net result, should a negative amount would be allocated to ordinary shares?
Derivatives on own equity	
In **October 2015 and July 2016** the IASB analysed the classification of derivatives on own equity. In particular, it discussed the application of the Gamma approach to different types of derivatives, the unit of account for accounting for derivatives on own equity and whether derivatives should be split into components for classification. The IASB tentatively decided that entities should: • not classify all derivatives as assets or liabilities; and	When discussing the accounting for derivatives on own equity, the IASB considered whether it should simply classify all derivatives on own equity as assets or liabilities (a more narrow approach on equity). This is in line with the feedback that we received from some EFRAG members who see derivatives as executory contracts and not funded arrangements. The IASB considered some of the challenges of such an approach (e.g. it would be inconsistent with the classification of standalone obligations to issue a fixed number of ordinary shares as equity) and the fact that such

• classify derivatives on 'own equity' in their entirety rather than splitting them into components.
 	
Assuming this, the IASB tentatively decided that, for the Gamma approach, an entity should:
 	
• classify as **equity** derivatives for the receipt of cash or other financial assets in exchange for the delivery of equity instruments (such as a forward to sell own shares, written call option on own shares and purchase put options on own shares) if:
  o they are settled by the exchange of a fixed amount of cash or other financial assets for a fixed number of the entity's equity instruments (because they solely depend on the residual amount); and
  o they are either physically settled or net-share settled.
 	
This is because such derivatives would require no transfer of economic resources other than at liquidation and they would be claims for an amount that solely depends on the residual. All other asset/equity exchange derivatives would be classified as liabilities, including derivatives for the receipt of a variable amount of cash or other financial assets in exchange for the delivery of a fixed number of equity instruments. This is because such derivatives would either require a transfer of economic resources prior to liquidation or they would be claims for an amount that would be wholly, or partly, independent of the entity's economic resources.
 	
• classify fixed-for-fixed derivatives (either physically settled or net-share settled) that result in the exchange of a liability for the delivery of equity instruments (such as an embedded conversion option) because such derivatives would be claims for an amount that solely depends on the residual;
 	
• 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 (this applies to derivatives that extinguish equity in exchange for a claim that meets the definition of a liability such as forward to buy own shares and written put options on own shares).
 	
• reconcile the interaction of the redemption obligation requirement with the requirement that only fixed-for-fixed derivatives that exchange a liability for equity instruments are classified as equity (e.g. forward to buy own shares and written put options).
 	
• classify as assets or liabilities all other derivatives for the receipt of cash or other financial assets, or for the extinguishment of financial liabilities, in exchange for the delivery of equity instruments. This is because such derivatives would either require a transfer of economic resources prior to liquidation, or they would be claims for an amount that would be wholly, or partly, independent of the entity's economic resources.
	an approach would not meet the objectives of the Gamma approach and tentatively decided not to not classify all derivatives as assets or liabilities. Nonetheless, EFRAG Secretariat considers that it could be useful to reflect in the future Discussion Paper the discussion of whether all derivatives on own equity should be classified as assets or liabilities.
	
	When comparing the classification outcomes of the Gamma approach with IAS 32, EFRAG Secretariat highlights some of the changes that it expects for the classification of derivatives on own equity:
	
	• forwards to sell own shares, written call options on own shares and purchased put options on own share (and others derivatives for the receipt of cash or other financial assets in exchange for the delivery of equity instruments) that are **net share settled** will be **classified as equity under the Gamma** approach while they are currently **classified as liability under IAS 32**. This is because these instruments are settled by the exchange of a specified amount for a fixed number of the entity's equity instruments (solely depend on the residual amount) and are net-share settled.
	
	• forwards to sell own shares, written call options on own shares and purchased put options on own shares (and others derivatives for the receipt of cash or other financial assets in exchange for the delivery of equity instruments) that are **physically settled in a foreign currency** and meet the foreign currency rights issue exception in IAS 32 will be **classified as a liabilities under the Gamma approach** while these instruments are classified as **equity under IAS 32**. These instruments would not be classified as equity because the amount does not solely depend on the residual amount; it also depends on the foreign exchange rate. This would be a strict form of fixed-for-fixed principle and reverse the amendments issued in October 2009 on the foreign currency rights issue exception.
	
	• written put options on own shares that are physically settled in a foreign currency will be **classified entirely as a liabilities under the Gamma approach** (including option feature) while the option feature currently usually remains within equity.
	
	• the Gamma approach seems to change the existing requirements on the "reclassification from equity" and "equity component" of derivatives on own equity that represent equity/liability exchanges (e.g. change to existing requirements on written put options).

In **December 2016** the IASB discussed whether a derivative with some particular variables would be solely dependent on the residual amount. The variables discussed were the following:

- **Time value of money** – under the Gamma approach, the contractual terms that reflect compensation for the time value of money does not preclude an instrument from being considered to be solely dependent on the residual amount. However, if a variable that represents the time value of money is leveraged or not related to the derivative instrument (e.g. benchmark interest rate of an unrelated currency), the derivative will not be classified as an equity instrument;
- **Currency –** under the Gamma approach a fixed amount of cash or other financial assets refers to a fixed amount in the reporting entity's functional currency. Thus, a derivative on own equity whose exercise price is denominated in a currency other than the reporting entity's own functional currency, is considered not solely dependent on the residual amount as the foreign currency rate changes independently of the residual amount;
- **Dilution** – under the Gamma approach entities will need to determine whether anti-dilution provisions, which protects the holder of the derivative, solely depends on the residual amount. If the provision ensures the holders of the derivative have a fixed proportion of the residual amount as their share, then such a provision does not preclude equity classification. However, if the provision ensures the holders of the derivative receive shares equal to an amount independent of the economic resources of the entity or guarantees a minimum payoff of a fixed amount, then such derivatives do not solely depend on the residual amount;
- **Distributions to holders of equity instruments –** an instrument that grants compensation for missed distributions (e.g. a provision that adjusts the conversion ratio, or exercise price, to compensate the holder for missed distributions) does not preclude equity classification under the Gamma approach;
- **Variable that depends on a specific part of the residual amount** – if an instrument depends solely on the residual amount, the amount cannot be beyond the residual amount, but it can be a component of the residual amount (e.g. share of residual amount or share of its changes). A share of the residual amount could be specified with reference to the entity's recognised net assets or comprehensive income as those variables solely depend on the residual amount. The holder will share the residual amount of the issuer with other equity instrument holders. This type of variable does not preclude equity classification of the instrument.
- **Non-controlling interest –** the amount of the NCI depends on the residual amount of the subsidiary, which is part of the residual amount of the consolidated group. The amount of NCI solely depends on the residual because the amount of the NCI will

- Under the Gamma, when accounting for written put options where an entity repurchases equity instruments by transferring a variable amount of cash equal to the value of the underlying shares (e.g. fair value puts) the equity component will be nil and all of the returns on the claim will be captured by the liability component. The separate presentation requirements will apply for liabilities that solely depend on the residual amount (i.e. the returns of such claim will be recognised in OCI)

When comparing the classification outcomes of the Gamma approach with IAS 32, EFRAG Secretariat highlights some of the changes that it expects for the classification of non-derivatives:

- *Non-redeemable cumulative preference shares* will be classified as a liabilities under the Gamma approach while these instruments are classified as equity under IAS 32. This is because under the Gamma approach, the entity is not required to transfer cash before liquidation and the amount of the claim is independent of the residual amount.

The IFRS Interpretations Committee received many requests in the past for guidance on equity/liability classification when variables such as anti-dilution provisions and conversion rates that change over time is present. Therefore, EFRAG Secretariat welcomes the effort to solve the issues identified in the past by the IFRS Interpretations Committee.

Nonetheless, EFRAG Secretariat thinks that it would be useful to have further clarity on the notion of "*amount solely dependent of the residual amount*" and further test its application, understandability and consistency, particularly with instruments that have been referred to the IFRS Interpretations Committee in the past (e.g. financial instruments that are mandatorily convertible into a variable number of own shares upon a contingent non-viability event). This is because determining whether an amount is solely depend of the residual amount may require significant judgement, particularly for financial institutions which develop financial instruments that include many different features, including contingencies.

The issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency is relevant and is directly linked to the discussion on and interpretation of what is a "fixed amount of cash". As currently IAS 32 does not make a specific reference to this issue and entities have an accounting policy choice which impairs comparability, EFRAG Secretariat welcomes guidance on this topic.

depend on the available economic resources of the subsidiary. The holder of NCI and the parent entity share the residual amount of the subsidiary. For this reason, a written call option to issue a fixed number of equity instruments of a subsidiary for receipt of a fixed amount of financial assets would be considered to be solely dependent on the residual amount, and does not preclude equity classification under the Gamma approach; • **Contingency that affects the amount of a derivative** – a contract to exchange a fixed amount of cash or other financial assets for a fixed number of ordinary shares is classified as equity even if its exercise is contingent on an event beyond the control of both the entity and the counterparty (in this case, contingency does not affect the amount of the claim). However, if a contingency affects the amount of a claim, then the entity would need to determine whether the variability introduced by a contingency solely depends on the residual amount. For example, if the variability moves independently of the residual amount, then the instrument would be a liability. In **February 2017** the IASB discussed some illustrative examples to clarify how its decisions on the Gamma approach would apply to accounting within equity, including a written put on own equity and a convertible bond. The examples illustrated the following aspects of the Gamma approach: • ensures that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured. More specifically, it ensures that the accounting for a convertible bond will be similar to the accounting for a written put option on own shares that is issued together with ordinary shares. In both cases, the holder will have the option to either receive cash or shares of the entity; • the redemption amount is the present value of the strike price of the option; • the derecognition from equity is based on the fair value of the ordinary shares at the date the written put is issued; and • the equity component is the sum of the premium received and the difference between the two amounts calculated above. • presentation of gains and losses that arise from the financial liability; • attribution of profit or loss and other comprehensive income to derivative equity instruments other than ordinary shares; and • accounting for the settlement outcomes within equity. In **March 2017** the IASB discussed how the Gamma approach would apply to the classification of derivatives on non-controlling interests with an exercise price denominated in a foreign currency. In particular, the IASB considered how that classification principle applies to derivatives on subsidiaries' equity instruments with a strike price denominated in	Finally, the EFRAG Secretariat notes that the foreign currency variable is also important for the separate presentation requirements of derivatives that have been classified as liabilities. More specifically, it affects the assessment of whether income and expenses that arise from liabilities that are neither completely independent nor solely dependent of the residual amount (e.g. foreign currency denominated written call option).

the functional currency of the subsidiary which differs from the functional currency of the parent. The IASB considered that the following would be the case when applying the Gamma approach to such derivatives: • a derivative on own equity “solely depends on the residual amount” when it is a contract that is settled with a fixed amount of the entity’s functional currency; • when 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; and • when an entity issues a derivative on its own equity and functional currency (e.g. parent or its subsidiary), the classification as equity or debt does not change in the consolidated financial statements. This holds even if the consolidated financial statements are presented using another currency.	
Claims with conditional alternative liability and equity settlement outcomes	
In **February 2016** the IASB discussed the challenges in accounting for **claims with conditional alternative liability and equity settlement outcomes**. In particular, it discussed: • whether the requirements for “indirect obligations” (paragraph 20 of IAS 32), “contingent settlement alternatives” (paragraph 25 of IAS 32) and “unconditional rights to avoid a liability settlement outcome” (paragraph 19 of IAS 32) should be carried forward but updated to reflect the features used to identify a liability under approach Gamma; and • whether these requirements in IAS 32 should be aligned with the “no commercial substance” principles included in IFRS 2 *Shared-based Payment* and Conceptual Framework ED. More specifically, whether a claim with alternative settlement outcomes conditional on rights within the control of the entity is a financial liability if the equity settlement outcome has no commercial substance. Equity settlement outcomes with no commercial substance could include, for example, equity settlement outcomes for which the entity is legally prohibited from exercising, or equity settlement outcomes that are structured in such a way that their value always exceeds the liability settlement outcome. In **October 2016** the IASB continued to discuss the classification of claims with alternative settlement outcomes, particularly those that grant the entity (or issuer) the right to choose between alternative outcomes. In that meeting the IASB discussed: • whether economic incentives that may influence the entity’s decision to exercise its option should be considered when classifying claims with alternative settlement	Both the IASB and the IFRS IC have considered several times the application of IAS 32 to some types of claims with conditional alternative liability and equity settlement outcomes (e.g. financial instruments mandatorily convertible into a variable number of shares upon a contingent ‘non-viability’ event). *Alternative settlement outcomes conditional on rights within the control of the entity*: A key question is whether economic incentives should be considered when the manner of settlement is at the option of the entity. EFRAG Secretariat notes that a number of questions would arise if economic incentives were to be considered in identifying a liability. Nonetheless, EFRAG Secretariat considers that it would be important to make clear that as a first step an entity should consider whether one of the options to settle the contract has “no commercial substance” or whether there is an indirect obligation which does not permit an equity settlement. *Alternative settlement outcomes contingent on events beyond the control of both issuer and holder:* EFRAG Secretariat notes that past discussions on financial instruments that are mandatorily convertible into a variable number of share upon a contingent non-viability event focused not only on classification but also on measurement of the liability and accounting for any interest paid on the instrument. Many respondents to the IFRS

outcomes, and if so, how strong those incentives need to be to amount to economic compulsion. When discussing this issue, the IASB considered the instruments such as “callable shares”, “purchased call options”, “reverse convertible bonds”, “callable preferred shares with resets” and “cumulative preference shares”; • For “callable preferred shares with resets” and “cumulative preference shares” the IASB staff noted that under the Gamma Approach such instruments would be classified as liabilities since the claim is for a specific amount that is independent of the entity’s economic resources. Thus, there was no need to consider economic incentives or economic compulsion. • When discussing instruments such as “reverse convertible bonds” the IASB staff suggested that economic incentives should not be considered for classification purposes as such an approach would not be consistent with current IAS 32 and would raise more questions than answers. However, the IASB staff suggested maintaining the requirements in paragraph 20(b) of IAS 32 which state that a financial instrument is liability if the entity has the option to deliver cash or its own shares but the value of its own shares exceed substantially the value of the cash (i.e. the share settlement alternative is such that the entity will settle with cash). The IASB tentatively decided that, under the Gamma approach, economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a claim as either a liability or equity. Thus, under the Gamma approach, classification would be based on the substantive rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract, which is similar to the requirements in IAS 32 *Financial Instruments: Presentation.*	IC’s tentative agenda decision expressed the view that the relevant requirements in IAS 32 were unclear and asked the IFRS IC to clarify the existing requirement by taking this issue onto its agenda, improving the wording of its agenda decision or referring the issue to the IASB. Thus, we consider that it would be useful to consider any impact on measurement resulting from the new Alpha, Beta and Gamma approaches.
Contractual terms	
In **February 2017** the IASB discussed the scope of contractual rights and obligations an entity should consider when applying the Gamma approach to a financial instrument. The IASB tentatively decided to: • to require an entity to apply the Gamma approach to the contractual terms of a financial instrument consistently with IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*. • to consider whether it should take any action to address the accounting for mandatory tender offers (MTOs), including potential disclosure requirements • not to reconsider IFRIC 2 *Members’ Shares in Cooperative Entities and Similar Instruments*, given that it is not aware of any challenges to its application.	The EFRAG Secretariat notes that the interaction between ‘contractual rights and obligations’ and ‘regulatory and legal’ requirements is fundamental and considers that IFRS Standards are not consistent, or even contradictory, when dealing with these two concepts. More specifically, the EFRAG Secretariat notes that under IFRIC 2 the effects of legislative requirements are considered for classification purposes while in IAS 32 and IFRS 9 they are not. EFRAG Secretariat acknowledges that ideally there should be consistency between the different standards. Nonetheless, if effects of law were to be considered for the purposes of classifying financial instruments this would be a fundamental change to current requirements in IAS 32 and have knock-on consequences in IFRS 9. We also note that when an entity assesses the extent of its obligations based on the terms

	and conditions of a contract, that contract has to comply with relevant laws and regulations but need not include all specific conditions in laws and regulations because the law makes them a component of the contract. Therefore, EFRAG Secretariat concurs, to some extent, with the IASB tentative decision that under the Gamma approach the classification should be focused on the contractual terms of a financial instrument (consistently with IAS 32 and IFRS 9). In addition, given the narrow fact pattern to which IFRIC 2 applies and the importance of this guidance to cooperative entities, the EFRAG Secretariat supports the tentative decision of the IASB not to reconsider IFRIC 2. Considering the different approaches in IAS 32 and IFRIC 2, the IASB will need to consider whether, and if so how, IFRIC 2 will be integrated in the future revised standard. Nonetheless, EFRAG Secretariat highlights the challenges that arise from the interaction between the contractual rights and obligations and the Banking Recovery and Resolution Directive ("BRRD"). We consider that the IASB should work together with regulators to address the challenges that arise with the new BRRD, particularly when considering the role of the national resolution authorities and the possibility of capital instruments being written down or converted. We also note that a similar approach has been done in IFRS 17 *Insurance Contracts* where specific legal issues are considered in the standard.
Exception in Paragraphs 16A-16D of IAS 32 ("Puttables exception")	
In **November 2016** the IASB discussed whether the exception as set out in paragraphs 16A and 16B, or 16C and 16D, of IAS 32 *Financial Instruments: Presentation* is still needed given the classification and presentation requirements of the Gamma approach. The IASB noted that one of the objectives of the FICE project is to reinforce the underlying rationale of the distinction between liabilities and equity in IAS 32, but not to perform a fundamental review of IAS 32. The IASB was not aware of any issues with the application of the exception as set out in paragraphs 16A and 16B, or 16C and 16D, of IAS 32. The IASB also observed that applying the Gamma approach to instruments that meet the exception might address some, but not all, of the previous concerns which led to the exception. Hence, the exception might continue to be required under the Gamma approach. The IASB tentatively decided to include its discussion in the future FICE Discussion Paper.	EFRAG Secretariat considers the accounting treatment provided by paragraphs 16A to 16D of IAS 32 is still relevant and should be retained until the IASB is able to find a solution that addresses all the issues that gave rise to the exception. Still, this should not prevent the IASB from exploring improvements to the existing guidance in paragraphs 16A to 16D of IAS 32 and related disclosures.

Disclosures	
In **September 2016** the IASB discussed improvements to disclosure requirements to provide information to users that is not provided through classification and presentation improving the consistency, completeness and clarity of the requirements for derivatives on own equity. More specifically, the IASB discussed the inclusion of disclosures about financial instruments with characteristics of equity in the notes to the financial statements. It tentatively decided to include a discussion of the following potential disclosures in the forthcoming Discussion Paper: • the priority of claims on liquidation; • the potential dilution of ordinary shares; and • additional supporting information about the presentation and classification requirements of the Gamma approach.	EFRAG Secretariat discussed with users to understand their needs in terms of information about an entity's claims. Some users considered that the classification needs to be supported by suitable disclosures about the contractual terms and conditions. They also requested better disclosures about potential dilution. Some wanted more information that would help them assessing the effects of dilution resulting from instruments settled with own equity. Similarly, users considered that information about priority of claims was useful to them, although some considerations would have be taken into account in terms of the reporting entity which is being considered. EFRAG Secretariat agrees that the latest developments on additional supporting information about the presentation and classification requirements of the Gamma approach will help investors, particularly on the terms and conditions of financial instruments with characteristics of equity. Many users have also expressed in the past that they often look for information about the nature and extent of any significant restrictions of the entity's ability to transfer funds to its shareholders in the form of cash dividends or any significant restrictions of the entity's ability to repay debt. To address user's needs, it could be argued that IAS 1 could be improved to require additional disclosures about the impact of externally imposed capital requirements (e.g. those resulting from borrowing arrangements, legal/regulatory requirements or contractual arrangements) or the existence of any other significant restriction (e.g. solvency test, cash flow test, undistributable reserves etc.) on the entity's ability to transfer, in practice, funds to its shareholders and creditors. Nonetheless, the EFRAG Secretariat considers that improvements to Disclosures should not result in boilerplate disclosures that are of limited value to investors.
Interaction between the projects Conceptual Framework and FICE;	
In **October 2014**, the IASB noted the interaction between the FICE research project and the Conceptual Framework project as follows:	EFRAG Secretariat has not made, at this stage, a detailed assessment of the possible consequences of the Conceptual Framework for Financial Reporting.

• the Exposure Draft for the Conceptual Framework will propose retaining the existing definition of equity and clarifying some aspects of the definition of a liability that are not directly related to distinguishing liabilities from equity. • the proposed definitions of a liability and of equity to be included in the Exposure Draft for the Conceptual Framework will not constrain the work in the research project. Instead, the research project will consider various approaches to distinguishing between liabilities and equity, including approaches that could require changes to the definitions of a liability or of equity in the Conceptual Framework. Nevertheless, any such changes are unlikely to reverse the clarifications to be suggested in the Exposure Draft for the Conceptual Framework. In **April 2016**, the IASB discussed the interaction between the Conceptual Framework for Financial Reporting and FICE project and possible refinements to the proposals in the Exposure Draft to reduce the risk of adding to the Conceptual Framework new concepts that it may need to revisit as a result of future decisions on classification of financial instruments (e.g. “no practical ability to avoid” and the notion of “economic compulsion”). In **April 2016** the IASB tentatively decided: • not to develop concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity as part of the Conceptual Framework project; • instead, to continue to develop concepts to address those challenges in the FICE research project, acknowledging that one outcome of that project might be a need to make further amendments to the revised Conceptual Framework; • to explain this approach in the Basis for Conclusions of the revised Conceptual Framework; • to continue to develop concepts to address other problems in identifying liabilities (such as the concepts describing a ‘present obligation’ in paragraphs 4.31-4.39 of the Exposure Draft), and add those concepts to the Conceptual Framework, as part of the Conceptual Framework project; and • to consider refinements to the proposals in the Exposure Draft to reduce the risk of adding to the Conceptual Framework new concepts that the IASB may need to revisit as a result of future decisions on the classification of financial instruments. In **March 2017** the IASB discussed a summary of the potential implications of the Gamma approach for *The Conceptual Framework for Financial Reporting*. The IASB noted that some of the potential differences with the Conceptual Framework is that the Gamma approach considers:	

• one additional feature for classification purposes: whether the amount of the obligation is independent of the entity's economic resources; and • proposes separate presentation requirements for income and expenses that depend on the residual amount (i.e. use of OCI without recycling to profit or loss).	
Interaction with other IFRSs	
In March 2017 the IASB discussed a summary of the potential implications of the Gamma approach for other IFRS Standards, IFRIC Interpretations and other projects on its agenda. The IASB considered the following: • **IFRS 2 *Share-based payments*** – at present, the distinction between liabilities and equity under IFRS 2 is consistent with the revised Conceptual Framework (but not with IAS 32). If the IASB ultimately proposes changes to the Conceptual Framework as a result of the FICE project, the IASB would need to consider the implications for a future revision of IFRS 2 (e.g. whether the separate presentation and the attribution approach should also be applied to shared-based payment transactions); • **IFRS 3 *Business Combinations*, IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*** - questions have arisen in the past about the lack of consistency between the requirements in these standards and IAS 32, in particular for NCI puts. The IASB's discussions on the Gamma approach could help clarify the interaction between IAS 32 and these standards; • **IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 *Financial Instruments*** – if the IASB decides to add a project to amend or replace IAS 32, there will be likely consequential amendments to other IFRSs focused on financial instruments such as IFRS 9 and IFRS 7. One are of interaction is the application of the separate presentation requirements to stand-alone and embedded derivative financial liabilities that depend on the residual amount; • **IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*** - in February 2016, the IASB tentatively decided that it would not reconsider the requirements of IFRIC 2 other than for consequential amendments; • **IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*** – as the interpretation does not address classification issues but rather addresses the recognition and measurement of liabilities as a result of settling the liability by issuing equity instruments, it is beyond the scope of the project; • **IAS 1 *Presentation of Financial Statements*** - the effect of the Gamma approach on the different classes of equity and liabilities and separate presentation requirements may have a significant impact on the presentation of financial statements. In particular, it	EFRAG Secretariat has not made, at this stage, a detailed assessment of the possible consequences for other IFRS Standards and IFRIC Interpretations. Nonetheless, considering the level of changes that the FICE project will propose on the classification, presentation and disclosure requirements for financial instruments, the project is likely to have a pervasive effect on particularly IAS 1, IFRS 2, IFRS 7, IAS 32 and IAS 33.

could have an impact on the Principles of Disclosures project, the Primary Financial Statements project and IAS 1; and • **IAS 33 *Earnings per Share*** - if the IASB proceeds with an approach that attributes total profit or loss and OCI to derivatives classified as equity and requires separate presentation requirements (i.e. use of OCI), then it may consider the implications of the attributions and separate presentation requirements for the earnings per share calculation (basic and diluted). For example, the additional use of OCI and attribution approach will have impact on the calculation of EPS.	