EFRAG
European Financial Reporting Advisory Group

EFRAG TEG meeting
21 September 2017
Paper 09.02
EFRAG staff: Filipe Alves,
Joachim Jacobs

EFRAG Secretariat assessment of how the Gamma approach addresses the issues that arise in practice.

Issues that arise in practice	How the Gamma approach addresses these issues
Application of the fixed for fixed condition **Issue:** diversity in practice and requests for guidance on the application of the fixed-for-fixed condition (***IFRS IC January 2010***). In particular, the accounting for: • **foreign currency instruments**: derivatives contracts that may be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency (e.g. convertible debt denominated in a foreign currency), including the foreign currency rights issue exception (***IFRS IC June/September 2005***); • **foreign currency instruments exchangeable into equity instruments of other entities of the group**: for example financial instruments issued by a subsidiary that provide holders with the rights to exchange a fixed number of equity instruments of the parent of the issuer at a fixed amount of currency (***IFRS IC November 2006***); • **features that cause variability on the amount of financial instruments, such as anti-dilution provisions, conversion features that may be adjusted on settlement date, conversion features that depend on a contingency and conversion features that are linked to net profit, EBITDA or other.** This would include financial instruments that are	The Gamma approach clarifies that the underlying principle of the fixed-for-fixed condition is that to be classified as equity, a derivative must be, in its entirety, "solely dependent on the residual amount". The Gamma approach is also expected to provide additional guidance on some features that cause variability to the amount of the claim. For example, for foreign currency instruments**,** the Gamma approach clarifies that: • a derivative "solely depends on the residual amount" when it is a contract that is settled by exchanging a fixed amount of own shares for 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. This means that forwards to sell own shares, written call options on own shares and purchased put options on own shares (and others derivatives for the receipt

Issues that arise in practice	How the Gamma approach addresses these issues
mandatorily convertible into a variable number of shares subject to a cap and a floor **(*IFRS IC May 2014*)**; financial instruments which conversion ratio may be adjusted to consider payment of dividends; anti-dilution provisions; and financial instruments that are mandatorily convertible into a variable number of shares, subject to a cap and floor, but gives the issuer the option to settle by delivering the maximum fixed number of shares **(*IFRS IC January 2014*)**. As these features cause variability, questions arise on the fixed-for-fixed condition.	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 liabilities under the Gamma approach while these instruments are classified as equity under IAS 32. Under the Gamma approach, these instruments are not classified as equity because the amount of the claim does not solely depend on the residual amount. The Gamma approach is also expected to provide guidance on the variability introduced by the time value of money, anti-dilution provisions, contingencies, distributions to shareholders, non-controlling interest and conversion features that are linked to net profit, EBITDA or other elements of the financial statements. For example, a conversion obligation to deliver a variable number of own equity instruments to equal a fixed amount of cash, subject to a cap and a floor. Such a conversion obligation is not an equity instrument because the amount changes in response to an amount independent of the economic resources of the entity under one possible settlement outcome.
Exception for puttable financial instruments and obligations arising on liquidation **Issue:** inconsistent application of the existing definition of liability in IAS 32 and Conceptual Framework and the puttable amendments have been criticised for being rules-based and difficult to apply (***IFRS IC November 2013 and March 2009***). The IFRS IC has also considered a request for clarification on guidance relating to the classification of puttable financial instruments that include contractual obligations to provide pro rata distributions. The request observed such obligations were often included within the terms of income trust units that are redeemable on demand by the holder (**IFRS IC 2010**).	The IASB discussed whether the exception as set out in paragraphs 16A and 16B, or 16C and 16D, of IAS 32 is still needed given the classification and presentation requirements of the Gamma approach. Currently, the IASB is not aware of any issues with the application of the exception. 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. Under the Gamma approach, the separate presentation requirements will apply for liabilities that solely depend on the residual amount. Thus, if a puttable financial instrument that includes a contractual obligation to provide pro rata distributions is classified as a liability, an entity will have to assess whether separate presentation requirements (in other comprehensive income) will apply.

Issues that arise in practice	How the Gamma approach addresses these issues
Mandatory Tender Offers **Issue:** whether a liability should be recognised for a Mandatory Tender Offer (MTO) required by law at the date the acquirer obtains control of the acquiree (***IFRS IC November 2012***).	For classification purposes, under the Gamma approach an entity will only consider the contractual terms of a financial instrument (i.e. it does not consider the effects of law). This is consistent with the current financial instruments literature in IFRS Standards, particularly with IAS 32 and IFRS 9 (except for IFRIC 2 which is considered to be very narrow in scope and where no challenges have been identified in its application guidance). As a result, in accordance with IAS 32 and the Gamma approach, MTOs will not be accounted for similarly to written put options, which would have been desirable given their similar economic consequences. The IASB will consider in the future whether it should take any action to address the accounting for MTOs. The DP is expected to mention this issue, including potential disclosures on this area and reference to current requirements in IAS 32 and IFRS 9, which are focused on the rights and obligations that arise from contracts.
Accounting for forward purchase contracts and written put options on an issuer's equity instruments that require physical settlement in exchange for cash **Issue:** challenges for forward purchase contracts and written put options on an issuer's equity instruments that require physical settlement in exchange for cash typically relate to whether the redemption requirement meets the definition of a financial liability. This is particularly the case if the redemption price is equal to the value of the underlying share.	Under the Gamma approach, a derivative that extinguishes equity in exchange for a claim (e.g. written put option) and meets the definition of a liability gives rise to a financial liability for the present value of the redemption amount. Thus, under the Gamma approach entities will continue to apply a requirement similar to the existing redemption obligation requirement in paragraph 23 of IAS 32. The Gamma approach is only expected to clarify that this accounting treatment ensures that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured. More specifically, it will ensure 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 requirement should also apply to 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). If the derivative requires the entity to transfer economic resources other than at liquidation, then it is a liability under the Gamma approach (this would result in the shares being, in substance shares redeemable at fair value). 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

Issues that arise in practice	How the Gamma approach addresses these issues
	the residual amount. Thus, the returns of such claim will be presented in other comprehensive income (OCI).
Accounting for written put options and forward contracts on non-controlling interests **Issue:** diversity in practice on the accounting for written put options and forwards on non-controlling interests (***IFRS IC November 2006***), in particular, on: • **initial recognition:** IAS 32 does not state clearly whether the contra to the liability recognised for the put option is a derecognition of NCI or a general reduction in equity (alongside NCI). There was also the question of whether the parent recognises a financial liability for the present value of the option exercise price (on a gross basis) or a derivative liability (on a net basis at fair value). • **subsequent measurement:** some believe that changes in the measurement of the financial liability should be recognised in profit or loss while others believe that these changes should be recognised directly in equity. There have also been requests for clarification around puts and forwards held by non-controlling interests that expire unexercised. There is also the issue of how an entity accounts for a written put option over non-controlling interests in its consolidated financial statements when the NCI put has a strike price that will, or may, be settled by the exchange of a variable number of the parent's own equity instruments. The question relates to whether the parent should account for the NCI put as a financial liability for the present value of the option's strike price on a gross basis, or as a derivative liability on a net basis (***IFRS IC November 2016***).	Under the Gamma approach, an entity that issues a fixed-for-fixed written put option (or forward contract to buy own shares) recognises a liability for the present value of the strike price. The Gamma approach clarifies that this will ensure 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. The Gamma approach is also expected to provide additional guidance on the accounting within equity, particularly around derecognition/reclassification of the equity as a result of the recognition of the redemption amount. In particular, at initial recognition: • 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. On subsequent measurement of the liability component, if the redemption amount (i.e. present value of the strike price) is fixed, then the gains or losses that arise from the financial liability component are presented in profit or loss. However, if the NCI put is a fair value put, then the NCI equity component will be nil and all of the returns on the claim will be captured by the liability component. As the amount of the claim solely depends on the residual amount, then the separate presentation requirements will apply and the gains and losses that arise from the liability are presented in OCI. The equity component is potentially remeasured over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns, and it is a transfer within equity. At maturity the carrying amount of the equity component is transferred to ordinary shares. If the put option expires unexercised, then the carrying amount of the redemption amount would be reclassified to NCI shares.

Issues that arise in practice	How the Gamma approach addresses these issues
	For variable share settled puts, if the amount of shares to be delivered is determined by a fixed amount independent of the entity's economic resources, then the obligation is a liability under the Gamma approach.
Accounting for financial instruments in which the manner of settlement is conditional on rights within the control of the entity **Issue:** notwithstanding the stated right of the entity to choose between alternative settlement outcomes in such claims, challenges include determining whether the claim, in substance, establishes an obligation that would meet the definition of a liability: • as a result of economic compulsion (e.g. callable preferred shares with dividend resets and reverse convertible bond) (***IFRS IC March 2006*** *and* ***November 2006***); • indirectly through its terms and conditions; ***(IFRS IC September 2013);*** or • barriers to the entity exercising the equity settlement outcome, such as regulatory or legal requirements.	Under the Gamma approach, economic incentives/compulsion that might influence the issuer's decision to exercise its rights should not be considered for classification purposes. 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. Under the Gamma approach, obligations for a specified amount will be classified as liability regardless of whether the manner of settlement is at the option of the entity. This would include callable preferred shares with dividend resets, which would be classified as liabilities under the Gamma approach without the need to consider economic compulsion. Under the Gamma approach, claims which grant the entity the unconditional right to avoid transferring cash until liquidation and to settle the claim at an amount that is solely dependent of the entity's economic resources are classified as equity. This would include reverse convertible bonds, which would be classified as equity under the Gamma approach. Finally, the Gamma approach is likely to clarify that a claim with alternative settlement outcomes conditional on rights within the control of the entity may be classified as a financial liability if the equity settlement outcome has no commercial substance. This would include, for example, equity settlement outcomes for which the entity is legally prohibited from exercising and equity settlement outcomes that are structured in such a way that their value always exceeds the liability settlement outcome.
Accounting for financial instruments in which the manner of settlement is contingent on events beyond the control of the entity and the counterparty **Issue**: there have been questions about how IAS 32 applies to features that are contingent on events beyond the control of the entity and the counterparty. Some have commented that it can be difficult to distinguish events that are within the control of the issuer, from those that are beyond their control. For example:	The requirements in IAS 32 on the unconditional right to avoid delivering cash (paragraph 19 of IAS 32) and contingent settlement provisions (paragraph 25 of IAS 32) are expected to be carried forward under the Gamma approach. However, these requirements may be updated to reflect the features used to identify a liability under approach Gamma. The Gamma approach also clarifies that:

Issues that arise in practice	How the Gamma approach addresses these issues
• NCI puts where the share is puttable in the event of death of the holder; • instruments that require cash settlement or redemption in the event of a change in control; • instruments that require cash settlement or redemption in the event a future transaction with the entity occurs (such as an initial public offering); • ordinary share conversion 'ratchets' which require the delivery of a variable number of ordinary shares on conversion of a bond or preference share, if the share price is lower than a specified amount.	• a contract to exchange a fixed amount of cash for a fixed number of ordinary shares is classified as equity even if its exercise is contingent on events beyond the control of both the entity and the counterparty; • a contract for a specified amount to be settled either by transferring cash, or by transferring a variable number of shares equal to a specified amount of cash or financial assets, is classified as a liability regardless of whether the alternative settlement outcome is contingent on events beyond the control of both the entity and the counterparty; • 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 contingency has the effect of varying the amount of cash or varying the number of equity instruments in a way that would not depend on the residual amount, then the instrument is a liability; and • an equity component would only be recognised if the contingent conversion option is solely dependent on the residual amount (e.g. contingent convertible bond where the contingency is related only to the conversion feature).
Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event **Issue**: whether instruments that do not have a stated maturity date but are mandatorily convertible into a variable number of shares if the issuer breaches the Tier 1 Capital ratio meet the definition of a financial liability in its entirety or must be classified as a compound instrument (comprised of a liability component and an equity component related to the issuer's discretion to pay interest). In addition, there have been questions on how the liability should be measured ***(IFRS IC January 2014)***. Similar challenges for classification of such contingently convertible instruments may arise from additional features such as caps or floors on the number of shares to be delivered or denomination in foreign currency. Additional Tier 1 capital instruments may also, upon a trigger event, be written down on a permanent or temporary basis. The permanent write-down could imply that they are actually subordinated even to the claims of shareholders since they absorb losses before the shareholder in a going concern.	For classification purposes, under the Gamma approach an entity will only consider the contractual terms of a financial instrument (i.e. does not consider the effects of law). Consequently, any contingent equity conversion feature that results from a national authority's power derived from legislation will not be considered by the issuer for classification purposes and an entity will only consider contingencies reflected in the contract. If the law has no effect on a contingent convertible (i.e. it is contractually contingent convertible), then applying the Gamma approach would result in it being classified as a financial liability in its entirety. An equity component would only be recognised if the contingent conversion option is solely dependent on the residual amount. The IASB has not specifically discussed the issue related to measurement of such instruments or derivatives that may be written down on a permanent or temporary basis. It is worth noticing that under the Gamma approach 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

Issues that arise in practice	How the Gamma approach addresses these issues
Conversion or write-down a central element of the "bail-in" mechanism established by Directive 2014/59/EU (Bank Recovery and Resolution Directive). It applies to a wide range of liabilities at a point of non-viability decided by regulatory authorities.	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.
Payments at the ultimate discretion of the issuer's shareholders **Issue**: diversity in assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer's shareholders, and consequently whether a financial instrument should be classified as a financial liability or equity. Rights to declare dividends and redeem capital may depend on the decision made in a general shareholders' meeting, therefore the role of shareholders may be critical in deciding whether the entity has an unconditional right to avoid delivering cash. There are mixed views on this issue. Some take the view that if shareholders make decisions as part of the corporate governance decision-making process of the entity (generally exercised in a general meeting) this means that the entity has an unconditional right to avoid payment of cash and financial instruments such as preference shares should be classified as equity. However, there are others who believe that the actions of ordinary shareholders are not part of the entity's decision-making process and are outside the control of the issuing entity ***(IFRS IC March 2010).***	The IASB has not specifically addressed this issue in the FICE project, even though there were some brief discussions on voting rights.
Inconsistency in the accounting of derivatives in IAS 32 and IFRS 2 **Issue:** the classification of financial instrument differs between IFRS 2 *Share-based Payments* and IAS 32: • In IFRS 2, obligations to deliver equity instruments prior to liquidation are classified as equity if certain conditions are met. Thus, if the entity has an obligation to deliver a variable number of equity instruments equal to a specified amount (i.e. if it uses its own shares as 'currency' to settle the instrument) it will be classified as equity under IFRS 2 while it is a liability under IAS 32. • obligations to transfer cash or other assets [prior to liquidation] are liabilities under IFRS 2. However, IAS 32 includes a limited-scope exception from the definition of a liability for some puttable instruments that represent a residual interest in the entity.	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 share-based payment transactions). For example, the separate presentation requirements for both liabilities and equity under the Gamma approach might be relevant to addressing some of the concerns that have been identified with IFRS 2. One of those challenges is that IFRS 2 uses two measurement models: grant date fair value for equity-settled share-based payments and reporting date fair value for cash-settled share-based payments. The separate presentation requirements under the Gamma approach might open up some possibilities for reducing the tension between the two measurement models in IFRS 2. If the Gamma approach proceeds with an attribution model of total profit or loss and other comprehensive income to

Issues that arise in practice	How the Gamma approach addresses these issues
	derivatives classified as equity, it would need to consider consequences for equity-settled share based payments.
Requirements which lead to financial reporting that is counter-intuitive **Issue**: Many have considered that the current requirements lead to financial reporting that is counter-intuitive for a number of instruments such as: • puttable shares; • derivatives over own equity including NCI Puts; • perpetual instruments that entitle holders to discretionary payments that are fixed or determinable; or • instruments that require an entity to distribute an amount based on a proportion of profit or loss. *(EFRAG Comment letter to IASB Discussion Paper* Review of the Conceptual Framework for Financial Reporting*)*	Under the Gamma approach there will be subclasses of liabilities to which separate presentation requirements will apply. The income and expenses arising from financial instruments that meet the separate presentation requirements should be presented under OCI. More specifically: • income and expenses that arise from liabilities that do not depend on the residual amount would be presented in profit or loss (e.g. interest and dividends on cumulative preference shares); • income and expenses that arise from liabilities that solely depend on the residual amount would be presented in OCI (e.g. shares redeemable at fair value); and • income and expenses that arise from liabilities that are neither completely independent nor solely dependent of the residual amount will be separately presented in OCI if a specific criterion is met (e.g. foreign currency denominated written call option), which is likely to be limited to specific types of derivatives with foreign currency exposure and only under certain circumstances.
Other issues A number of other issues were raised by respondents to the Discussion Paper on the Conceptual Framework for the IASB to consider within the context of amending or developing standards, including: • Significant differences between equity and liability classification in terms of presentation and measurement; • disclosures for equity instruments; • other depictions of the effects of dilution (e.g. earnings per share); • accounting for compound instruments; • accounting for remote events; • hedge accounting for equity instruments (particularly if they are directly measured);	The creation of subclasses of liabilities and equity and their separate presentation within the statement of financial position and statement of financial performance represents a significant change to existing presentation requirements in IAS 1 and IAS 32. The creation of subclasses of equity and liabilities aims to address the difficulties that arise from using a binary distinction between claims to depict a wide range of claims with various features and the polarised financial reporting effects of classifying those claims as either liabilities or equity. The creation of subclasses will also impact the measurement of equity instruments and classes of equity "other than ordinary shares" are potentially remeasured over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns, and it is a transfer within equity. In terms of disclosures, the IASB discussed improvements to disclosure requirements to provide information to users on the priority of claims on liquidation, the potential dilution of ordinary shares and additional disclosures to

Issues that arise in practice	How the Gamma approach addresses these issues
• instruments that are issued by limited-life entities; or • classification of discretionary payments made on instruments which are wholly classified as liabilities; • own shares that are held for trading purposes (***IFRS IC August 2002)***	assist users in understanding the timing and amount of financial instruments classified as equity and liabilities under the Gamma approach (e.g. for each group of financial instruments classified as derivative equity claims, entities would have to disclose the fair value of the group of financial instruments). On the other topics, the Gamma approach is not expected to be significantly different from current IAS 32.