Financial Instruments with Characteristics of Equity
Potential practical implications of the new approach

Objective

1 The objective of this session is to discuss with the EFRAG CFSS and TEG members the illustrative examples developed by the IASB Staff and the potential practical implications of the Gamma approach that will be included in the forthcoming Discussion Paper on the *Financial Instruments with Characteristics of Equity* ("FICE") research project.

Potential practical implications of the new approach being developed

2 The Gamma approach classifies 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. All other claims will be classified as liabilities.

3 The IASB has been discussing the application of the Gamma approach to different types of financial instruments, including derivatives on own equity. In its discussions, the IASB has 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 *Financial Instruments: Presentation* and not to perform a fundamental review of IAS 32 (i.e. not to start from a blank sheet of paper). However, they also noted that the requirements in IAS 32 may need to be updated to reflect the features used under the Gamma approach and this may lead to some classification changes.

4 To illustrate the potential practical implications of the Gamma approach, in agenda paper 07 - 03 the IASB applied it to a number of financial instruments and compared the outcome with the IAS 32. A summary of that analysis is included in the table below:

Instrument	Gamma	IAS 32
Foreign currency denominated written option Receive a fixed amount of foreign currency units equal to strike price (e.g FCU 100) in exchange for delivering a fixed number of own shares (e.g. 100).	**LIABILITY** *Settlement prior to liquidation and amount partly independent of the entity's economic resources (due to foreign currency effects)* Income and expenses that arise from changes in the carrying amount of the liability are separately presented in OCI if certain criteria is met. Otherwise, they are presented in profit or loss. (criteria to be developed and no decision on recycling).	**EQUITY OR LIABILITY** It is classified as liabilities unless it meets the foreign currency rights issue exception in paragraph 16 of IAS 32. If classified as liability, income and expenses that arise from changes in the carrying amount of the liability are presented in profit or loss.
Foreign currency denominated convertible bond The counterparty has the right to elect to receive a fixed number of ordinary shares of the entity, in lieu of the payment of an amount in a foreign currency.	**LIABILITY** *Amount partly independent of the entity's economic resources (due to foreign currency effects)* The whole convertible bond, including the **conversion option**, would be classified as a liability in its entirety as the amount is independent of the entity's economic resources (i.e. not solely dependent on the residual). Income and expenses that arise from changes in the carrying amount are separately presented in OCI if certain criteria is met. Otherwise, they are presented in profit or loss.	**LIABILITY** The whole convertible bond, including the conversion option, is classified as a liability in its entirety. The obligation to pay cash would be a liability. The conversion option would also be a liability as it relates to an exchange of a variable amount of cash for a fixed amount of shares.
Shares redeemable for their fair value Obligation to redeem the shares at fair value in cash on demand of the holder and assuming that it does not meet the puttable instruments exception in IAS 32.	**LIABILITY** *Settlement prior to liquidation* Income and expenses that arise from changes in the carrying amount of the liability are separately presented in OCI as the liability dependents solely on the residual amount (no decision on recycling).	**LIABILITY** *Meets the definition of liability.* Contractual obligation to redeem the shares for cash. Income and expenses that arise from changes in the carrying amount of the liability are presented in profit or loss.

Instrument	Gamma	IAS 32
Written put option on own shares (gross physical settlement) Requires the entity to redeem a fixed number of own shares in exchange for a fixed amount of cash which is exercisable by the holder.	**LIABILITY and EQUITY leg** Gamma approach is similar to IAS 32. Apply redemption requirements in IAS 32. Income and expenses that arise from changes in the carrying amount of the liability are presented in profit or loss. Accounting within equity to be discussed in future meeting.	**LIABILITY and EQUITY leg** The option feature meets the definition of equity. However, an entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount. Questions around subsequent measurement and the accounting within equity.
Non-redeemable cumulative preference shares Instrument that requires the entity to pay interest per annum on a fixed principal amount, however the entity has the right to defer payments indefinitely. Any payments deferred are compounded over time.	**LIABILITY** *Amount independent of the entity's economic resources* Income and expenses that arise from changes in the carrying amount of the liability are presented in profit or loss. Separate presentation in the statement of financial position to signal that these liabilities have a low order of liquidity.	**EQUITY** Equity if they are non-redeemable and the payment is at the ultimate discretion of the issuer's shareholders because the entity has the unconditional right to avoid transferring cash or another financial asset. Otherwise it is a liability.

EFRAG Secretariat analysis

5 EFRAG Secretariat considers that these examples are useful to understand the potential practical implications of the Gamma approach that will be included in a future Discussion Paper.

6 However, EFRAG Secretariat considers that it would be useful to have an example which would illustrate the potential practical implications of the Gamma approach on the face of the statement of financial performance and statements of financial position.

7 In addition, we consider that it would be useful to encompass financial instruments that would be classified as equity under the Gamma approach to better understand the presentation, measurement and attribution of profit or loss and OCI requirements related to derivatives on own equity in the statement of financial performance and statement of financial position.

Questions for EFRAG TEG members

8 Do EFRAG CFSS and TEG members **consider that the examples demonstrate the application of the approach to be included in the Discussion Paper?**

9 Do EFRAG CFSS members have any other suggestions to make the examples more useful?