

## STAFF PAPER

September 2016

## IASB Meeting

<b>Project</b>	<b>Financial Instruments with Characteristics of Equity research project</b>		
<b>Paper topic</b>	Presentation: Derivatives classified as liabilities		
<b>CONTACT(S)</b>	Uni Choi	uchoi@ifrs.org	+44207246 6933
	Manuel Kapsis	mkapsis@ifrg.org	+44207246 6459

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® Update.

## Introduction

1. As discussed at the IASB Board meeting in July 2016, the presentation of derivatives on ‘own equity’ classified as liabilities is an important consideration in assessing the application of the Gamma approach to derivatives on own equity. Presentation of financial instruments with characteristics of equity, including how their effects on profit or loss are driven by changes in the residual amount, has been one of the main practical challenges with respect to IAS 32 *Financial Instruments: Presentation*. As we have learned, during our journey of re-defining the distinction between liabilities and equity, a single-dimensional distinction through classification only, does not adequately address all the challenges and information needs of users of the financial statements.
2. In this paper, we build on the classification of derivatives on own equity under the Gamma approach as discussed in July 2016 ([Agenda papers 5C](#) and [5D](#)). We explore a number of alternative ways of providing better information to the users about particular types of derivatives on ‘own equity’ using presentation. The proposals in this paper are intended to complete the discussion of applying the Gamma approach to derivatives on ‘own equity’ and presents the proposals as a whole. We ask the Board whether it agrees that the Gamma approach including the separate presentation requirements, as developed to date, should be proposed in the future Discussion Paper.

3. The Board has also not yet made a decision on whether the separate presentation requirement should mean separate presentation within profit or loss (e.g. using sub-totals) or separate presentation of some income and expenses in other comprehensive income. Having completed discussion of the separate presentations for the financial instruments with characteristics of equity that are classified as liabilities, including derivatives on ‘own equity’, at the end of this paper, we will ask the Board whether the Board would like to include a preliminary view in the Discussion Paper.
4. To date, with respect to the separate presentation requirements for liabilities under the Gamma approach, the Board has decided that:
  - (a) income and expenses that arise from liabilities that solely depend on the residual amount should be separately presented, which we will refer to as ‘the separate presentation requirement’ in this paper ([Agenda paper 5A, February 2016](#));
  - (b) under the Gamma approach the following will be separately presented in the statement of financial position:
    - (i) liabilities that solely depend on the residual amount such as shares redeemable at fair value; and
    - (ii) liabilities that do not require a transfer of economic resources until liquidation such as cumulative preference shares ([Agenda paper 5A, February 2016](#)); and
  - (c) The separate presentation requirement should be applied to standalone derivatives and embedded derivatives that are separated out from their host instruments ([Agenda paper 5A, April 2016](#)).

### Structure of this paper

5. This paper is structured as follows:
  - (a) Scope of this paper (paragraphs 6–9)
  - (b) Separation presentation: financial performance (paragraph 10)
    - Disaggregation approach (paragraphs 11–13)

- All-in or all-out approach (paragraph 14)
- Defining the all-in or all-out criteria (paragraphs 15–34)
- (c) Illustration of approaches using a foreign currency denominated written call option (paragraphs 35–45)
- (d) Application to embedded derivatives (paragraphs 46–47)
- (e) Separate presentation: financial position (paragraphs 48–52)
- (f) Comparison between disaggregation approach and all-in or all-out approach (paragraphs 53–57)
- (g) Summary and questions for the Board (paragraphs 61–70)
- (h) Separate presentation within profit or loss, or using other comprehensive income? (paragraphs 64–70)

**The scope of this paper: what particular types of derivatives are we focusing on?**

6. Under the Gamma approach, which uses two features (settlement terms and the value dependency on the residual amount) to determine the classification, the following classifications of derivatives on ‘own equity’ would be possible:
- (a) derivatives classified as equity instruments. For a derivative to be classified as equity under the Gamma approach they will have to require settlement in ‘own equity’ (gross settlement or net-share settlement) and their value has to be solely dependent on the residual amount.
  - (b) derivatives classified as liabilities. These will include:
    - (i) derivatives whose value is solely dependent on the residual amount but will be net-settled in cash or financial assets other than ‘own equity’, such as cash-settled share conversion options issued in functional currency.
    - (ii) derivatives whose value is completely independent of the residual amount regardless of the form of settlement (whether it is in cash or in own equity shares) such as

derivatives to exchange a variable number of own shares for another financial asset.

- (iii) derivatives whose value is neither completely independent nor solely dependent on the residual amount. The value of such derivatives partly depends on the residual amount and partly depends on other variable(s) that are independent of the residual amount such as a foreign currency denominated rights issue or a conversion option embedded in a foreign currency convertible bond. This type of derivatives includes both, those that can be net-cash settled or those that are settled in own equity.

7. In February 2016 ([Agenda paper 5A](#)), the Board agreed that, under the Gamma approach (as with the Alpha approach), it would be useful to distinguish between:
- (a) liabilities and associated income or expense of the liabilities that are independent of the residual amount; and
  - (b) those that depend on the residual amount.

The discussion at that time focused on one specific example, shares redeemable at fair value.

8. In April 2016 ([Agenda Paper 5A](#)), the Board continued their discussion on the separate presentation requirements, where the Board indicated that the separate presentation requirements should apply to derivatives classified as liabilities. The Board has, to date, discussed the application of those requirements to some, but not all, derivatives, which would result in the separate presentation requirements:
- (a) applying to the derivatives in paragraph 6(b)(i), ie those that are solely dependent on the residual amount.
  - (b) not applying to the derivatives in paragraph 6(b)(ii), ie those that are completely independent of the residual amount.

9. This paper completes the Board's discussion of the application of the separate presentation requirements to derivatives classified as liabilities by focussing on the derivatives described in paragraph 6(b)(iii), ie those whose value is neither completely independent nor solely dependent on the entity's residual amount of

economic resources. In July 2016, the Board decided that such derivatives are classified as liabilities under the Gamma approach ([Agenda papers 5C](#) and [5D](#)).

### **Separate presentation: financial performance**

10. We set out below two alternative approaches to separate presentation for the derivatives that are within the scope of this paper:
  - (a) Disaggregation approach; and
  - (b) All-in or all-out approach.

#### ***Disaggregation approach***

11. The disaggregation approach disaggregates, for presentation purposes, the total income and expenses of a derivative that is neither completely independent nor solely dependent on the residual amount into:
  - (a) income and expenses arising from a variable(s) of a derivative that are independent of the residual amount of an entity; and
  - (b) those arising from the variables that represent the residual amount, i.e. the portion of income and expenses that solely depends on the residual amount.
12. The portion of income and expenses arising from changes in the residual amount is separately presented, for example in other comprehensive income, whereas the balance is presented as part of the entity's performance, i.e. in profit or loss.
13. For example, let's say an entity has written an option on 'own equity' with an exercise price denominated in a currency other than its functional currency. The income and expenses arising from changes in variables that depend on the residual amount, e.g. share price and share price volatility, are presented separately from the rest. Later in this paper, we will explore how an entity might perform the disaggregation in more detail using illustrative examples.

***All-in or all-out approach***

14. Under the all-in or all-out approach, the income and expenses arising from the derivatives within the scope of this paper will or will not, be presented separately depending on whether or not the derivative meets some specific criteria. We will devote the next part of this paper to explore potential ways of defining such ‘all-in or all-out criteria’, which would require separate presentation of all income and expenses arising from such derivatives if the criteria are met.

***Defining the all-in or all-out criteria***

15. The objective of the separate presentation requirement is to allow the users of the financial statements to distinguish income and expenses that arise from liabilities that depend on the residual amount from those that arise from liabilities that are independent of the entity’s residual amount. In defining the all-in or all-out criteria we should bear in mind that the criteria should result in presentation outcome that is useful to the users in meeting their information needs without compromising understandability.
16. Two notable risks associated with defining the criteria are that:
- (a) If the criteria are too complicated then they might undermine the understandability of the information and will not ultimately meet the objective of providing useful information to the users of the financial statements. This complexity results in difficulty for users to interpret the information and increases the cost for preparers to provide the information.
  - (b) The all-in or all-out approach could lead to structuring opportunities. For example, at one extreme, if they merely require the inclusion of any ‘own equity’ exposure; an entity could avoid presenting the income and expenses arising from unrelated exposures in profit or loss. The all-in or all-out criteria therefore need to be sufficiently stringent to mitigate such risk. This rationale is similar to that for the embedded derivatives’

‘closely related’ requirements<sup>1</sup>, which aim to prevent entities circumventing the recognition and measurement requirements for derivatives by embedding a derivative in a non-derivative contract.

17. Given the objectives and risks described above, one possible way to define the all-in or all-out criteria is to use existing criteria as a basis; such as the ‘closely related’ assessment that is used for embedded derivatives. So, if an independent variable(s) (i.e. the variable(s) that caused liability classification of the entire derivative that would have otherwise been equity) meet the all-in or all-out criteria, the separate presentation requirement applies to the total income and expenses arising from the derivative. For example, for a fixed-for-fixed written call option on own equity that would have been classified as equity had the exercise price not been denominated in a foreign currency, the variabilities resulting from foreign currency exposure will be subject to the assessment based on the all-in or all-out criteria.
18. In order to define the all-in or all-out criteria, we examine some of the examples of closely related economic characteristics provided by paragraph B4.3.8 of IFRS 9<sup>2</sup> and consider whether they are applicable to the derivatives that are neither completely independent nor solely dependent on the residual amount. We identified the following:
  - (a) Interest rate/index that can change the amount of interest payable on the host provided it is not leveraged. See paragraphs 21-25 for further discussion relating to interest rate exposure; and
  - (b) Foreign currency subject to further conditions. We will explore this further in paragraphs 26-32.
19. Other examples of closely related economic characteristics and risks such as prepayment features in a principal-only or interest-only strip, unit-linking features where the unit-denominated payments are measured at the current fair value of the fund’s net assets and other lease or insurance contract related examples do not appear to be relevant to derivatives on ‘own equity’ as these examples relate to the

---

<sup>1</sup> Paragraph 4.3.3 of IFRS 9. See Appendix A for extracts of relevant paragraphs from IFRS 9.

<sup>2</sup> See Appendix A for extracts of relevant paragraphs from IFRS 9.

types of contracts that are so specific that the application to derivatives on ‘own equity’ will not be meaningful.

20. IFRS 9<sup>3</sup> also provides examples of economic characteristics and risks that are *not* closely related to the host contract. We have also examined the list of examples to determine whether any of them may be relevant to our analysis, and have not identified any further types of variables that are relevant to, and appropriate for the separate presentation requirements of derivatives on ‘own equity’. These included exposures to commodity or equity indices (for the purposes of this paper, equity indices other than own equity), credit derivatives and any type of leveraged exposure.

#### *Consideration of variability created by interest rate exposure*

21. Let’s consider an example of a convertible bond where the bond pays interest of Libor + 3% and the number of equity shares deliverable upon conversion is fixed. One may argue there is variability in the amount receivable due to an indexation to an independent variable, Libor. If the conversion occurs prior to the maturity of the bond, the amount of the bond could vary depending on the timing of conversion due to changes in Libor.
22. If the specified amount of the liability extinguished on conversion is not fixed, the conversion option would be classified as liability under the Gamma approach.
23. In the staff’s view, variation due to changes in interest rates that represents compensation for time value of money should not preclude equity classification when we apply the Gamma approach. This is because the exposure to interest rate variability cannot be avoided in any derivative because the definition of derivative includes settlement at a future date. An interest rate, that represents time value of money, is intrinsic in all variables including a variable that is solely dependent on the residual amount, e.g. share price. For fixed contractual amounts, either the amount will be specified at a future date, which would then be discounted to a

---

<sup>3</sup> Paragraph B4.3.5 of IFRS 9. Please see Appendix A for extract.



present value, or the amount will be specified at a present date together with an interest rate that will compensate for the changes in the time value of money<sup>4</sup>.

24. On the other hand, if a derivative has interest rate exposure that is leveraged, similar to how a leveraged interest rate derivative is considered not closely related to the host instrument under IFRS 9<sup>5</sup>, such an interest rate exposure would not meet the all-in or all-out criteria<sup>6</sup>. This is because the leverage introduces risks other than compensation for the time value of money. Therefore, no separate presentation requirement would apply and all income and expenses arising from such a derivative would be presented in profit or loss together with other similar exposures. This is similar to the IFRS 9 requirements for classification of financial assets, which permits financial assets to be classified as subsequently measured at amortised cost if the contractual cash flow characteristics of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. Under the requirements in IFRS 9, the contractual cash flows would still meet the solely payments of principal and interest criteria if they vary with changes in the benchmark interest rate, and they would not meet those criteria if they are leveraged, or vary due to changes in, a commodity index or equity index, for example.
25. Based on the above we will not discuss interest rate further in defining the all-in or all-out criteria. Also, we note that the application of the rationale discussed in this section would not result in classification or presentation outcomes that are dissimilar from those under IAS 32.

---

<sup>4</sup> Similarly, paragraph 22 of IAS 32, in describing the ‘fixed-for-fixed’ condition uses the term ‘fixed stated principal amount’ for a bond. It also states that particular variability in the fair value arising from market interest rates do not preclude equity classification

...For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity’s shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument...

We are aware that there are some practical challenges that arise from the application of fixed-for-fixed. We plan to consider them in our future staff paper along with other practical application issues.

<sup>5</sup> Paragraph B4.3.8 of IFRS 9. Please see Appendix A for extract.

<sup>6</sup> A derivative, by its definition, would always include leveraged return and risk. By ‘leveraged interest rate exposure’, we mean additional leverage that is introduced by indexation to a particular interest rate exposure which would have not existed in the derivative without the interest rate indexation.

*Consideration of variability created by foreign currency denomination*

26. In relation to embedded foreign currency derivatives, paragraph B4.3.8 (d) of IFRS 9 states that:

...An embedded foreign currency derivative is closely fa related to the host contract provided it is not leveraged, does not contain an option feature and requires payments/receipts denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

27. Although the above paragraph relates to a host contract that is a non-financial instrument or an insurance contract, some of the rationale appear relevant to some derivatives on 'own equity' that are classified as liabilities due to the foreign currency denomination. As noted in paragraph 16(b), our objective of setting the all-in or all-out criteria includes mitigating the risk of structuring opportunities for 'hiding' the effects of unrelated exposure through merely including 'own equity' exposure. We are aware that some entities enter into derivatives on 'own equity' that are denominated in a foreign currency as they are not able to do the same in their own functional currency. For example, an entity may find that there is no market for convertible bonds that deals with issuances in the entity's functional currency. The entity then issues a convertible bond in US dollars, not because they want the US dollar exposure but because a convertible bonds market in the entity's own functional currency does not exist. The foreign currency exposure is incidental to the issue of a convertible bond rather than a result of the entity's

choice. On the other hand, the exposure would have the same effect on the entity regardless of the circumstances in which the entity entered into the transaction.

28. We have considered whether it is appropriate to treat foreign currency exposures differently from other types of exposures. Foreign currency exposures are accounted for differently in a number of ways<sup>7</sup>:
- (a) There is an accounting standard that deals specifically with the effect of changes in foreign exchange rates, IAS 21 *The effects of changes in Foreign Exchange Rates*. Among other things, IAS 21 requires presentation of foreign exchange gains or losses outside profit or loss for non-monetary items whose gains or losses are recognised in other comprehensive income.
  - (b) The effect of changes in foreign exchange rates is presented separately in the statement of cash flows in accordance with paragraph 28 of IAS 7.
  - (c) IAS 39 makes an exception for foreign currency risk for a number of requirements relating to hedge accounting, e.g. designation as a hedged item, and allowing the use of a non-derivative financial instrument as a hedging instrument for foreign currency risk.

*Summary and conclusion on defining the all-in or all-out criteria*

29. We propose that separate presentation requirements apply to income and expenses of a derivative that is neither completely independent nor solely dependent on the residual amount if it meets the following criteria:
- (a) the derivative would have been considered as solely dependent on the residual amount, had it not been denominated in a currency other than the issuer<sup>8</sup>'s functional currency;
  - (b) the foreign currency exposure is not leveraged<sup>9</sup>;

---

<sup>7</sup> See Appendix B for extracts from the relevant standards.

<sup>8</sup> The issuer here means the party whose own equity is used as the underlying of the derivative.

<sup>9</sup> A derivative, by its definition, would always include leveraged return and risk. By 'leveraged foreign currency exposure', we mean additional leverage that is introduced by the indexation to foreign currency exposure.

- (c) the foreign currency exposure does not contain an option feature, i.e. a party to the contract does not have an option to choose which currency to deliver or receive the amount due under the derivative contract; and
  - (d) the foreign currency denomination is imposed by market rather than as a result of the entity's choice, i.e. it would not have been practically possible for the entity to enter into the same derivative contract denominated in its functional currency and the foreign currency is one of the currencies used for the type of derivative contract in a market that the entity has access to.
30. Circumstances may change over the life of the derivative. Similar to embedded derivatives assessment, we propose that the above assessment is done at initial recognition and not reassessed subsequently unless there is a significant change in the relevant contractual terms, in which case reassessment is required. This requirement is particularly relevant when the result of the above assessment could change due to changes in market conditions, e.g. the condition in paragraph 29(d). One of the objectives of restricting the separate presentation to specific cases is to avoid entities circumventing 'normal' presentation in profit or loss by including 'own equity' exposure. Changes in external circumstances are not ways to circumvent the requirement. Also, reassessment could be onerous because frequent monitoring might be required.
31. One may ask what distinguishes 'foreign currency' from other types of exposures such as commodity. In this regard, the fact that the foreign currency denomination is imposed by the market rather than a result of the entity's choice may be a more relevant factor than the foreign currency itself. For instance, if for some reason a commodity index is commonly used to denominate a type of derivative contract in the market that the entity has access to, then perhaps the rationale for the all-in criteria could be extended to this type of contract. Or, perhaps it could be argued that, if such a case would exist, the commodity<sup>10</sup> is acting as a foreign currency (a not-so-far-fetched example could be gold).

---

<sup>10</sup> We observe some precious metal indices such as gold and silver are included in the foreign currency exchange rates quotes. The ISO 4217, the International Standard for currency codes, includes codes for gold, silver, platinum and palladium, which are denoted as XAU, XAG, XPT and XPD respectively.

32. Based on the analysis above, we propose that the all-in or all-out criteria be limited to the foreign currency exposure that meets all of the conditions described in paragraph 29.

### ***Other criteria we considered***

33. In defining the potential all-out criteria, we have considered other provisions in IFRS that allow or require separate presentation of financial instruments to determine whether we could use them as a starting point. These include:
- (a) ‘accounting mismatch’ criteria of determining whether separate presentation is required for changes in the fair value attributable to changes in the credit risk of financial liabilities designated at fair value through profit or loss under IFRS 9<sup>11</sup>; and
  - (b) qualifying hedging relationship under IAS 39 and IFRS 9<sup>12</sup>.
34. However, the objectives of such provisions, as summarised in the footnotes, are different from that of the separate presentation requirement for derivatives that are neither completely independent nor solely dependent on the residual amount, which attempts to help the users distinguish the liabilities whose value is dependent on the residual amount, from the other liabilities. For this reason, we will not further explore these alternatives in this paper.

### **Illustration of approaches using a foreign currency denominated written call option**

35. We illustrate the disaggregation approach and all-in or all-out approach using an example of a foreign currency denominated written call option.

---

<sup>11</sup> As noted in paragraph BCZ5.37 of IFRS 9 basis of conclusion, the presentation of the effect of changes in a liability’s credit risk in other comprehensive income would create or enlarge an accounting mismatch if an entity holds large portfolios of financial assets that are measured at fair value through profit or loss and there is an economic relationship between changes in the fair value of those assets and the effects of changes in the credit risk of the financial liabilities designated under the fair value option.

<sup>12</sup> As noted in paragraph 6.1.1 of IFRS 9, the objective of hedge accounting is to represent, in the financial statements, the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income).

36. An entity has issued 1000 units of call options to receive a fixed amount of cash in a foreign currency (FCU10) in exchange for delivery of one ordinary share issued by the entity. The options are share-settled on a gross basis. The derivative does not meet the fixed-for-fixed condition due to the variability in the cash receipt leg introduced by foreign currency exposure, and for that reason is classified as liability under the Gamma approach. The following fact pattern applies:

*Table 1*

	<b>Year 0</b>	<b>Year 1</b>
<i>Number of options</i>	1,000	1,000
<i>Terms of options</i>	5 years	4 years
<i>Exercise price in foreign currency</i>	FCU10	FCU10
<i>Exchange rate</i>	1:1	1:1.10
<i>Exercise price in functional currency</i>	CU10	CU9.09
<i>Share price</i>	CU10	CU12

### ***Disaggregation approach***

37. Applying the disaggregation approach, we would disaggregate changes in the carrying amount that depends on the residual variables from those that are independent of the residual variables. In practice, the disaggregation of income and expenses this way is likely to be much more complicated due to interdependency of variables, for example, between foreign currency exchange rate and interest rate of that currency, and the correlation between the foreign currency and share price volatility. In our illustration below, we assumed that the same time value of money will apply to the functional currency and foreign currency which is unlikely in practice.

- (a) Step 1: Identify the variables that are independent of the residual amount. In this example, had the exercise price of the options not been denominated in a foreign currency, they would have considered to be

solely dependent on the residual amount. Based on the variables identified in the table above, independent variables are foreign exchange (FX) rate and the associated FX volatility.

- (b) Step 2: Calculate the full fair value of the derivative at issuance (year 0), using the variables shown in table 1 above<sup>13</sup>. The fair value of the options at year 0 is CU2,280.
- (c) Step 3: Calculate the full fair value of the derivative at year 1, using the variables shown in table 1 above. The fair value of the options at year 1 is CU4,680. Total changes in the fair value is CU2,400. By ‘full fair value’, we mean the fair value of derivatives as defined by IFRS 13 *Fair Value Measurement*, which would be applicable to all derivatives within the scope of IFRS 9.

Table 2

	CU
<b>Step 2</b>	
<i>Fair value of the option at year 0</i>	2,280
<b>Step 3</b>	
<i>Fair value of the option at year 1</i>	4,680
<i>Total changes in the fair value</i>	2,400

- (d) Step 4: Calculate the value of the derivative again but this time we will do so while assuming no change in the FX rate and FX volatility since the inception of the options. So, at the end of year 1, we calculate the value of the options using the FX rate of 1:1 and FX volatility as they were as at year 0. The option value at year 1 is calculated as CU4,080. Based on this calculation, the value of the options has increased by CU1,800.

<sup>13</sup> In practice, option premium would represent the fair value at initial recognition and no separate computation of the fair value may be necessary.

There are other ways to try to isolate the effect of changes in the residual amount which may lead to different figures. They are all likely to have challenges which we discuss in paragraphs 39-43.

Table 3

	CU
<b>Step 2-3</b>	
<i>Fair value of the options at year 0</i>	2,280
<i>Fair value of the options at year 1</i>	4,680
<i>Total changes in the fair value</i>	2,400
<b>Step 4</b>	
<i>Value of the options at year 1 holding FX rate and FX volatility constant</i>	4,080
<i>Value changes excluding the effect of changes in FX variables (CU4,080-CU2,280)</i>	1,800

- (e) Step 5: The changes excluding the effect of changes in the variables that are independent of the residual amount are presumed to be the changes arising from changes in the residual amount. CU1,800 is presented separately from the rest of profit or loss, for example, in other comprehensive income, while the difference between the two calculated values of CU600 (CU2,400-CU1,800) is presented in profit or loss.

Table 4

	CU
<b>Total fair value changes</b>	2,400
<b>Changes arising from the independent variables</b>	600



(presented in profit or loss)

<b>Changes excluding those arising from independent variables (CU2,400-CU600)</b> <b>(separately presented, e.g. in OCI)</b>	1,800
---	-------

*Would the result differ if we try to isolate changes in the fair value resulting from variables that depend on the residual amount?*

38. We have repeated step 4 above, but this time without the variation resulting from the variables that depend on the residual amount. We will do so by calculating the value of the derivatives while assuming no change in the share price and share price volatility since the inception of the options, i.e. share price of CU10 would be used for valuation of the options as at year 1. Again, there are a number of issues doing the calculation this way which we discuss in paragraphs (39-43). The results are as follows:

*Table 5*

	CU
<b><i>Step 2-3 of the initial calculation</i></b>	
<i>Fair value of the options at year 0</i>	2,280
<i>Fair value of the options at year 1</i>	4,680
<i>Total changes in the fair value</i>	2,400
<b><i>Step 4</i></b>	
<i>Fair value of the options at year 1 holding share price and share price volatility constant</i>	2,850
<b><i>Changes in the fair value excluding those arising from</i></b>	<b>570</b>

***changes in the residual amount (CU2,850-CU2,280)***

Table 6

	CU
<b>Total fair value changes</b>	2,400
<b>Changes arising from the independent variables (presented in profit or loss)</b>	570
<b>Changes excluding those arising from independent variables (CU2,400-CU600) (separately presented, e.g. in OCI)</b>	1,830

*Why do the two methods result in different answers? What does the difference of CU30 represent?*

39. By applying the disaggregation approach, we have attempted to separate the options into:
- (a) a functional currency written call option on ‘own equity’; and
  - (b) a foreign exchange option contract.
40. However, if we examine the rights and obligations arising from the foreign currency written call option in our example, the variables are interdependent. Because of this interdependency, the calculations we have performed in Step 4 of paragraph 37(d), which ‘freeze’ the foreign currency rate and associated volatility (or in the alternative calculation the share price and associated volatility), cannot isolate and capture the changes in a single variable. Freezing the FX rate and FX volatility of a foreign currency denominated option does not make the option the same as an option in functional currency. This is because the volatility that is priced into the functional currency option would be different to that priced into the functional currency. Whichever way the disaggregation calculation is performed

will lead to some anomaly. However, this is hidden by the method because any residual change is deemed to arise from other variables. The significance of the anomaly will change depending on the assumptions. The interdependency is taken into account in the fair value of the foreign currency written call option, but is lost if we try to isolate the effect of one, or the other variable.

41. As we have said in paragraph 37, there are some variables that are not completely independent, nor solely dependent on the residual amount such as the correlation between the stock price and FX. Using the illustrative example above, we have tried to disaggregate changes in the fair value into fair value changes resulting from individual variables. However, as the illustration demonstrates the disaggregation of fair value changes into individual variable level is not always sufficient due to their interdependency.
42. What this means is that calculating the fair value by assuming some variables are constant results in numbers that do not represent the contract as a whole. Not only are the calculations costly to perform, but it would also be difficult for users to interpret the results. Also, because of various different methods that can be used, it could lead to a lack of comparability, which makes the interpretation of results more challenging.
43. In fact, these difficulties are part of the reason why we think that bifurcating standalone derivatives for classification purposes is problematic.

### ***All-in or all-out approach***

44. Under this approach, we assess whether all income and expenses should be separately presented in their entirety based on the nature of the variable that is independent of the entity. Similar to disaggregation approach our assessment will focus on the variables that have triggered the liability classification of an otherwise equity instrument.
  - (a) Step 1: Identify the independent variable, foreign currency rate and FX volatility in this case. Had the exercise price of the options not been denominated in the foreign currency, they would have been considered to be solely dependent on the residual amount.

- (b) Step 2: Assess whether they meet the criteria set out in paragraph 29 of this paper. Based on the fact pattern above, we know that the exercise price is denominated in one currency and the holder of the option does not have an option to choose in which currency to pay the exercise price. The entity assesses whether the foreign currency element is not leveraged and determines whether it is the currency imposed by market rather than the entity's choice.
- (c) Step 3: If all-in or all-out criteria are met, the entire change in the carrying amount, CU2,400 as calculated above, is separately presented, e.g. in other comprehensive income.

Table 6

		<b>Presented in Profit or loss</b>	<b>Separately presented, e.g. in OCI</b>
<b><i>Total fair value changes</i></b>	CU2,400	-	CU2,400

45. If the derivative had other types of independent variables, for example a commodity index (that is not used as a currency), then the derivative would not meet the all-in or all-out criteria. No separate presentation requirement would apply and all income and expenses arising from the derivative will be presented in profit or loss.

### Application to embedded derivatives

46. For ease of illustration, we have limited our examples to standalone derivatives as the relevant analysis determining equity/liability classification and separate presentation would consistently apply to embedded derivatives once they are separated out from the host contract. For contracts with embedded derivatives that are dependent on the residual amount, convertible bonds for example, the following assessments are required to determine the classification, measurement basis and presentation:

- (a) firstly, determine whether to bifurcate the embedded derivative, the share conversion option in our example, from its host contract based on the ‘closely related’ assessment in accordance with IFRS 9;
- (b) secondly, determine the classification of the derivative that has been separated by applying the Gamma approach. Let’s say the share conversion option, if exercised by the bondholder, will require a conversion of the bond into a fixed number of shares, and the bond is denominated in a currency other than a functional currency of the issuer. The option is share-settled on a gross basis but because of the variability introduced by the foreign currency, the option is classified as a liability under the Gamma approach.
- (c) thirdly, if the derivative is classified as liability in the second step, determine whether the derivative has any dependency on the residual amount. The share conversion option, as it requires delivery of a fixed number of shares, depends on the residual amount, but because of the foreign currency variability, which is a variable independent of the issuing entity, the option is neither completely independent nor solely dependent on the residual amount and
- (d) finally if the derivative partially depends on the residual amount, whether the income and expenses arising from the derivative should be presented separately using either the disaggregation or the all-in or all-out approach. The steps shown in our illustrative example will apply in a similar way.

47. An alternative accounting available for the issuing entity is designating the whole convertible bond as measured at fair value through profit or loss in the step in paragraph 46(a) above. When the Board discussed the scope of the separate presentation requirements for liabilities that depend on the residual in April 2016 ([Agenda Paper 5A](#)), the Board 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 Board noted that IFRS 9 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 will include an analysis of the interaction of the separate presentation requirements with the fair value option in IFRS 9.

### Separate presentation: financial position

48. In July 2015 ([Agenda Paper 5A](#)) and February 2016 ([Agenda Paper 5A](#)), we identified the following assessments of financial position that would be useful to the users of the financial statements:

**Assessment A:** For this assessment, users need information about the required timing of the transfer of economic resources to settle the claim. This will help them assess its future economic resource needs, and whether the entity is expected to have the economic resources required to meet its obligations as and when they fall due. If the timing of transfer of economic resources is other than at liquidation, then the amount and type of economic resources required will be relevant.

**Assessment B:** For this assessment, users need information about the amount of economic resources required to settle the claim. This will help them assess whether the entity has sufficient economic resources to satisfy the total claims against it. If the amount of the obligation is independent of the availability of the entity's actual economic resources, the priority of the claim on liquidation will also be relevant. This will help a user assess how any potential shortfall will be distributed amongst claims.

49. With respect to the assessment A, the Board agreed with the staff's preliminary view that no additional requirements for subclasses or subtotals in the statement of financial position are necessary on the basis that IAS 1 requires disclosure of the timing of the settlement through the current and non-current or the order of liquidity presentation. In addition, IFRS 7 requires disclosure of a maturity analysis for financial liabilities.
50. With respect to the assessment B, the Board agreed with the staff's preliminary view that it would be useful under the Gamma approach to present on the statement of financial position the liabilities that depend on the entity's residual

amount separately from those liabilities for an amount that is independent of the residual amount. Based on this decision, we could extend the application of the disaggregation approach or the all-in or all-out approach to the presentation of the carrying amount of derivatives on ‘own equity’ in the statement of financial position.

51. Applying the disaggregation approach on a consistent basis between the statement of financial position and statement of financial performance would result in the disaggregation of the carrying amount of a single derivative instrument into two portions: the portion of the carrying amount that is independent of the entity’s economic resources and the portion that depends on the residual amount. This means, for derivatives with non-zero fair value at initial recognition such as options, the option premium will need to be disaggregated. This is likely to be arbitrary, if possible to be done. For the same reasons why we have rejected the classification of a derivative into the sub-components, we do not propose we apply the separate presentation of a derivative’s carrying amount into sub-components. However, without the application of the separate presentation to the carrying amount as well as income and expenses, the benefit of the disaggregation is reduced as it only provides part of the complete set of information.
52. If we were to apply the all-in or all-out approach, we would be presenting the whole carrying amount of a single derivative instrument without further split. The derivatives that are neither completely independent nor solely dependent on the residual amount could be presented as a separate class enabling the users to distinguish such derivatives separately from those that are fully independent and those that are solely dependent on the residual amount.

### **Comparison of the disaggregation approach and all-in or all-out approach**

53. The disaggregation approach as a concept may be an ideal approach in terms of showing the portion of income and expenses that is relevant to an entity’s performance in profit or loss while the portion that depends on residual amount is separately presented.
54. However, challenges exist with respect to:

- (a) practical difficulty to disaggregate the income and expenses accurately due to the interdependency of the variables that affect the value of derivatives as we have seen in the illustrative example. If such a separation were possible to a sufficient degree of accuracy, some may argue that classifying sub-components of derivatives separately as liability and equity would be the most accurate depiction of the characteristics of this type of instruments. As demonstrated in the illustration, the separation of income and expenses attributable to an independent amount involved lengthy and complicated steps even when we have ignored the interdependency between some of the variables.
- (b) conceptual challenges about what the calculated amounts represent. Because of the interdependency of the variables, and the interdependency of the rights and obligations (obligations under an option is only triggered when the right under the option is exercised), any simplified method to isolate the effect will be subject to challenges. This results in amounts that do not completely reflect the changes that occurred, and also the amounts calculated for each component will be dependent on the methodology adopted for the computations. For these reasons, we also did not propose bifurcating derivatives for the purpose of classification.
- (c) inconsistency in the unit of account between classification, where a derivative is not split into subcomponents, and presentation. This could result in increased complexity and reduced understandability.

55. The all-in or all-out approach has the following benefits when compared with the disaggregation approach.

- (a) There is no need for disaggregation of income and expenses, or of the carrying amount, therefore the amounts represent the effects of all the variables in the contract, including interdependencies.
- (b) It is more consistent with the unit of account used for the presentation of other derivatives under IFRS 9.



- (c) It is expected to be less complex than the disaggregation approach both in terms of implementation effort by preparers and understandability from the users' perspective.
56. However, the all-in or all-out approach is not free from challenges. Under the all-in or all-out approach, some changes that do not depend on the residual amount, which is therefore relevant for assessing the entity's performance, will sometimes be presented separately. However, the risk is mitigated by the stringent definition of the all-in or all-out criteria that allow the presentation, say in other comprehensive income, only in limited circumstances. On the other hand, stringent criteria mean that, failing the criteria, some income and expenses that do depend on the residual amount are presented in profit or loss, perhaps more often than they would have with more lenient criteria. Also, the criteria might be considered as rule-based.
57. Both disaggregation approaches and all-in or all-out approaches have their advantages and disadvantages. However, in the staff's view, the all-in or all-out approach achieves the objective of the separate presentation requirement better than the disaggregation approach.

***Why don't we consider applying the approaches to classification instead of presentation?***

58. One of the main objectives of the FICE project is to set out the principle that will provide a consistent classification framework. Application of either of the above approaches to classification will create exceptions and inconsistency in the classification principles that we have established under the Gamma approach. For this reason, we propose that the approaches are applied to presentation rather than classification. This way classification is still based on a consistent set of principles while we use the presentation requirements to complement the information needs that are not met by classification.
59. Furthermore, by classifying all derivatives on 'own equity' as liabilities unless they meet both of the two conditions under the Gamma approach, the economic effects are fully measured and accounted for. This is in contrast with the existing foreign currency rights issue exception, which classifies some foreign currency

derivatives as liabilities, and others as equity, with the equity classified derivatives not being measured.

60. Also, it is worth noting that separate classification, i.e. componentisation approach, was explored previously as part of the Reassessed-Expected Outcome model but was not pursued due to operational difficulty, as well as conceptual challenges as to whether the resulting subcomponents would meet the definition of assets, liabilities and equity. This challenge is particularly prominent for derivatives whose rights and obligation are interdependent.

### **Summary and questions for the Board**

61. Based on the analysis detailed in this paper and in the staff's view, the future Discussion Paper should include the following proposal with respect to the separate presentation requirement.
62. All income and expenses of a derivative that is neither completely independent nor solely dependent on the residual amount apply the separate presentation requirements if it meets all of the following criteria:
- (a) The derivative would have been considered to be solely dependent on the residual amount had it not been denominated in a currency other than the issuer's functional currency;
  - (b) The foreign currency exposure is not leveraged;
  - (c) The foreign currency element does not contain an option feature, i.e. a party to the contract does not have an option to choose which currency to deliver or receive the amount due under the derivative contract; and
  - (d) The foreign currency denomination is imposed by market rather than by the entity's choice, i.e. it would not have been practically possible for the entity to enter into the same derivative contract denominated in its functional currency and the foreign currency is one of the currencies used for the type of derivative contract in a market that the entity has access to.

In all other cases, all income and expenses of such derivatives are presented in profit or loss without separate presentation.

63. For presentation in the statement of financial position, the application of the all-in or all-out approach would mean the carrying amount of a derivative that is neither completely independent nor solely dependent on the residual amount will be presented separately. We propose such derivatives to be presented as a separate class from those that are completely independent and from those that are solely dependent on the residual amount.

#### **Question 1—Separate presentation requirement**

- (a) With respect to derivatives on 'own equity' that are neither completely independent nor solely dependent on residual amount, does the Board agree with the staff's view that the all-in or all-out approach is proposed in the future Discussion paper?
- (b) With respect to determining the all-in or all-in or all-out criteria, does the Board agree that they should be limited to foreign exchange variability that meets the criteria specified in paragraph 29 and as repeated in paragraph 62 of this paper?

#### **Question 2—the Gamma approach for derivatives on 'own equity'**

Based on the discussion set out in this paper with respect to how the proposed separate presentation requirement complements the classification outcome under the Gamma approach, does the Board agree with the application of the Gamma approach to derivatives on 'own equity'?

### **Separate presentation within profit or loss, or using other comprehensive income?**

64. In this paper, we have referred to the use of other comprehensive income for the application of the separate presentation requirement. However, the Board has not yet made a decision on whether the separate presentation requirement should

mean separate presentation within profit or loss using a sub-total, or separate presentation in other comprehensive income.

65. The Board held a preliminary discussion of the advantages and disadvantages of both approaches in February 2016 ([Agenda Paper 5A](#)). We reproduce a summary of those advantages and disadvantages below.
66. For applying the separate presentation requirement within profit or loss:
- (a) The advantage is that it is consistent with the default requirement for income and expenses.
  - (b) The disadvantages are that:
    - (i) including income and expense that depends on the residual within profit or loss may not adequately distinguish them from other incomes and expense for the purpose of assessing whether the entity has produced a sufficient return on its economic resources to satisfy the promised returns on claims against it. It might be difficult for a user to understand the relationship between, and disentangle, those various aspects of performance.
    - (ii) we have not identified a particular assessment of an entity's financial performance, for which it would be relevant to include all those different components of income and expenses together.
    - (iii) income and expense that depends on the residual amount means that it depends on any unrecognised changes in economic resources and claims, and other recognised changes presented in other comprehensive income. Therefore, presenting income and expenses that depend on the residual amount in profit or loss will result in accounting mismatches and may appear counterintuitive. This may not enhance the relevance of profit or loss as the primary and most inclusive source of information about an entity's financial performance.
67. For applying the separate presentation requirement using OCI:
- (a) The advantages are that:
    - (i) it will clearly separate out income and expenses that would be useful for separately assessing to what extent the entity has

produced a return sufficient to meet its promised returns, and to assess how any surplus or deficit is allocated amongst claims.

- (ii) it will enhance the relevance of profit or loss because it avoids apparent anomalies that would arise if income and expense is presented in profit or loss without recognising changes in the unrecognised economic resources and claims that it depends on.
- (iii) the income and expense that depends on the residual is similar to changes in own credit risk, therefore it should be presented similarly.
- (iv) it will alleviate some of the issues in paragraph 66(b)(iii) while not diminishing the usefulness of using a current measure to provide information about the entity's financial position (in particular relating to its liquidity for instruments such as shares redeemable at fair value). This would be as opposed to alleviating the issues in paragraph 66(b)(iii) by either not using a current measurement of the liability, or classifying the claim as equity, which may not provide useful information about the entity's financial position.

(b) The disadvantages are that:

- (i) it will use OCI for a new type of income or expense. While, in our view, the rationale is similar to changes in own credit risk, it is still expanding the use of other comprehensive income.
- (ii) entities may try to structure claims to meet the description of this new class in order to avoid reporting changes in the carrying amount of claims within profit or loss.

68. In that February 2016 paper ([Agenda Paper 5A](#)) we also discussed, for the approach that uses other comprehensive income, whether income and expense that depends on the residual should be reclassified to profit or loss. In our view, amounts presented in other comprehensive income should not be reclassified to profit or loss because the nature of that income and expense will not be different in the future, (ie it will not become a promised return by the act of settlement of the claim), therefore it will not be relevant to that assessment at some future time to reclassify that income and expense to profit or loss.

69. Our preliminary view in February 2016, based on the advantages and disadvantages of each approach, was to use other comprehensive income for the separate presentation requirements. At that meeting, the Board did not form a preliminary view, partly because it had not yet considered whether, and to what extent, the separate presentation requirements would apply to derivatives that depend on the residual amount.
70. The future discussion paper will include a discussion of both separate presentation within profit or loss, and separate presentation in other comprehensive income. Given that we have now considered the application of the separate presentation requirements to derivatives that are solely, and partially, dependent on the residual amount, we ask the Board whether it would like to include a preliminary view as to its preferred approach in the Discussion Paper.

**Question 3—separate presentation with profit or loss, or between profit or loss and other comprehensive income**

Does the Board want to include a preliminary view in the Discussion Paper as to whether the separate presentation requirements will apply within profit or loss (using a subtotal), or using other comprehensive income?

## Appendix A - Summary of relevant requirements relating to embedded derivatives under IFRS 9 [paraphrased]

- A1. Paragraph 4.3.3 of IFRS 9 requires a separation of an embedded derivative from the host if, and only if:
- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host...
- A2. Paragraph B4.3.5 of IFRS 9 provides examples of the economic characteristics and risks of an embedded derivative that are not closely related to the host contract:
- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index...
  - (b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension...
  - (c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed of the value of equity instruments...because the risks inherent in the host and the embedded derivative are dissimilar.
  - (d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract...
  - (e) A call, put, or prepayment option embedded in a host debt contract or an insurance contract is not closely related to the host contract unless...[the exercise price is approximately equal to the amortised cost of the host on each exercise date] or [the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract]...
  - (f) Credit derivatives that are embedded in a host debt instrument...

- A3. Paragraph B4.3.8 of IFRS 9 provides examples of the economic characteristics and risks of an embedded derivative that are closely related to the host contract:
- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract...unless...the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return...and a rate of return that is at least twice what the market return...
  - (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract...provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged...[Similarly, a cap and a floor in a contract to purchase or sell an asset if both of them are out of the money at inception and not leveraged]
  - (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (for example, a dual currency bond)... Such a derivative is not separated from the host instrument because IAS 21 *The effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
  - (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
    - (i) the functional currency of any substantial party to that contract;
    - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely



- denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
- (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- (e) An embedded prepayment option in an interest-only or principal-only strip... provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
- (f) An embedded derivative in a host lease contract...if the embedded derivative is (i) an inflation-related index..., (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.
- (g) A unit-linking feature embedded in a host financial instrument or host insurance contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund...
- (h) A derivative embedded in an insurance contract...if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately...

## Appendix B - Summary of example requirements applicable to foreign currency risk

- B1. Paragraph 80 of IAS 39: ... As an exception, the foreign currency risk of an intragroup monetary item may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21. In accordance with IAS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.
- B2. Paragraph 82 of IAS 39: If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks...
- B3. Paragraph 72 of IAS 39: ...a non-derivative financial assets or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.