

STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity		
Paper topic	Applying Gamma to asset/equity exchange derivatives		
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Introduction

1. In Agenda Paper 5B, the staff recommend that the Gamma approach should classify derivatives on own equity in their entirety.
2. The objective of this paper is to:
 - (a) explore how the Gamma approach could be applied to classify asset/equity exchange derivatives in their entirety.
 - (b) discuss possible ways of addressing the challenges that arise.
3. This paper is structured as follows:
 - (a) Background
 - (b) Instruments classified as equity under the Gamma approach
 - (c) Instruments classified as liabilities under the Gamma approach
 - (d) Instruments that present challenges for the Gamma approach
 - (e) Summary and questions for the Board
 - (f) Appendix A—Summary of staff’s analysis of classification under Gamma

Background

Summary of the Gamma approach

4. As we note in Agenda Paper 5B, the Gamma approach, as developed to date, tells us whether one of the underlying legs might be equity or not. However, if the Gamma approach will classify derivatives in their entirety, then we need to consider how the Gamma approach would apply when considering both legs of derivative contracts.
5. Under the Gamma approach, a liability includes an obligation:
 - (a) to transfer economic resources at particular points in time other than at liquidation or
 - (b) for a specified amount independent of the economic resources of the entity.
6. All other claims will be classified as equity. This means that instruments classified as equity:
 - (a) do not require transfer of economic resources prior to liquidation; and
 - (b) are an obligation for an amount that depends on the residual amount.
7. Based on paragraph 6, if we are to apply the Gamma approach to a derivative in its entirety, then to be classified as equity the derivative *as a whole*:
 - (a) do not require transfer of economic resources prior to liquidation; and
 - (b) are an obligation for an amount that depends on the residual amount.

Summary of IAS 32 requirements for comparison

8. As part of the analysis in this paper, we compare the classification of derivatives under the Gamma approach to the classification under the existing requirements of IAS 32 *Financial Instruments: Presentation*.
9. IAS 32 classifies asset/equity derivative contracts in their entirety using the fixed-for-fixed condition. However, it has one exception, the ‘foreign currency rights issue’ exception.
10. The fixed-for-fixed condition is part of the definitions of a financial asset and a financial liability in IAS 32. Any derivative that is not settled by the exchange of

a fixed amount of cash or another financial asset for a fixed number of the entity's 'own equity' instruments is a financial asset or a financial liability. Thus, a derivative is only classified as an equity instrument if the fixed-for-fixed condition is met and is settled by receiving cash or other financial assets and delivering shares (physically settled). The following derivatives would be classified as financial assets or financial liabilities:

- (a) derivatives settled net in cash or net in shares; and
- (b) derivatives where the equity 'leg' is variable, and/or the asset 'leg' or liability 'leg' is variable.

11. The fixed-for-fixed condition is subject to one exception. The foreign currency rights issue exception requires an entity to classify a right, option or warrant as equity if:

- (a) the amount of cash to be received in exchange for delivering a fixed number of equity instruments is fixed in any currency; and
- (b) the derivative is issued pro-rata to all existing holders of the same class of 'own equity' instrument.

Instruments classified as equity under the Gamma approach

12. In the staff's view, asset/equity exchange derivatives would be classified as equity under the Gamma approach if both of the conditions are met:

- (a) it does not require the entity to transfer cash or other financial assets other than at liquidation. This would be the case if the derivative is either physically settled or net-share settled. For both of these settlement methods, there would be no requirement to transfer economic resources other than at liquidation. This contrasts with a net-cash settled derivative, which would require a transfer of economic resources prior to liquidation (see paragraphs 25–27); and
- (b) the amount of the derivative depends on the residual amount. This would be the case if the amount of the derivative is determined by receiving a fixed amount of economic resources and delivering a fixed number of equity instruments. This is because the value of such

derivatives in their entirety would be determined as the difference between the amount of assets to be received and the value of the equity to be delivered. Because the asset leg is for a certain amount, the value of the derivative in its entirety will be solely determined by the equity leg. That is, the amount of the derivative solely depends on the residual amount.

13. We illustrate the above using:
- (a) Example 1—a simple, physically settled, fixed-for-fixed forward contract to sell equity (paragraphs 14–17).
 - (b) Example 2—a simple net share-settled fixed-for-fixed forward contract to deliver equity. The example is the same as Example 1 except for the net share settlement requirement (paragraphs 18–23).

Example 1: Fixed-for-fixed forward contract physical settlement

14. An entity has a forward contract for the receipt of a fixed amount of cash (CU100) in exchange for the delivery of a fixed number of 10 ordinary shares. At inception, the shares to be transferred and the cash to be received have a value of CU10 each, so the contract is initially recognised at nil. The contract is settled gross. Subsequently, we assume that the values of each of the ‘legs’ might change as follows:
15. Subsequently, we assume that the values of the shares will be:
- (a) Scenario A: CU8
 - (b) Scenario B: CU12

Table 1

Scenario	Value of cash receivable	Value of shares deliverable	Net position of contract
A	100	80 (10 x CU8)	20
B	100	120 (10 x CU12)	(20)

16. Such an instrument would be classified as equity under the Gamma approach because:
- (a) it does not require the entity to transfer cash or other financial assets other than at liquidation; and
 - (b) the amount of the derivative depends on the residual amount. Because the asset leg is fixed, the changes shown in scenario A and B, result only from the change in the value of the shares deliverable (the equity 'leg').
17. Such an instrument would also be classified as equity under IAS 32 because the fixed-for-fixed condition is met. Therefore, contracts that meet the fixed-for-fixed condition as defined in IAS 32 (and excluding the foreign currency rights issue exemption) would meet the definition of equity under the Gamma approach.¹
- Example 2: Fixed-for-fixed forward contract net-share settlement*
18. An entity has a forward contract for the receipt of a variable number of shares equal to a fixed amount (CU100) in exchange for the delivery of a fixed number of 10 ordinary shares (ie the contract is net share settled for the difference in the amount of shares). At inception, the shares to be transferred have a value of CU10, therefore, the number of shares to be transferred and received is nil, so the contract is initially recognised at nil.
19. Subsequently, we assume that the values of the shares will be:
- (a) Scenario A: CU8
 - (b) Scenario B: CU12

¹ In accordance with paragraph 22 of IAS 32, changes in derivatives classified as equity are not recognised in the financial statements, neither is the net position of the contract. However, under the Gamma approach, amounts would be attributed to these contracts within equity.

Table 2

Scenario	Value of variable shares receivable	No of shares receivable	Value of fixed shares deliverable	Net value of contract	No of shares issued (received)
A	100	12.5 (100/CU8)	80 (10 x CU8)	20	(2.5)
B	100	8.3 (100/CU12)	120 (10 x CU12)	(20)	1.7

20. The changes shown in scenario A and B, result only from the change in the value of the shares deliverable (the equity ‘leg’). This is because the asset ‘leg’ is fixed. Also, there is no requirement to deliver any cash or other financial assets. The contract will only ever be settled by receiving or issuing an amount of shares that is determined by the changes in the share price.
21. Therefore, in the staff’s view, net share settled fixed-for-fixed contracts would be classified as equity under the Gamma approach. This is because:
- (a) it does not require the entity to transfer cash or other financial assets other than at liquidation; and
 - (b) the amount of the claim depends on the residual amount. Because the asset leg is fixed, the changes shown in scenario A and B, result only from the change in the value of the shares deliverable (the equity ‘leg’).
22. In other words, the features of the contract are similar to those of a physically settled fixed-for fixed contract.
23. However, under the existing requirements of IAS 32, the instrument is not classified as equity because the because of the net share settlement.

Instruments classified as liabilities under the Gamma approach

24. In the staff’s view, asset/equity exchange derivatives would be classified as liabilities under the Gamma approach if:

- (a) they are net-settled in *cash* (regardless of whether they otherwise meet the fixed-for-fixed condition) (paragraphs 25–27); or
- (b) they require the entity to *deliver a variable number of equity instruments* equal to an amount independent of the entity's economic resources (paragraphs 28–30)

Net cash settlement

- 25. If a derivative is *net cash settled*, then the entire instrument is classified as an asset or liability under the Gamma approach. This is because the contract could require the entity to transfer economic resources prior to liquidation, regardless of the amount of cash to be transferred.
- 26. For example, if Example 2 was net-cash settled instead of net-share settled, then it would require the receipt of CU20 in Scenario A, or transfer of CU20 in Scenario B. However, in this case, if the amount of the obligation depends solely on the residual amount, then separate presentation requirements within liabilities would apply.
- 27. Such an instrument would also be classified as a liability under the existing requirements of IAS 32.

Variable number of shares equal to an amount independent of the entity

- 28. If the fixed-for-fixed condition is not met because the contract requires the entity to deliver a variable number of equity instruments equal to an amount independent of the entity's economic resources, in exchange for a fixed amount of cash or other financial assets, then the entire instrument is classified as an asset or liability under the Gamma approach. This is because the contract in its entirety would be for an amount that is completely independent of the entity's economic resources.
- 29. For example, if Example 1 required the entity to deliver a variable number of shares to the value of CU100, in exchange for receiving cash of CU100, then the amount for the derivative as a whole would be completely independent of the entity's economic resources. This is because both legs of the contract would be

for an amount independent of the entity's economic resources, therefore there would not be a leg that depends on the residual amount.

30. Such an instrument would also be classified as a liability under the existing requirements of IAS 32.

Instruments that present challenges for the Gamma approach

31. The classification of a contract for the *receipt of a variable amount of cash* or other financial assets in exchange for delivering *a fixed number of equity instruments* (variable-for-fixed derivatives) presents challenges for the Gamma approach.
32. The challenge for such a contract does not arise because of the settlement requirements. If such a contract is cash settled, then it would be a liability (see paragraphs 25–27). If physically settled, or net-share settled, then the contract would not require the entity to transfer economic resources other than at liquidation.
33. However, the challenge arises when determining whether the derivative *as a whole* is for an amount independent of the entity's economic resources, or for an amount that depends on the residual amount. As we note in paragraph 12(b), the value of such derivatives in their entirety is determined as the difference between the amount of assets to be received and the value of the equity to be delivered.
34. If the asset leg is for a *variable* amount that is independent of the entity, and the equity leg is for a *fixed* number of equity instruments, then, **the amount of the obligation is neither completely independent of the entity's economic resources, nor solely dependent on the residual amount.** This is in contrast to:
- (a) a fixed-for-fixed derivative, for which the amount of the derivative as a whole depends solely on the residual amount and is thus classified as equity under the Gamma approach (see paragraphs 12–23); and
 - (b) a fixed-for-variable derivative, for which the amount of the derivative as a whole is completely independent of the entity's economic resources (see paragraphs 28–30).
35. Classifying a variable-for-fixed derivative in its entirety will result in either:

- (a) including the variability of the asset leg within equity if classified as equity; or
 - (b) including the variability of the equity leg as income or expense if classified as an asset or liability.
36. The challenges that result from the equity classification, or liability classification, of the contract as a whole are illustrated in the following examples:
- (a) A foreign currency forward contract that is classified as equity (paragraphs 38–41)
 - (b) A commodity indexed forward contract that is classified as a liability (paragraphs 42–45)
37. Subsequently, in paragraphs 46–51, we discuss whether liability or equity classification would be more appropriate for variable-for-fixed derivatives given the challenges that arise.

Example 3: Foreign currency forward contract classified as equity

38. An entity enters into a forward contract for the receipt of a fixed amount of foreign currency (ie not the entity’s functional currency) in exchange for delivering a fixed number of ordinary shares. At inception, the shares to be transferred and the cash have a value of CU100 each, so the contract is initially recognised at nil. The contract is physically settled. Subsequently, we assume that the values of each of the ‘legs’ change as follows:

Table 3

Scenario	Value of cash receivable	Value of shares deliverable	Net position of contract
A	120	80	40
B	120	140	(20)
C	80	60	20
D	80	120	(40)

39. For the purposes of illustration, we assume that the instrument is classified as equity. In contrast to Example 1, the changes in the net position of the derivative do not result only from the change in the value of the shares deliverable (the equity ‘leg’), but also from changes in the foreign currency. If the contract is classified as equity in its entirety, all changes in value, including the changes in the foreign currency receivable leg, and the net position of the contract, are not recognised as income or expense. This would be the case, even if the magnitude of the changes in the asset leg arising from foreign currency movements were much greater than the equity leg.
40. IAS 32 takes two different approaches to variable-for-fixed derivatives depending on whether the contract meets the foreign currency rights issue exception:
- (a) foreign currency rights issues are classified as equity under very limited circumstances;
 - (b) other variable for fixed are classified as liabilities.
41. Even though we have used a forward contract (which would be classified as a liability under IAS 32), the above example illustrates the challenges that would arise with instruments that meet the existing foreign currency rights issue exception in IAS 32. That exception applies only when the instrument is offered pro-rata to all existing holders of the same class of own non-derivative equity instruments.

Example 4: Commodity indexed forward contract that is classified as a liability

42. An entity enters into a forward contract for the receipt of a variable amount of cash based on some commodity index in exchange for delivering a fixed number of ordinary shares. At inception, the shares to be transferred and the cash have a value of CU100 each, so the contract is initially recognised at nil. The contract is settled gross. Subsequently, we assume that the values of each of the ‘legs’ change as follows:

Table 4

Scenario	Value of cash	Value of shares	Net value of contract
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	receivable	deliverable	
A	120	80	40
B	120	140	(20)
C	80	60	20
D	80	120	(40)

43. For the purposes of illustration, we assume that the instrument is classified as a financial asset or a financial liability. Similar to Example 3, the changes in the net position of the derivative do not result only from the change in the value of the shares deliverable (the equity ‘leg’) but also from changes in the amount of cash to be received based on changes in the commodity index. However, in contrast to Example 3, all resulting changes in value, including the changes in the underlying equity instruments, are recognised as income or expense. Depending on the net position of the forward contract, the instrument will either be classified as a financial asset (scenarios A and C) or a financial liability (scenarios B and D).
44. As a result, the net position and changes in value caused by changes in the equity ‘leg’ would be recognised as income and expense inconsistently with other similar equity items.
45. Such an instrument would also be classified as a liability under the existing requirements of IAS 32.

Should variable-for-fixed derivatives be classified as liabilities or equity under Gamma?

46. The Gamma approach does not provide a clear answer for variable-for-fixed derivatives because the amount of the obligation is neither completely independent of the entity’s economic resources, nor solely dependent on the residual amount.
47. The Gamma approach could be applied to variable-for-fixed derivatives in their entirety by requiring either:
- (a) classification as equity; or

- (b) classification as a liability.
48. If the Board were to, under the Gamma approach, classify some or all variable-for-fixed derivatives as equity, it would raise a number of questions. These would include
- (a) what changes are we willing to accept within equity?
 - (b) how do we justify accepting some types of variability and not other types of variability? In our view, there would be little conceptual rationale for treating for instance, foreign currency indexation, differently to other indexed variables for the purposes of classification.
 - (c) does the dominance of the variables matter? (for example, should classification consider whether the variable asset leg is orders of magnitude larger than the fixed equity leg?)
 - (d) would the attribution requirements within equity that the Board is considering adequately present the effects of variable-for-fixed derivatives? Those approaches include a no-attribution approach, and an ordinary share equivalents approach.
49. On the other hand, if variable-for-fixed derivatives are classified as liabilities, then it might be possible to mitigate some of the challenges through the separate presentation requirements. Such an approach would result in a statement of financial position that includes only fixed-for-fixed derivatives within equity, but mitigates the issue of changes in the residual amount being classified as liabilities through the separate presentation requirements. However, more work may need to be done on the separate presentation requirements to ensure that the challenges are addressed.
50. We could attempt to express a principle under Gamma (such as residual amount) that captures fixed-for-fixed and some appropriate variability in the amount of cash and/or number of shares. However, given the big effect on the financial statements of whether a claim is classified as a liability or equity, classifying a smaller set of contracts as equity, combined with the separate presentation requirements within liabilities, might provide better information.

51. In the staff's view classifying derivatives on own equity using a strict form of fixed-for-fixed would be a better application of the Gamma approach than classifying all (or some) variable-for-fixed derivatives as equity because:
- (a) the current fixed-for-fixed principle provides a clear distinction between what should be classified as equity and what should not. Without such a clear distinction, it becomes increasingly difficult to draw the line without unduly complicating the requirements.
 - (b) some of the approaches to the separate presentation requirements **for equity** might not best depict the asset leg variability that exists in such contracts. Some of these approaches may assume that the amount of the derivatives depends solely on the residual amount.
 - (c) the separate presentation requirements within equity would not sufficiently differentiate the items that are not 'equity'-like from other changes of classes of equity that depend solely on the residual amount (such as typical fixed-for-fixed warrants). In contrast, one of the options under the separate presentation requirements within liabilities could be to separate and present the changes in the residual amount in other comprehensive income.
 - (d) it would be more consistent with using the existing requirements of IAS 32 where possible instead of starting with a blank sheet of paper.

Summary and questions for the Board

52. Based on the analysis above, the Gamma approach is consistent with the fixed-for-fixed condition used in IAS 32 except for:
- (a) the classification of fixed-for-fixed net share settled contracts; and
 - (b) the classification of foreign currency rights issues that meet the exception under IAS 32.
53. The classification of derivatives using the fixed-for-fixed has its advantages and disadvantages:

- (a) On the one hand, using fixed-for-fixed to classify a derivative in its entirety is a pragmatic approach that alleviates the need to componentise derivatives.
- (b) On the other hand, items that fail to meet the fixed-for-fixed condition sometimes result in changes in the equity ‘leg’ being recognised as income or expense (or in the case of the foreign currency rights issue exception, changes in the asset ‘leg’ would not be recognised as income or expense).
54. In our view, the fixed-for-fixed condition might be amended to include net share settled contracts that would otherwise meet the fixed for fixed condition.
55. What is less clear is the best approach to the classification of variable-for-fixed derivatives. The challenges of these contracts arise because we are classifying the derivative in its entirety. As a result, the amount of the obligation for a variable-for-fixed derivative is neither completely independent of the entity’s economic resources, nor solely dependent on the residual amount.
56. As discussed in paragraphs 46–51, the staff’s preference would be to apply a strict form of fixed-for-fixed and mitigate the challenges that arise through the separate presentation requirements.
57. Regardless of the classification, the Gamma approach would use presentation and disclosure to highlight the differences within liabilities and within equity. This includes requirements to:
- (a) separately present liabilities that depend on the residual, including embedded derivatives.
- (b) attribute amounts within equity to classes of equity other than ordinary shares.

Questions for the Board

Do you agree with the staff’s analysis of the application of the Gamma approach to asset/equity exchange derivatives? (see paragraphs 12–30)

Do you agree that variable-for-fixed derivatives should be classified as liabilities? (see paragraphs 31–51)

Next steps

58. If the Board agrees with staff analysis that the proposed application of the Gamma approach is consistent with the classification of derivatives using the fixed-for-fixed condition (subject to the points in paragraph 52), then we will have to:
- (a) reconsider the separate presentation requirements for liabilities for the specific issue of the variable-for-fixed derivatives.
 - (b) consider clarifications to the requirements to address some of the application challenges that have arisen in practice at a future meeting.
59. One application problem that arises is that the term ‘fixed’ in the fixed-for-fixed condition is not always clear. For example, questions arise whether the fixed-for-fixed condition violated if:
- (a) The amount of cash or other financial assets to be received changes as a result of:
 - (i) changes in the risk-free rate, or a reference interest rate?
 - (ii) changes to different predetermined fixed amounts at different points in time?
 - (iii) changes based on dividends paid on the underlying equity instrument, so that the strike price is reduced by the amount of the dividend paid?
 - (b) The amount of equity instruments to be delivered changes as a result of:
 - (i) changes in the number of shares outstanding, such as share splits?
 - (ii) changes based on dividends paid on the underlying equity instrument, so that the number of equity instruments to be delivered is increased by the amount of the dividend paid?

Appendix A—Summary of staff’s analysis of classification under Gamma

Summary of application of Gamma	Fixed cash for fixed shares	Variable cash-for fixed shares	Fixed-cash for variable shares
Physical settlement	Equity	Liability ^	Liability
Net share settlement	Equity *	Liability	Liability
Net cash settlement	Liability	Liability	Liability

* Under IAS 32, these would be classified as liabilities.

^ Under IAS 32, there would be classified as liabilities, unless they met the foreign currency rights issue exception.