

## STAFF PAPER

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<b>Project</b>	<b>Financial instruments with characteristics of equity</b>		
<b>Paper topic</b>	Application of the Gamma approach to derivatives on 'own equity'		
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**Objective of this paper**

1. The objective of this paper is to discuss how the Gamma approach addresses some common issues that arise in practice when applying IAS 32 *Financial Instruments: Presentation* to classification of derivatives on 'own equity'. This paper focuses on the area that gives rise to the most number of questions and application difficulties in practice: the interpretation of the 'fixed-for-fixed' condition for the purpose of classifying derivatives on 'own equity'<sup>1</sup>.

**Structure of this paper**

2. This paper is structured as follows:
  - (a) Background (paragraphs 3-5);
  - (b) Classification of derivatives under the Gamma approach (paragraphs 6-22);
  - (c) Analysis of variables that change the amount of the derivative (paragraphs 23-53); and
  - (d) Summary and question for the Board (Paragraph 54).

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<sup>1</sup> Based on submissions to IFRS Interpretations Committees and informal interaction with constituents;

## Background

3. Under IAS 32, a contract to exchange cash (or another financial asset) for an entity's own equity instruments is classified as an equity instrument only if both the amount of cash (or other financial asset) and the number of equity instruments is fixed. This raises questions about what 'fixed' means and whether there are particular types of variability that do not violate the fixed-for-fixed condition.
4. IAS 32 provides little additional guidance, and no guiding principle, regarding how the fixed-for-fixed condition might be interpreted. Some of the questions that have arisen in applying the fixed-for-fixed condition include:
  - (a) for the cash or other financial assets, whether 'fixed amount' refers to currency units, or the volume of financial assets, eg CU100 or 100 units of securities.
  - (b) for the equity instruments, whether some changes in the number of instruments, for example adjustments to the share conversion ratio to prevent dilution, violate the fixed-for-fixed condition.
  - (c) whether the instrument has to have the same fixed amounts throughout its life (for example, does an instrument meet the fixed-for-fixed condition if it requires the exchange of 100 in cash for 100 shares at 20x1 or 104 in cash for 100 shares at 20x2).
5. This paper discusses how the principles of the Gamma approach address some of the issues that arise in practice when applying IAS 32 to derivatives. Please note that the discussion in this paper is not intended to explain the application of the classification requirements of IAS 32. The discussion relates to application of the Gamma approach.

## Classification of derivatives under the Gamma approach

6. The Board has tentatively decided that, under the Gamma approach, an entity would classify derivatives for the receipt of cash or other financial assets, or the

extinguishment of a financial liability, in exchange for the delivery of equity instruments as an equity instrument if<sup>2</sup> ([Agenda Paper 5C, July 2016](#)):

- (a) they are settled by the exchange of a fixed amount of cash or other financial assets for delivery of a fixed number of the entity's equity instruments (ie fixed for fixed); and
  - (b) they are either physically settled or net-share settled.
7. This is because such derivatives:
- (a) would require no transfer of economic resources other than at liquidation; and
  - (b) would be claims for an amount that *solely* depends on the residual amount. When an entity receives a fixed amount of cash or other financial assets for delivery of a fixed number of own equity instruments, the amount of claims will solely depend on changes in the residual amount of the entity.
8. All other derivatives on 'own equity' would be classified as derivative financial assets or derivative financial liabilities in accordance with IFRS 9 *Financial Instruments*.
9. In this paper, we focus on the application of the principle that the amount of the derivative must *solely* depend on the residual amount, and consider whether some variables introduced to an otherwise fixed-for-fixed contract would be consistent with this principle.
10. In the rest of this section we provide additional background, including:
- (a) What does the residual amount mean? (paragraphs 11-16)
  - (b) Why must equity derivatives be *solely dependent* on the residual amount? (paragraphs 17-19)
  - (c) How does classification of derivatives under the Gamma approach compare to IAS 32? (paragraphs 20-22)

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<sup>2</sup> The Gamma approach would also apply a requirement similar to the existing redemption obligation requirement in paragraph 23 of IAS 32 for derivatives that extinguish equity in exchange for a claim that meets the definition of a liability (to ensure that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured). However, that requirement is beyond the scope of this paper.

**What does the ‘the residual amount’ mean?**

11. The term ‘residual amount’ is critical in determining classification of claims under the Gamma approach. Simply put, the residual amount is the difference between the entity’s economic resources, and the claims against the entity that specify an amount that is independent of the entity’s economic resources. Defining ‘residual amount’ is difficult for many reasons, one of which being the fact that the definition of an equity instrument drives what is included in the ‘residual amount’ and that the definition of an equity instrument depends on how the residual amount is defined. This is also the reason why, when identifying the relevant feature of the claim, we refer to an amount that is independent of the economic resources, as opposed to independent of the residual amount.
  
12. We have over time, and through discussions with the Board, refined the notion of what the residual amount and independent amount mean within the context of this project. Our starting points were the two instruments, one that represents a claim that is independent of the economic resources and the other representing a claim that solely depends on the residual amount:
  - (a) the fixed contractual cash flow in a zero coupon bond on the one hand (being an amount independent of the entity’s economic resources); and
  - (b) an ordinary share’s claim to the economic resources of the entity after deducting all other claims (being an amount that depends on the residual amount).
  
13. As discussed by the Board in July 2015, the aim of the classification outcome was to facilitate the following assessments:
  - (a) the extent to which an entity has sufficient economic resources to satisfy the total claims against it; and
  - (b) the extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it.
  
14. If the amount of a claim depends on the residual amount, such instruments will not be relevant in determining whether the economic resources are sufficient as per paragraph 13(a). The amount of such a claim depends on how much economic

resources are available. If there are no economic resources available after satisfying all claims of an independent amount, the amount of claim of an instrument that solely depends on the residual amount is nil. Such instruments are equity instruments unless it contains an obligation to transfer economic resources prior to liquidation.

Similarly, if the amount of a claim depends on the residual amount, such instruments will not be relevant in determining whether the return on the economic resources is sufficient as per paragraph 13(b).

15. Classification of a simple instrument is straightforward under any approach - either existing IAS 32 or the Gamma approach. The instrument in paragraph 12(a) is clearly a liability under both approaches and instrument in 12(b), clearly an equity instrument.
16. We then considered instruments that sit between the two extreme ends as in practice, there are many instruments that do not fit clearly into either of the two ends. Instruments that are particularly problematic are derivatives. This is because the terms and conditions of derivatives may introduce various variables that affect the amount of the claim. Some of these variables depend on the residual amount, while there are others that do not. Although a single derivative may sometimes have both types of variables, the objective of classifying the derivatives as liabilities or equity would still be to provide information that is useful for the assessments identified in paragraph 13.

***Why must equity derivatives be solely dependent on the residual amount?***

17. The Board tentatively decided that entities should classify derivatives on ‘own equity’ *in their entirety* rather than splitting them into components. Derivative contracts involve a receive leg and a pay leg, and the net effect of the two determines the amount of the claim under a derivative contract. Thus, the entire contract can include both an amount that is independent of the entity’s resources, and an amount that depends on the residual amount.
18. Consequently, the Board decided that:
  - (a) if the amount of the derivative *in its entirety* is *solely* dependent on the residual amount, then it would be classified as equity. This would be the case, for example, if the amount of the receive leg is fixed in terms of the

entity's functional currency, and the pay leg is fixed in terms of the number of units of the entity's equity instrument.

(b) if the amount of the derivative *in its entirety* is *wholly, or partly*, independent of the economic resources of the entity, then it would be classified as a liability. This would be the case, for example, if the amount of the receive leg varies because it is indexed to a commodity, *or* if the amount of the pay leg varies because it is indexed to something other than a fixed number of the entity's equity instruments.

19. Consider a derivative that requires exchange of a fixed number of equity instruments with a *variable* amount of cash, eg cash receivable varies with a stock market index. When considering the aim of classification under the Gamma approach in paragraph 13, the changes in the variable amount of cash receivable that are independent of the economic resources of the entity (ie variability in the stock market index in this example) are relevant to assessing the extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it. Thus, classifying such claims as equity would not meet the objective of the Gamma approach.

***How does classification of derivatives under the Gamma approach compare to IAS 32?***

20. The Gamma approach does not replace the fixed-for-fixed condition. Rather, the Gamma approach incorporates the fixed-for-fixed condition and seeks to provide clarity by explaining the principle underpinning the fixed-for-fixed condition. In our view, clarifying the underlying principle, that the derivative in its entirety must solely depend on the residual amount, will help more consistent application of the classification requirements.

21. In our view, this does not mean that to be classified as equity, all derivatives must be strictly for the exchange of a fixed amount in the entity's functional currency for a fixed number of ordinary shares. Instead, some variables might result in changes in the fixed amount of financial assets, or to the number of equity instruments, but would still be consistent with the principle that the amount of the claim is solely dependent on the residual amount.

22. In the following section, we analyse whether some variables would be consistent with that principle.

### **Analysis of variables that change the amount of the derivative**

23. In July 2016, the Board tentatively decided that, under the Gamma approach:
- (a) derivatives would be classified in their entirety, and would not be split into smaller components.
  - (b) a derivative on ‘own equity’ is classified as an equity instrument only when the derivative in its entirety solely depends on the residual amount<sup>3</sup>.
  - (c) derivatives that are wholly, or partly, independent of the economic resources of the entity would be classified as liabilities.
24. In our view, one way of operationalising the principle is to consider whether the derivative includes a variable that introduces changes in the amount that do not depend on the residual amount. If it does, then it would be wholly, or partly, independent of the economic resources of the entity, and result in liability classification. Therefore, a derivative solely depends on the residual amount when all variables of the derivative depend on the residual amount.
25. In this section we consider whether the particular variables introduce changes in the amount of the derivatives that do not depend on the residual amount. We do not consider variables that do not result in changes in the amount of the derivative.<sup>4</sup>
26. The following variables have been identified from the discussions by the IFRS Interpretations Committee and previous consultations regarding the project:
- (a) time value of money;
  - (b) currency;

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<sup>3</sup> Subject to the derivative not requiring a transfer of economic resources prior to liquidation (e.g. net cash settled derivatives are not an equity instrument even if their amount solely depends on the residual amount).

<sup>4</sup> Also, when considering variables, the *amount* of the claim should be distinguished from the *value* of the claim. What we refer to as the amount of the claim is the contractually specified amount, whereas the value of the claim will be affected by various factors, including the amount of the claim, credit risk etc.

- (c) dilution;
- (d) distributions to holders of equity instruments;
- (e) variable that depends on a specific part of the residual amount;
- (f) non-controlling interest; and
- (g) contingency that affects the amount of a derivative

27. When discussing each variable in the following sections, we use some example instruments to describe the application of the principle to classifying those instruments. When discussing the example instruments, we focused on specific variables one at a time. Therefore, we assume that the instrument would be otherwise classified as equity if that variable were to be ignored. However, in reality an entity would need to consider all variables that affect the amount of the derivative.

*Time value of money*

28. Compensation for time value of money, whether it is implicit or explicit, is an inevitable component in any financial instrument, especially so in derivatives which by definition are settled at a future date. Also, the residual amount itself such as ordinary shares is exposed to changes in time value of money. The contractual terms that reflect compensation for the time value of money does not therefore preclude an instrument from being considered to be solely dependent on the residual amount. However, if a variable that represents the time value of money is leveraged or not related to the derivative instrument (eg benchmark interest rate of an unrelated currency), the derivative will not be classified as an equity instrument.

***Example: Variable strike price—option strike price changes depending on the exercise date***

29. Consider for example a Bermudan option<sup>5</sup> with fixed but different strike prices that vary based on variables such as when the option is exercised. An entity would need to determine what variables the exercise prices are indexed to. For example:

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<sup>5</sup> a type of option that can be exercised only on predetermined dates between the option issue date and the expiration date



- (a) if the strike prices of the option are indexed to a relevant market interest rate to provide compensation only for the time value of money then such variables do not preclude equity classification.
- (b) if the strike prices are indexed to independent variables such as foreign currency or an unrelated or leveraged interest rate, such derivatives do not solely depend on the residual amount and are not an equity instrument.

### *Currency*

30. The availability of the economic resources and the entity's performance are measured in the functional currency of the reporting entity. Therefore, the fixed amount of cash or other financial assets refers to a fixed amount in the reporting entity's functional currency. For this reason, a derivative on 'own equity', eg a share option, whose exercise price is denominated in a currency other than the reporting entity's own functional currency, is considered not solely dependent on the residual amount because the foreign currency rate changes independently of the residual amount. Similarly, if a derivative involves receipt of a fixed *number* of financial assets (eg 100 units of securities) other than cash, the financial asset needs to be a fixed amount in terms of the reporting entity's functional currency. In other words, the fixed amount does not refer to the volume, or number, of specified assets to be received, but to the amount of functional currency units that they represent.

***Example: Foreign currency derivatives—derivatives to exchange a fixed amount of foreign currency unit with a fixed number of own equity instruments***

31. A derivative on 'own equity' whose exercise price is denominated in a currency other than the functional currency of the issuer, is not a claim whose amount solely depends on the residual amount of the issuing entity. Such foreign currency derivatives would not be classified as an equity instrument applying the Gamma approach<sup>6</sup>.

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<sup>6</sup> In September 2016, the Board decided that the future Discussion Paper will propose that income and expenses arising from foreign currency derivatives whose value solely depend on the residual amount if not for the foreign currency, should be separately presented subject to the derivative meeting specific conditions ([Agenda Paper 5B](#)). This specific consideration applies to presentation only and do not affect the classification outcome.

***Example: Derivatives to exchange a fixed number of financial assets that are indexed to a commodity price with a fixed number of own equity instruments***

32. If the fixed number of financial assets to be received is indexed to a commodity price, then the derivative is not a claim whose amount solely depends on the residual amount of the issuing entity, and is therefore not classified as an equity instrument.

***Dilution***

33. Some derivatives such as warrants and options embedded in convertible bonds contain an anti-dilution provision, which protects the holder of the derivatives from dilution resulting from later issues of equity instruments that increases the total number of shares. This dilution arises because if the fixed number of shares are predetermined, at inception of the contract, later issues of equity instruments will reduce the share of the residual amount. Some of this type of provision adjust the number of shares to be issued only when there is an increase in the total number of shares in issue (ie in the event of anti-dilution only) while some do so for both increases and decreases in the total number of shares outstanding (ie ensuring a fixed proportion of the residual amount).
34. The entity would need to determine whether the variability introduced by dilution provisions solely depends on the residual amount. For example:
- (a) if the provision ensures the holders of the derivative have a fixed *proportion* of the residual amount as their share, then such a provision does not preclude equity classification. Similar to a derivative that requires exchange of a fixed number of equity instruments for receipt of a fixed amount of financial assets, a derivative that requires exchange of a fixed proportion of the total number of that class of equity instruments for receipt of a fixed amount of financial assets solely depends on the residual amount.
  - (b) if the provision ensures the holders of the derivative receive shares equal to an amount independent of the economic resources of the entity (say, equal to CU100) or guarantees a minimum payoff of a fixed amount (say, a floor of CU100), then such derivatives do not solely depend on the residual amount because CU100 is a fixed amount that does not change in response to changes in the residual amount. Shares are being used as a means to

settle a claim of an amount that is independent of the economic resources of the entity<sup>7</sup>. Such derivatives are not an equity instrument.

35. In the staff's view, the presence or the absence of anti-dilution protection provisions themselves do not introduce changes in the amount of the derivatives that do not depend on the residual amount. What matters is, if such provisions exist, then they do not introduce changes in the amount of the derivatives that do not depend on the residual amount. Similarly, an anti-dilution protection clause may be symmetric (eg the conversion ratio could be adjusted both ways depending on the change in the total number of shares) or asymmetric (eg the conversion ratio is adjusted only in the event of dilution). The asymmetric nature of the clause, on its own, does not violate the sole dependency on the residual amount as long as it does not introduce a claim of an independent amount, eg floor value of CU100.

***Example: A fixed proportion of the residual amount—a derivative to exchange a fixed amount of cash with a fixed proportion of the residual amount***

36. Consider an option to exchange a fixed amount of cash with a variable number of shares equal to a proportion of shares in issue. An example could be:
- (a) a warrant that has a strike price of \$1 for 2.5% of the shares currently in issue. A fixed percentage of shares *currently* in issue is just another way to express a fixed number of shares. The amount of claims arising from the option solely depends on the residual amount, therefore such a variable does not preclude equity classification.
  - (b) an option that has a change in control provision that has an effect of promising a fixed proportion of the residual amount e.g. an option where the conversion ratio is adjusted relative to what it would have been in the absence of the change of control. The amount of claims arising from the option solely depends on the residual amount, therefore such a variable does not preclude equity classification. (refer contingencies, paragraphs 47-53)

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<sup>7</sup> The amount of the obligation is determined by CU100. The number of equity instruments to be delivered for such an obligations might change in response to changes in the share price, but neither the number of shares, nor the share price changes the amount of the obligation.

***Example: A fixed amount anti-dilution provision—a provision to issue a variable number shares equal to a fixed amount***

37. Consider an instrument with an anti-dilution provision that, on issuance of additional equity instruments, requires the entity to issue a variable number of equity instruments equal to a specified value independent of the economic resources of the entity eg share conversion option with a floor value of CU100, that ensures the holder of the option receives CU100 as a minimum amount. Instead of ensuring the holder of the instrument has a specific *proportion* of the residual amount as their share, such a provision ensures the holder has a specific amount independent of the economic resources of the entity and is not an equity instrument.

***Distributions to holders of equity instruments***

38. If contractual terms of an instrument adjust the conversion ratio, or exercise price, to compensate the future equity instrument holder for missed payments that the holder would be entitled to, eg dividends, it would not violate the instrument being solely dependent on the residual amount. Dividends that are discretionary and represent a part payment of the residual amount rather than a part payment of an independent amount.
39. Similar to anti-dilution provision that seeks to protect the dilution of ownership resulting from increases in the total number of equity instruments, compensation for missed dividends seeks to protect the reduction of claim resulting from distribution of the residual amount. Also, because instruments that are classified as equity can have different rights to distributions, the presence or absence of such rights do not introduce changes in the amount of the derivatives that do not depend on the residual amount. Consequently, whether or not an instrument grants compensation for missed distributions does not preclude the equity classification of the instrument.

***Example: Derivative whose equity conversion ratio is adjusted for missed payments***

40. Consider the following two examples:
- (a) A convertible bond that mandatorily converts to equity shares where the conversion ratio is *adjusted* if dividends are paid to ordinary shareholders;  
and

(b) A convertible bond with a coupon indexed to a benchmark interest rate that is mandatorily converted to equity shares based on a fixed conversion ratio at its maturity – the coupon, if unpaid, accumulates and converted into shares.

41. In both cases, the issuer delivers additional shares in lieu of payment of dividends or interest. The nature of the payment matters rather than the form of payment. The dividends that are discretionary represent a share of the residual amount, whereas the coupons do not:

(a) In example 40(a), the compensation for missed dividends seeks protect the holder of the conversion option from the reduction of claim resulting from distribution of the residual amount.

(b) In example 40(b), the relevant variable to consider would be the time value of money. The interest payments are converted to shares based on a *fixed conversion ratio*, which means, assuming the benchmark interest rate represents compensation for time value of money and nothing else, the variability in the number of shares to be delivered introduced by changes in the benchmark interest rate does not preclude the equity classification. If benchmark interest rate is leveraged or if it is unrelated to the instrument, eg it is the benchmark interest rate for a different currency, then such variability would make the conversion obligation no longer solely dependent on the residual amount.

*Dependency on a specific component of the residual amount*

42. If an instrument is dependent solely on the residual amount, the amount cannot be beyond the residual amount, but it can be a component of the residual amount. A component of the residual amount could be a share of the residual amount or a share in changes in the residual amount. This could be specified by reference to a variable such as the entity’s recognised net assets, unrecognised net assets, or profit or loss and other comprehensive income (eg 5% of the issuer’s total profit or loss and other comprehensive income) because those variables solely depend on the residual amount. The holder of an instrument whose amount is specified by reference to such a variable will share the residual amount of the issuer with other equity instrument holders. The

assessment about the sufficiency of the economic resources to meet the claim (as in paragraph 13) is not relevant as the economic resources will *always be sufficient* to meet a claim that is specified as part of the residual amount. This means by classifying this type of instruments as equity, the objective of classification of the Gamma approach is achieved. This type of variable does not preclude the equity classification of the instrument.

***Example: A derivative whose amount depends on a specific % of Earnings before interest, tax, depreciation and amortisation (EBITDA)***

43. Consider an instrument whose amount depends on EBITDA. Although EBITDA is a component of profit or loss, it does not represent a share of the residual amount. The residual amount is the amount of the entity's economic resources after deducting *all* the claims against the entity that specify an amount that is independent of the entity's economic resources. All assets and all liabilities comprise the residual amount but that doesn't mean that each of the assets and liabilities, individually, are an instrument that depends on the residual amount. EBITDA, because it represents economic resources before deducting *all* relevant claims or charges that are independent of the the economic resources, is not a variable that solely depends on the residual amount. For example, it is possible for an entity to have made a loss while having a positive EBITDA. The entity would still have to transfer economic resources to meet a claim that depends on EBITDA regardless of the available economic resources. Such an instrument is relevant to assessing whether an entity has sufficient economic resources to meet the claims. Accordingly, it is not classified as an equity instrument.

***Example: Derivative that obliges an entity to exchange a fixed number of shares of one class of its own equity for a fixed number of shares of another class***

44. Consider an instrument that obliges an entity to exchange a fixed number of shares of one class or its own equity, such as non-cumulative preferred shares, for a fixed number of shares of another class, ordinary shares. The only variability of the amount of claims arising from the derivative will be from the amount of claims arising from the equity instruments to be exchanged. As long as both classes of equity instruments solely depends on the residual amount, so will the derivative for exchanging a fixed number of shares of one class of its own equity with a fixed number of another class of own equity instruments. It is not necessary for all instruments that are classified as

equity to have an equal pro-rata share of the residual amount. Instruments that are classified as equity can have different rights attached to them, but the difference in rights do not change that they still depend solely on the residual amount. The obligation to exchange a fixed number of two different classes of equity instruments does not preclude equity classification of an instrument with such obligation.

*Non-controlling interest*

45. The amount of the non-controlling interest solely depends on the residual amount of the subsidiary, which is part of the residual amount of the consolidated group. The amount of the claims depends on the availability of economic resources after deducting all liabilities of the subsidiary. There is a key difference between a non-controlling interest and other variables that depend on part of the residual amount but not solely such as EBITDA. The amount of non-controlling interest solely depends on the residual amount because the amount of the non-controlling interest will depend on the available economic resources of the subsidiary. Although the non-controlling interest will have a higher priority to *the subsidiary's* economic resources than the claims against the parent entity (eg debt instruments issued by the parent entity), the parent entity is not obliged to transfer economic resources of the parent to satisfy the non-controlling interest claim. The holder of non-controlling interest and the parent entity share the residual amount of the subsidiary. For this reason, a written call option to issue a fixed number of equity instruments of a subsidiary for receipt of a fixed amount of financial assets would be considered to be solely dependent on the residual amount<sup>8</sup>, and does not preclude equity classification.

***Example: Derivative that obliges an entity to exchange a fixed number of shares of its own equity for a fixed number of shares of its subsidiary***

46. Consider a derivative that obliges an entity to exchange a fixed number of its own shares for a fixed number of its subsidiary's shares, i.e. the entity issues additional shares in return for buying back additional shares in subsidiaries. As discussed in paragraph 45 above, the residual amount of the subsidiary is the residual amount of the group. Because the amount of claims arising from the derivative depends on the

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<sup>8</sup> Assuming the strike price of the option is in the functional currency of the reporting entity (the parent).

residual amount of the group and the subsidiary, and no other variable, the derivative solely depends on the residual amount. The dependency on the subsidiary's residual amount does not preclude equity classification.

*Contingency that determines the probability of settlement outcomes*

47. We have previously said that a contract to exchange a fixed amount of cash or other financial assets for a fixed number of ordinary shares is classified as equity. This would be the case regardless of whether it is:
- (a) a forward contract to issue shares (ie unconditional).
  - (b) a written call option (conditional on the counterparty).
  - (c) a purchased put option (conditional on the entity).
48. It would follow that a contract to exchange a fixed amount of cash or other financial assets for a fixed number of ordinary shares is classified as equity even if its exercise is contingent on an event beyond the control of both the entity and the counterparty. If the event happens, the contract is exercised, if not, the contract expires. In that sense, these outcomes are similar to the options, and whether the contract is exercised or not does not affect the amount of the claim.
49. However, if a contingency affects the amount of a claim, then the entity would need to determine whether the variability introduced by a contingency solely depends on the residual amount. If the contingency has the effect of varying the amount of cash or other financial assets or varying the number of equity instruments in a way that would not depend on the residual amount, then the instrument is a liability.

***Example: Derivative exercisable contingent on event***

50. Consider a derivative that requires the exchange of CU100 for the issuance of 100 ordinary shares that is mandatorily exercisable if event A occurs. The probability of the contingent event occurring will affect the value of the derivative. However, it does not affect the amount of the claim arising from the derivative, therefore the contingency does not preclude equity classification.



***Example: Derivatives with variable that depend on a contingent event***

51. If the variability moves independently of the residual amount, then the instrument would be a liability. An example of such an instrument is a written call option with a pre-determined number and price of exchange – e.g. if event *E* occurs 120 shares for CU100, if event *E* does not occur then 100 shares for CU100. Unless the event *E* is a 20% increase in the number of shares (in which case the amount of the claim is a fixed proportion of residual amount, see dilution in paragraphs 33-37), then the contingency will introduce a variable that is independent of the economic resources of the entity, and therefore the instrument would be a liability.

***Example: Adjustments to the number of equity instruments to be delivered based on share price movements***

52. Share price represents a variable that depends on the residual amount. However, not all variables that might be linked to share price are dependent on the residual amount. For example, some adjustments to the number of equity instruments to be delivered or the amount of financial assets to be received may depend on the share price movement and could still have an effect of introducing changes in the amount of the derivative that are independent of the economic resources of the entity.
53. Consider an example of a conversion obligation to deliver a variable number of own equity instruments to equal a fixed amount of cash, subject to a cap and a floor. Such a conversion obligation is not an equity instrument because it the amount changes in response to an amount independent of the economic resources of the entity under one possible settlement outcome. The fact that the adjustment to the number of shares varies with share price does not make it an equity instrument. Also, the classification outcome does not change even if the number of shares to be transferred is restricted to a particular range by a cap and a floor. If the amount of claims arising from a derivative varies with a variable, or is a fixed amount that is independent of the economic resources of the entity, the derivative is not classified as an equity instrument.

## Summary and question for the Board

54. This paper illustrated how the underlying rationale of the Gamma approach could help classify derivatives on own equity for which challenges arose under the existing fixed-for-fixed condition. As demonstrated through this paper, the staff is of the view that the Gamma approach will improve consistency of the application of the classification requirements by clarifying the principle of classification. In this paper we operationalised the principle of solely dependent on the residual amount by considering various variables that might change the amount of cash or other financial assets to be received or the number of shares to be delivered. We considered whether those variables were consistent with the amount being solely dependent on the residual amount.

**Question – application of the Gamma approach to the fixed-for-fixed condition**

Does the Board agree with the application of the Gamma approach as set out in this paper?