Staff paper

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Topic	**Fixed-for-fixed condition: Preservation adjustments—feedback and analysis**
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Introduction

1. In this paper, the staff summarises and analyses the feedback from comment letters and outreach on the Exposure Draft *Financial Instruments with Characteristics of Equity* (the ED) related to 'preservation adjustments' when applying the 'fixed-for-fixed condition'. The staff also considers whether further clarifications or changes to the proposed requirements would be necessary in response to the feedback.

2. This paper is structured as follows:

   (a) summary of staff's preliminary views;

   (b) question for the IASB;

   (c) feedback on preservation adjustments; and

   (d) staff analysis.

Summary of staff's preliminary views

3. Considering the feedback on the ED, the staff thinks the IASB should finalise the proposed requirements related to preservation adjustments, subject to potential

refinements and minor drafting improvements. The potential refinements could include:

(a) clarifying the meaning of 'future equity instrument holders' and 'current equity instrument holders' (paragraphs 12–13 of this paper); and

(b) updating draft Example 17 in the ED to clarify the reasons for not meeting the fixed-for-fixed condition (paragraphs 32–34 of this paper).

Question for the IASB

Question for the IASB
Does the IASB have any questions or comments on the matters discussed in this paper?

Feedback on preservation adjustments (proposals in draft paragraphs 22B–22C and AG27A(c) of IAS 32)

4. In the ED, the IASB proposes that, for the purposes of the fixed-for-fixed condition, the amount of consideration to be exchanged for each of an entity's own equity instruments could vary solely because of a preservation adjustment that:

   (a) is made upon the occurrence of a contractually specified event(s) that affects the economic interests of the current equity instrument holders; and

   (b) preserves the economic interests of the future holders of the entity's own equity instruments to an equal or lesser extent, relative to that of the current equity instrument holders.

5. Many respondents that commented on the proposed amendments to the fixed-for-fixed condition, provided feedback on the proposals related to preservation adjustments.[1] Among those, many respondents (mainly standard-setters, accountancy bodies and preparers) agreed with the IASB's proposals. However, many other respondents (mainly accounting firms and accountancy bodies and in particular, those from Asia-Oceanian jurisdictions) expressed significant concerns and/or disagreed with the proposals.

6. Many respondents said that more clarity or additional guidance would be helpful to apply the proposed requirements consistently. Their comments included:

   (a) how to interpret 'current equity instrument holders'. Respondents asked whether this refers to ordinary shareholders only or all equity instrument holders. They also asked whether this includes only shareholders that held equity instruments before a dilutive transaction or also those that might hold equity instruments as a result of the transaction (for example, the beneficiaries of the below-market-price issuance (see paragraph 7(b) of this paper);

   (b) how to interpret 'future equity instrument holders' and whether this refers to only future holders of the equity instrument underlying the derivative being assessed or all future holders who might hold different equity instruments;

   (c) whether general 'catch all' clauses that allow for adjustments to be made upon the occurrence of events that are *not contractually specified* but put the holders of the instruments in the same economic position relative to ordinary shareholders after the event, would be preservation adjustments; and

   (d) how to interpret 'to a lesser extent' and clarify the underlying rationale because it might result in adjustments that have a significant negative impact on future equity instrument holders to meet the fixed-for-fixed condition.

[1] Please refer to Agenda Paper 5 for this meeting for explanations of the terms used to broadly indicate the portion of respondents that reported a particular view. The feedback analysis on specific matters is based on the comments specifically made on that matter. Therefore, the terms that are used to indicate the portion of respondents that expressed a view are based on the population of respondents who specifically commented on each topic.

7. Respondents who had significant concerns or disagreed with the proposals mentioned that the proposals are too restrictive and would affect common contractual terms in their jurisdiction which are widely accepted by the market as anti-dilutive and meeting the fixed-for-fixed condition. Examples of such widely accepted adjustments include:

(a) *volume-weighted average share price adjustments*—where shares are not traded in an active market, it is common for the preservation adjustment (eg to adjust the conversion ratio in convertible bonds) to be determined or calculated based on a volume-weighted average price (VWAP) during a specified period rather than the spot price of the share at the date of dilution. This mechanism is widely used in the market where the underlying shares are thinly traded to approximate the fair value of the shares in an anti-dilution calculation. Other reasons include avoiding outliers or price spikes for corporate governance or securities law purposes.

(b) *adjustments to compensate for below-market-price issuance of shares*—if new shares are issued to investors below the market price of the shares, the conversion ratio of convertible bonds is adjusted to compensate the bondholders for the dilution loss. The current shareholders can participate in the decision whether or not the entity issues shares below the market price, while the convertible bondholders cannot. Issuing a large number of shares at a discount may be done to improve the liquidity of the shares.

(c) *types of 'down-round' adjustments*—if the share price declines below the conversion price of a convertible bond, the conversion price is adjusted downwards to equal the share price, subject to specified limits. A regulator specifically disagreed with classifying instruments subject to these down-round adjustments as financial liabilities mainly due to the volatility in profit or loss from the derivative valuation and the impact in their jurisdiction on companies with high growth potential. They said if the stock price of a company in a growth industry rises rapidly, a large derivative valuation loss may be recognised for the conversion feature. The company may therefore be forced to delist or be unable to list on the stock market. They noted that a down-round feature does not preclude equity classification under US GAAP.

8. Some respondents, regardless of whether they agreed or disagreed with the proposals, made suggestions for the IASB to consider, including:

   (a) making the proposals less restrictive by making the assessment more qualitative.

   (b) making the proposals more restrictive either by requiring the economic interests of the future equity instrument holders to be preserved to an *equal extent* relative to that of the current equity instrument holders or placing limitations on when situations that favour current equity instrument holders should pass the fixed-for-fixed condition. Using the example of a feature that maintains a specified return regardless of the stock price, they questioned why adjustments that are advantageous to current shareholders (eg reduction in the number of shares to be converted into in the event of an increase in the share price) would qualify for equity classification.

   (c) providing more illustrative examples of how to apply the proposals including assessing 'equal or lesser extent'.

9. A few of these respondents said that it is not possible to ensure that the condition will always preserve the economic interests precisely as intended and determining whether the adjustments preserve the economic interests of the future shareholders to 'an equal or lesser extent' will only be known in the future. Others have said that it was unclear how an adjustment that preserves the relative economic interests of a future equity instrument holder to a *lesser extent* compared to a current equity instrument holder would introduce the *same variability or risks* as if the entity had issued the equity instruments for cash.

Staff analysis

10. For the purposes of our analysis, we identified the following themes from the feedback summarised in paragraphs 5–9 of this paper:

    (a) terminology related to preservation adjustments (paragraphs 11–20 of this paper);

    (b) rationale for including 'to a lesser extent' (paragraphs 21–28 of this paper);

    (c) volume weighted average share price adjustments (paragraphs 29–34 of this paper); and

    (d) adjustments to compensate for a below-market-price issuance or a type of down-round adjustment (paragraphs 35–38 of this paper).

Terminology related to preservation adjustments

11. With regards to the suggestions in paragraph 6 of this paper to clarify the meaning of some of the terminology related to preservation adjustments, the staff agrees that clarifying the IASB's intention will enhance the understanding of the proposed amendments.

12. In our view, 'future' equity instrument holders refer to those parties to the derivative that will become holders of the equity instruments as a result of the contract. As discussed in Agenda Paper 5B for the April 2020 IASB meeting (see paragraph 7 of that paper), they are the parties whose economic interests the adjustments aim to 'preserve'. Therefore, they represent the future holders of the equity instruments underlying the derivative being assessed.

13. In contrast, 'current' equity instrument holders are those parties that, prior to the preservation event (the event that triggered the adjustment), already hold the equity instruments underlying the derivatives being assessed. In most cases the underlying equity instruments are shares, however the principle would apply even if the underlying equity instruments are equity instruments other than shares.

14. Therefore, in response to the question in paragraph 6(a) of this paper about whether in the case of a below-market-price issuance of shares, the current equity instrument holders would include the beneficiaries of the below-market-price issuance, the staff notes that these beneficiaries are not current equity instrument holders. Even if these beneficiaries were included in the definition of current equity instrument holders, the staff thinks the adjustment would not preserve the future equity instrument holders to the same or lesser extent than the current equity instrument holders. This is because 100% of the future equity instrument holders being assessed would benefit from the adjustment but less than 100% of all the current equity instruments holders would benefit from the below-market-price issuance.

15. Regarding the feedback in paragraph 6(c) of this paper about whether general 'catch all' adjustments would qualify as preservation adjustments, the staff thinks it is similar to the IASB's previous discussion about 'make-whole' provisions.

16. As noted in Agenda Paper 5 for the December 2019 IASB meeting (see paragraph 35 of that paper), the IASB intended for adjustments intended to put the holder of a derivative in the same position as the holder of the underlying equity instrument after a particular dilutive event, to meet the fixed-for-fixed condition. That is because those adjustments preserve the relative economic interests of the future equity instrument holders to the same extent as the current equity instrument holders (which is the position they would have been in if the equity instruments were issued at inception of the derivative) and ensure they have the same relative residual interest in the net assets of the entity. The entity is not exposed to any additional risks by including such 'make-whole' provisions.

17. The staff also notes that the IASB's intention with the proposals in the ED was to require an assessment of the objective of the adjustment and not an evaluation of the actual outcome. This determination is based on the contractual adjustment to either the amount of cash or number of shares or both, even if the contract refers to adjustments more generally and doesn't specify each particular event. We therefore think that as long as the objective of an adjustment is to compensate the future

instruments holders to an equal or lesser extent compared to the current equity instrument holders, the adjustment would be considered a preservation adjustment. We also therefore do not agree with the feedback in paragraph 9 of this paper that it will only be known after the event whether an adjustment preserved the interests of the future equity holders to an equal or lesser extent than the current equity holders.

18. Although the staff acknowledges and agrees with the feedback that the wording of the proposed amendments could be improved and made more qualitative, we do not agree with the suggestion to make the proposals less restrictive. We think it is important for any potential refinements to the proposals in the ED, to stay consistent with:

(a) the underlying principle of the fixed-for-fixed condition; and

(b) the objectives of this project, being to clarify the underlying principles in order to reduce diversity in practice without fundamentally changing the principles and definitions of equity and financial liabilities.

19. As with all other aspects of assessing whether a financial instrument is classified as equity or a financial liability, the fixed-for-fixed condition is applied from the perspective of the issuer of the equity or financial liability, not the holder.

Potential refinement

20. Based on the staff analysis in paragraphs 12–13 of this paper, the staff thinks the IASB could clarify the meaning of 'future equity instrument holders' and 'current equity instrument holders'.

Rationale for including 'to a lesser extent'

21. The feedback described in paragraphs 6(d) and 8(b) of this paper suggests that preservation adjustments should be allowed only when the economic interests of the future equity instrument holders are preserved to an *equal extent* relative to the economic interests of the current equity instrument holders.

22. When the IASB developed the proposals, it already considered this issue as noted in Agenda Paper 5B for the April 2020 IASB meeting (see paragraphs 15–19 of that paper). If only adjustments that require preservation to an equal extent are allowed, the outcome may be counterintuitive. It could result in a derivative that includes no or equal preservation to the future equity instrument holder to be classified as equity but a derivative that contains an adjustment that only partially preserves the interest of the future equity instrument holder to be classified as a derivative asset or liability.

23. The staff continues to believe that the current wording in the proposals, being 'preserves…to an equal or lesser extent…' should be maintained. Therefore, as explained in paragraph BC49 of the Basis for Conclusions on the ED, no minimum level of preservation of the economic interest of the future equity instrument holder is required. This is consistent with the underlying principle of the fixed-for-fixed condition—as currently drafted, and in its simplest form, the fixed-for-fixed condition neither requires nor permits an adjustment to the amount of cash or the number of shares.

24. The staff also notes that the IASB's intention with the preservation adjustment was that it should not introduce variability for the reporting entity to any risks or variables (eg forex risk) that would not have been present if the entity issued the underlying equity instruments for cash.[2] In the staff's view, this requirement would also apply to an adjustment that preserves the relative economic interests of a future equity instrument holder to a *lesser extent* compared to a current equity instrument holder.

25. The focus is on the *types* of risks or variables rather than on whether the adjustment introduces the same *amount* of variability or risks as if the entity had issued the underlying equity instruments for cash.

[2] Paragraph BC 47 of the Basis for Conclusions on the ED states that: "The purpose of these types of adjustments is to ensure current and future equity instrument holders have the same relative residual interest in the net assets of the entity. In other words, a preservation adjustment does not introduce variability to any risks or variables that would not have been present if the entity issued the equity instruments for cash […]."

26. A few respondents also questioned whether there should be any limitations for when a situation that favours current equity instrument holders should pass the fixed-for-fixed condition. For example, consider a feature that maintains a specified return regardless of whether the stock price rises or falls. If there is an increase in the share price, less shares will be issued to the future shareholder and the adjustment would favour the current shareholders, which in their view, would result in the derivative being classified as equity.

27. As noted in paragraph 23 of this paper, in its simplest form, the fixed-for-fixed condition does not permit or require any adjustment to preserve the rights of future equity holders. The focus of the preservation adjustments is on whether the economic interests of the future equity instruments holders are preserved in relation to that of the current equity holders.

28. However, this does not mean that all adjustments that favour the current equity instrument holders would pass the fixed-for-fixed condition. For example, a reduction in the number of shares to be issued to the future shareholder upon conversion when there is an increase in the share price, involves neither a fixed amount of cash for a fixed number of shares, nor does it '*preserve*' the economic interests of the future equity instrument holder. As such, even if such a feature favours the current equity instrument holders, it would not be a preservation adjustment and the instrument would be classified as a financial asset or financial liability.

Volume weighted average share price adjustments

29. With regards to the feedback described in paragraph 7(a) of this paper, the staff believes that respondents reached this conclusion after analogising to draft Example 17 of the Illustrative Examples accompanying IAS 32 *Financial Instruments: Presentation* in the ED. This example describes a convertible bond of CU100 with a path-dependent option, where the number of shares to be delivered varies based on Entity X's average share price over the six-month period before the conversion date. It concludes that the adjustment is not a preservation adjustment

because if the average share price decreases, the bondholder would be favoured with additional shares at the expense of the ordinary shareholders.

30. The staff understands that VWAP calculations are part of a market mechanism that is widely used in practice when the underlying shares are thinly traded and are used to approximate the fair market-based average share price. The period over which the VWAP is calculated differs eg it could be 5 days or 30 days and it is used as a basis in calculating the adjustment to the conversion or exercise price if certain events occur (such as a subsequent financing round). For example, the conversion price will be the *lower* of the initial fixed price or a price based on the average daily VWAP over a specific observation period.

31. Therefore, in the staff's view, it is not the VWAP calculation in itself that would cause the instrument to fail the fixed-for-fixed condition. Using a spot price or VWAP would not impact the classification. The adjustment should be assessed to see if it is an adjustment that preserves the economic interests of the future equity instrument holders relative to that of the current equity holders.

Potential refinement

32. As indicated in paragraph 7(a) of this paper, VWAP, instead of a spot share price, is widely used in practice to calculate the adjustment to the conversion ratio. In the staff's view, this use of VWAP is different from how the average share price calculation is used in draft Example 17 in the ED to determine the conversion price.

33. In draft Example 17 in the ED, the number of shares and the conversion price are not fixed until the conversion date and are based on the average share price in the six-month period before the conversion date. Draft Example 17 in the ED is similar to a situation in which a non-derivative financial liability is settled with a variable number of shares to the value of a specified amount. In such a case, the issuer is effectively using its own shares as currency as envisaged under paragraph 21 of IAS 32. Therefore, in draft Example 17, it could be argued that Entity X is using its shares as currency to settle the obligation of CU100 with the number of shares determined

based on the average price over a six-month period instead of the market price at settlement date. The same conclusion would have been reached if the spot price was used instead of the average share price.

34. The staff thinks the IASB could clarify the wording and rationale in draft Example 17 in the ED as it is not actually an illustration of a preservation adjustment because there is no adjustment to a fixed predetermined conversion ratio. Rather, it fails the fixed-for-fixed condition because the amount of consideration per share is not fixed at inception of the contract and will only be determined on the conversion date.

Adjustments to compensate for a below-market-price issuance or a type of down-round adjustment

35. With regards to the feedback described in paragraphs 7(b)–7(c) of this paper, the staff notes that these examples were the most commonly mentioned adjustments that respondents were concerned about. This is because these types of adjustments would not meet the fixed-for-fixed condition when entities apply the proposed requirements. The staff acknowledges respondents' concerns that classifying instruments with these adjustments as financial liabilities could cause volatility in profit or loss due to derivative valuations. However, we emphasise that the fixed-for-fixed condition, in its simplest form, does not permit or require any adjustment to preserve the rights of future equity holders. In developing the preservation adjustment proposals described in paragraph 4 of this paper, the IASB aimed to develop a principle that could be applied to many types of adjustments and be consistent with the definition of equity as a residual interest.

36. Adjustments that compensate future equity instrument holders for a below-market-price issuance of shares or for decreases in the entity's share price would favour the future equity instrument holders at the expense of current equity instrument holders. Similarly, the IASB already considered the typical type of down-round adjustments (when shares are issued at the then current market price which is below the conversion price), and concluded that adjustments that benefits future equity instrument holders

to a greater extent than the current equity instrument holders, are not consistent with the fixed-for-fixed condition (see paragraph BC48 of the Basis for Conclusions on the ED).

37. The argument given by a few respondents that current shareholders can participate in the decision whether or not to issue shares below the market price, is not a compelling reason to make an exception. This is because:

    (a) current equity holders have particular decision-making rights, which might include making decisions either in their capacity as investors or as part of the entity. For example, the current shareholders' decision to issue shares below their market price could be treated as an entity decision if it is made on a collective basis to benefit the entity by improving the liquidity of the shares.

    (b) future equity holders do not have the same decision-making rights as current equity holders because they are not yet equity holders of the entity.

38. The staff therefore continues to believe that both these adjustments are not preservation adjustments.