IASB® meeting

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Topic	**Fixed-for-fixed condition: Passage-of-time adjustments—feedback and analysis**
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Introduction

1. In this paper, the staff summarises and analyses the feedback received from comment letters and outreach on the Exposure Draft *Financial Instruments with Characteristics of Equity* (the ED), related to the proposed 'passage-of-time' 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 passage-of-time adjustments; and

   (d) staff analysis.

Summary of staff's preliminary views

3. Considering the feedback on the ED, the staff thinks the IASB could finalise the proposed requirements related to passage-of-time adjustments, subject to potential refinements and minor drafting improvements. The potential refinements would be to:

   (a) clarify the meaning of 'predetermined' (see paragraphs 17–18 of this paper).

   (b) clarify the principle whether the adjustment should compensate for the time value of money (see paragraphs 22–29 of this paper).

   (c) remove the third criterion to be classified as a passage-of-time adjustment, ie 'has the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments' (see paragraphs 32–36 of this paper).

   (d) clarify the overriding requirement is that the objective of the adjustment must be to solely compensate for the passage of time and not introduce any other risk exposure to the issuer. In assessing whether this objective is met, an entity would need to apply judgement (see paragraphs 44–45 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 passage-of-time adjustments (proposals in draft paragraphs 22B–22C of IAS 32)

4. In the ED, the IASB proposed that the fixed-for-fixed condition would be met if the amount of consideration to be exchanged for each of an entity's own equity instruments varies solely because of passage-of-time adjustments that are:

(a) predetermined at inception of the contract;

(b) vary with the passage of time only; and

(c) have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments—any difference in the amounts of consideration to be exchanged on each possible settlement date represents compensation proportional to the passage of time.

5. Most respondents who commented on the fixed-for-fixed condition provided feedback on the passage-of-time adjustments.[1] While most of these respondents (mainly accountancy bodies, standard setters, preparers, accounting firms and regulators) did not disagree with the proposals, they were concerned that the proposals are overly restrictive and not clearly articulated. In their view, there is a risk of new diversity developing in practice and would be counter-productive to what the IASB intended with this project. Some other respondents disagreed with the proposals for similar reasons. The main reasons for their concerns or disagreement were:

(a) instruments where the conversion price is adjusted based on interest rate benchmarks or inflation rates would not meet the passage-of-time adjustment.

(b) entities would face practical difficulties and/or require significant levels of judgement when assessing whether an adjustment is a passage-of-time adjustment. They said that especially the requirement described in paragraph 4(c) of this paper—to fix, on initial recognition, the present value of consideration—is too restrictive and overly complex and could result in new diversity in practice to develop (see paragraph 8 of this paper).

(c) it is common practice for the conversion ratio in convertible bonds to be adjusted if there is a change of control of the issuer. Such adjustments are

[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.

typically the result of applying a specified formula which includes inputs such as share price and volatility. In their view, the proposals would result in the retrospective reclassification of these conversion options from equity to derivative liabilities (see paragraph 10 of this paper)

6. With regards to the feedback in paragraph 5(a) of this paper, respondents said that:

   (a) in general, adjustments based on an interest rate benchmark or inflation index are made to compensate for the time value of money related to the passage of time. In their experience, these adjustments are widespread and meant to protect investors from inherent uncertainty in markets especially those with mild inflation rates and are not related to leverage. In addition, the fair value of these instruments is predominantly affected by the share price and not the adjustments for the time value of money.

   (b) the conclusion in draft Example 20 of the Illustrative Examples accompanying IAS 32 in the ED (illustrating an adjustment to the conversion ratio for benchmark interest rates) seems to contradict the conclusion in draft Example 14 in the ED (illustrating convertible bonds with accrued interest) if interest is calculated using a variable interest rate. A few respondents said it is not clear what additional useful information is provided by permitting variation if rates are fixed but not if rates are variable.

7. Regardless of whether they agreed or disagreed with the proposals, most respondents were concerned about the understandability and clarity of the proposed amendments and observed that applying the amendments would require significant judgement to be applied. Respondents made several suggestions on how the proposed amendments could be clarified, including:

   (a) clearer articulation of terms, explaining the intended meaning, for example 'predetermined'—whether it is a fixed monetary amount or based on a formula specified in the contract.

   (b) clearer explanations of whether passage of time is intended to refer to time value of money or not. They observed that:

(i) compensation for the passage-of-time can be equated to the current price of the time value of money.

(ii) paragraph BC54(c) of the Basis for Conclusions on the ED said "…the present value calculation is not intended to assess whether there is compensation for the time value of money or whether the adjustment is reasonable and is not related to any effective interest method calculation." However, the terms 'passage of time' and 'present value calculation' are used in other IFRS Accounting Standards to refer to the time value of money.[2]

(iii) in finance, passage of time is considered to be reflected by a fixed or variable interest rate. Respondents said that it is not clear why fixed and floating interest rates or inflation indices would be treated differently and could lead to structuring opportunities.

8. Some respondents specifically expressed concerns about the proposed amendment described in paragraph 4(c) of this paper. They are concerned about the practicality and operability of the proposed requirement, especially as the ED did not propose any application guidance or illustrative examples to assist entities in calculating the present value of the amount of consideration exchanged for each of the entity's own equity instruments. Their concerns and comments included:

(a) the potential for different interpretations of the requirement to develop and need for significant judgement to be applied would increase the complexity of IAS 32 *Financial Instruments: Presentation* and introduce new diversity in practice. For example, some interpreted this condition as permitting a change in exercise price that is compensation for the time value of money while others interpreted it as guaranteeing a minimum return.

[2] For example, paragraph B4.1.9A of IFRS 9 *Financial Instruments* states that "time value of money is the element of interest that provides consideration for only the passage of time…" Equally, when IFRS 13 *Fair Value Measurement*, IFRS 16 *Leases* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* refer to present value calculations or measurements, they incorporate time value of money.

(b) which discount rate should be applied when calculating the present value—is it the discount rate used at inception, a risk-free discount rate or a discount rate adjusted to reflect the risk associated with the instrument.

(c) how to assess whether any difference in the amounts of consideration to be exchanged on each possible settlement date represents compensation that is *proportionate to* the passage of time. For example, respondents noted that adjustments may not always be linear over time. If there is only one adjustment to the amount of consideration exchanged for an equity instrument, it is not clear whether at the time of issuance, there needs to be alignment between the time and rate of increase. Similarly, if there is more than one increase, it is not clear if they only need to be proportionate to each other (even if large). Other examples raised by respondents included adjustments made based on forward prices (which include future interest or inflation rates in their estimation) or growth rate forecasts at inception of the contract.

9. Suggestions made by respondents to address these concerns, included:

(a) removing the proposed criterion related to fixing the present value (see paragraph 4(c) of this paper) because the other two conditions (for the consideration per own equity share to be predetermined and vary only with the passage of time) would be sufficient to ensure consistent application.

(b) permitting fixed conversion ratios that vary over time to reflect not only time value of money but also other risks that are specific to the entity, have economic substance and do not create leverage. For example, this could include:

(i) permitting adjustments to the strike price based on benchmark interest rates or the unleveraged inflation index for the issuer's economic environment;

(ii) permitting adjustment to the conversion ratio in the event of a change of control that includes the entity's share price as an input in the predetermined formula; or

(iii) requiring such features to be accounted for separately by bifurcating additional separate embedded derivatives.

(c) require the compensation for the passage of time to be subject to a 'reasonableness' test to prevent the use of unrealistic discount rates in present value calculations.[3]

Change of control provisions

10. Some respondents who commented on the fixed-for-fixed condition raised significant concerns about and/or disagreed with the conclusion in draft Example 19 in the ED, In that example, the fixed-for-fixed condition is not met because the conversion ratio, in the event of a change of control, is determined using a formula containing share price as an input. In their feedback, respondents said:

(a) such adjustments are typically intended to compensate the derivative holder for loss of optionality upon a change of control of the issuer and seeks to approximate the 'lost' time value of the option. The inputs used to estimate an option's value also include other parameters, such as share price and share price volatility, which vary based on the remaining life of the option. These inputs are inter-dependent in calculating the time value of an option. A formula which calculates the time value element (being total fair value less intrinsic value) would use the current share price as an input.

(b) they believe that such adjustments have elements of both a passage-of-time adjustment (since the time value of an option captures the passage of time) and a preservation adjustment (since the relative economic interests of the bondholders and the shareholders are maintained given the bondholder is compensated for the lost time-value).

[3] Paragraph B54(b) of the Basis for Conclusions on the ED describes an approach that would require the amount of consideration to be paid or received for each of an entity's own equity instruments on each possible settlement date to be predetermined at inception of the contract, to vary only with the passage of time (similar to the approach described in paragraph BC54(a)) and to be 'reasonable'. Determining whether the adjustment is reasonable would require the exercise of judgement. If this approach were applied, the Board would have to develop application guidance to help entities make that judgement.

(c) the adjustment may also meet the requirements for preservation adjustments because a change of control may negatively affect bondholders relative to existing shareholders in a number of ways. For example, if the instrument can be settled at fair value, the bondholder would receive a portion of the entity's fair value that is in proportion to the share held by owners of the entity's shares. Respondents believe that the absence of any compensation to the bondholders, would result in the current shareholders benefitting from the loss of relative value suffered by the bondholders.

(d) clarifying the fact pattern of draft Example 19 in the ED to enhance the understanding of stakeholders.

Staff analysis

11. The IASB concluded that to meet the fixed-for-fixed condition, in general, a derivative contract is required to include a fixed exchange ratio (see paragraph 18 of Agenda Paper 5D for this meeting). Therefore, the staff wishes to highlight 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. 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.

12. The IASB also noted in paragraph BC51 the Basis for Conclusions on the ED that a passage-of-time adjustment is an adjustment that compensates either the issuer or the holder of a derivative for changes in the timing of settlement of that derivative resulting from the passage of time. Such adjustments result in variability in the exchange ratio to compensate for variability in the timing of settlement (for example, several possible exercise dates or a range of dates as an exercise period).

13. However, as noted in paragraph BC52 of the Basis for Conclusions on the ED, unlike other variables that could create uncertainty about the amount of consideration to be

received (or paid) or the number of equity instruments to be delivered (or reacquired) on settlement, the passage of time is not uncertain. Therefore, in the IASB's view, a passage-of-time adjustment to the amount of consideration to be received or paid per equity instrument, is consistent with the fixed-for-fixed condition.

14. The staff notes that to qualify as a passage-of-time adjustment, the IASB developed the criteria as described in paragraph 4 of this paper. The intention was that all of these criteria would have to be met. For example, it is not sufficient for the adjustment to the amount of consideration or the number of shares or both to merely be predetermined. However, the IASB's intention was not to start questioning the pricing of derivative contracts over own equity or to require entities to prove that the pricing is 'reasonable'.

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

    (a) adjustment is predetermined (see paragraphs 16–18 of this paper);

    (b) adjustment varies with the passage of time only (see paragraphs 19–29 of this paper);

    (c) effect of fixing on initial recognition the present value of the amount of consideration (see paragraphs 30–36 of this paper); and

    (d) change of control provisions (see paragraphs 37–45 of this paper).

Adjustment is predetermined

16. With regards to the suggestion in paragraph 7(a) of this paper to clarify the meaning of 'predetermined', the staff notes the discussion in Agenda Paper 5B for the April 2020 IASB meeting. For the purposes of the proposed amendments, 'predetermined' refers to a pre-determined fixed amount per share, eg the number of own shares and the amount of cash to be exchanged are both fixed at each contractually specified exercise date. The IASB also considered that the amount of consideration could be

determined by applying a specified (or predetermined) formula provided that the inputs to the formula only vary with time (ie time is the only variable input).

Potential refinement

17. The staff thinks that the IASB could clarify the meaning of ‘predetermined’. Because passage-of-time adjustments are meant to provide compensation for changes in the timing of settlement of a derivative, to meet the fixed-for-fixed condition, the amounts to be exchanged on each settlement date need to be:

    (a) known upfront at inception of the derivative; or

    (b) determinable in the future based on a known formula at inception of the derivative.

18. We understand that usually the contracts will specify fixed conversion ratios or fixed adjustments to the conversion ratios at specified points in time. However, in some cases a formula is set out in the contract which includes time as an input. Although the exact magnitude of the inputs will only be determined at the settlement date, the formula is known upfront.

Adjustment varies with the passage of time only

19. Based on the feedback described in paragraphs 5–10 of this paper, it is clear that some respondents consider the ‘passage-of-time’ to equate to ‘time value of money’. In other words, they understand compensation for the passage-of-time to require compensation for the time value of money and are therefore of the view that adjustments based on interest rate benchmarks or an inflation index should be allowed.

20. The staff acknowledges the perceived inconsistency between the requirements in IFRS 9 and the proposals in this regard. Paragraph B4.1.9A of IFRS 9 states that *time value of money* is the element of interest that provides consideration for only the *passage of time*. In addition, paragraph B4.1.13A of IFRS 9 analyses an inflation-linked bond and states that linking payments of principal and interest on the principal

amount outstanding to an unleveraged inflation index resets the time value of money to a current level (ie the interest rate on the instrument reflects 'real' interest).

21. In addition, we think that stakeholders' concerns are also partially due to the apparent inconsistencies between the conclusions in some of the illustrative examples. For example, the conclusion that adjustments to the strike price based on interest rate benchmarks or an inflation index would fail the fixed-for-fixed condition has led a few respondents to question whether conversion options in only fixed interest rate instruments would meet the fixed-for-fixed condition. We have therefore considered how best to clarify the principles underlying the adjustments that relate to the passage of time and resolve any remaining inconsistencies.

Potential refinement

22. We think the first question to be considered is whether the adjustment should compensate for the time value of money. In this regard, we have identified two potential approaches.

Adjustment DOES NOT compensate for time value of money

23. This approach is consistent with the IASB's original intention when developing the ED. At the time, the IASB considered that unlike other variables the passage of time is not uncertain and decided to deliberately use the phrase 'passage of time' to not refer to 'interest rates' or the 'time value of money'. The IASB acknowledged that IFRS 9 equates time value of money to consideration for the passage of time, but decided to use the phrase in a different context for the purposes of the ED.

24. The staff acknowledges that, in determining the amount of consideration to be exchanged, entities consider many inputs which might include the current or expectations about future interest rate benchmarks, inflation rates or other growth rates at inception of the contract. And as noted in paragraph 14 of this paper, the IASB's intention with the preservation and passage-of-time adjustments was not to start questioning the pricing of such contracts or require entities to prove that the

pricing is 'reasonable'. The starting point for the fixed-for-fixed condition has been and continues to be a fixed amount of cash in exchange for a fixed number of shares.

25. The IASB realised that, in practice, contracts might specify adjustments to be made to these fixed amounts and that the intention of such adjustments is not to introduce variability in the amounts but rather to protect the rights and interests of the issuer or holder of the derivative. The IASB therefore considered that using inputs such as interest or inflation rates to determine the fixed amount of consideration to be exchanged, is different from using the actual future benchmark interest, inflation or other growth rates at the date of conversion. The IASB was of the view that doing so would introduce additional exposure to risks that are not usually associated with issuing underlying shares or other equity instruments. Such adjustments are more akin to the accrual of interest on debt instruments.

26. In the staff's view, to remain consistent with the IASB's original intention, the IASB could clarify that the concept of 'passage of time' is not equivalent to the concept of 'time value of money' and potentially replace this with another phrase to avoid future confusion.

27. This would effectively restrict the scope of passage-of-time adjustments so that adjustments to the strike price that vary with an interest rate benchmark or inflation index that is unknown at inception of the contract would not pass the fixed-for-fixed condition. We think it will also be beneficial to make drafting improvements to the proposed requirements and illustrative examples to avoid potential future confusion about the IASB's intention.

Adjustment DOES compensate for time value of money

28. This approach would be different from the IASB's original intention when developing the ED and would align passage-of-time adjustments with how they are used in other IFRS Accounting Standards, so as not to create any unintended consequences. Based on the wording in IFRS 9, *time value of money* is the element of interest that provides consideration for only the *passage of time.* Reconsidering the elements of interest is

not within the scope of the FICE project but the staff acknowledges that in practice, both interest rate benchmarks and unleveraged inflation indexes are used to represent the time value of money.

29. However, in the staff's view, aligning the concept of 'passage of time' to the concept of 'time value of money', would be a fundamental change to not only the current principles underlying the fixed-for-fixed condition, but also to the proposals in the ED. Such a change would effectively expand the scope of the passage-of-time adjustments to include adjustments to the strike price that vary with an interest rate benchmark or an unleveraged inflation index and could result in changes to the future cash flows of these derivatives that are more akin to those associated with debt instruments.

Effect of fixing on initial recognition the present value of the amount of consideration

30. The staff notes that the feedback described in paragraph 8 of this paper highlights the concerns respondents raised about the practical difficulties and level of judgement required to apply the criterion in paragraph 4(c) of this paper.

31. When the IASB developed the proposals, it added this criterion to limit the risk of structuring opportunities because the criterion would aim to ensure the difference in the amount of consideration to be received or paid on each possible settlement date is clearly related to the passage of time. The intention was that entities would need to further analyse the magnitude of the adjustments to determine whether the adjustments are done in a proportionate manner over time to represent compensation for passage of time. However, applying this criterion would not involve questioning the reasonableness of the discount rate used, or the 'fairness' of the changes in the exchange ratio for different settlement dates (see paragraph 20(b) of Agenda Paper 5B for the April 2020 IASB meeting).

Potential refinement

32. The staff acknowledges respondents' concerns that there could be many different ways to calculate the adjustments and there is lack of clarity in the wording on how to assess if compensation is proportional to the passage of time, and which discount rate should be used. Respondents explained that adjustments could be made based on forward prices (which include future interest or inflation rates in their estimation) or growth rate forecasts determined at inception of the contract.

33. Therefore, the staff acknowledges that using a single discount rate would not have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments. Furthermore, there could be more structuring opportunities by not specifying the discount rate and the present value calculations can differ depending on for example, whether the original effective interest rate is used or whether the market rate of interest is used.

34. The IASB previously considered Bermudan options with predetermined fixed but different strike prices—an option to sell a fixed number of shares for a specified exercise price, but with a number of possible exercise prices that vary based on when the option is exercised. Such a contract could have been entered into as a series of options which are each settled by delivering a fixed number of own shares for a fixed amount of cash. The outcomes are mutually exclusive—a holder has only one option to exercise and once the exercise date is determined, it can no longer exercise the option on the other dates.

35. Based on the feedback received about the practical challenges with applying this criterion and the extent to which additional explanations and/or application guidance would need to be developed, the staff thinks there is a high risk for this criterion to result in unintended consequences if finalised.

36. In our view, the criteria for the consideration per own equity share to be predetermined and vary only with the passage of time (subject to the potential refinements discussed in this paper) would provide an adequate basis for applying the

fixed-for-fixed condition. As already explained in paragraph 14 of this paper, the intention with the proposed amendments was to assist entities in applying the fixed-for-fixed condition and not to require an assessment of the pricing of the derivative or whether the amount of the adjustment to the conversion ratio is proportional to the time value of money. Not finalising this criterion would also alleviate the need to develop a reasonableness test to prevent the use of unrealistic discount rates in present value calculations.

Change of control provisions

37. With regards to the feedback described in paragraph 10 of this paper, the staff agrees that the fact pattern in draft Example 19 in the ED is in the context of when the holder elects to exercise the conversion option immediately (losing the time value of the option) because if it does not elect to convert, the issuer will redeem the bond early in the event of the change of control of the issuer. As such, draft Example 19 in the ED focussed on whether the requirements for passage-of-time adjustments which solely compensate for passage of time were met. It also included a fact pattern that illustrates a situation in which the adjustment would clearly not only be for the passage of time.

38. The staff acknowledges that entities would need to apply judgement to determine how the share price is used in calculating the adjustment. To illustrate this principle, the staff contrasts two possible cases where share price is used in determining the adjustment to the conversion ratio.

39. In Case 1, simplistically the time value of an option is calculated by subtracting its intrinsic value (difference between current share price and strike price) from its premium (the total market price of the option contract). In this case, as was pointed out by several respondents, the share price is indeed an input in calculating the time value of the option.

40. In Case 2, the conversion ratio adjustments are predetermined based on various dates and share prices and reflected using a matrix.

[Example conversion ratio adjustment for illustrative purposes only]

Effective date	Share Price					
	CU20	CU40	CU60	CU80	CU100	CU120
31 December 20X1	1,500	870	250	70	15	0
31 December 20X2	1,500	850	200	50	10	0
31 December 20X3	1,500	800	170	35	3	0
31 December 20X4	1,500	750	130	20	0	0
31 December 20X5	1,500	650	80	0	0	0
31 December 20X6	1,500	500	20	0	0	0

42. The adjustment in Case 2 does not compensate solely for the passage of time because in this matrix:

(i) the amount of the adjustment generally decreases the later the date of the change of control and the higher the entity's share price;

(ii) in some cases, at a specific share price, the adjustment is the same regardless of the date of the change of control; and

(iii) in other cases, once a particular share price is reached at a particular date, there is no adjustment regardless of the date of change of control.

43. Therefore, in the staff's view, including inputs such as share price in the formula to adjust the conversion ratio in the event of a change of control, does not automatically mean the fixed-for-fixed condition is not met. Instead, entities would need to assess how the share price is used.

Potential refinement

44. The staff thinks that the IASB can clarify that the overriding requirement is that the objective of the adjustment must be to solely compensate for the passage of time and not introduce any other risk exposure to the issuer. In assessing whether this objective is met, an entity would need to apply judgement and consider all the inputs in the predetermined formula. An adjustment could therefore be a passage-of-time

adjustment even if time is not the only variable as long as the objective is solely to compensate for the passage of time.

45. The staff thinks it is important to note that in some circumstances, an adjustment related to a change of control clause, might also represent a preservation adjustment if it does not solely compensate for the passage of time. See Agenda Paper 5B for this meeting for discussion of preservation adjustments. In Agenda Paper 5B of the April 2020 IASB meeting (see paragraph 30 of that paper), the staff acknowledged that considering change of control clauses vary from contract to contract, they may need to be assessed as a preservation adjustment or a passage of time adjustment depending on what they are intended to compensate the bondholder for. For example, if the clause aims to provide additional shares on conversion to equal the remaining time value of the conversion option on the date of change of control, the issuer would assess whether the change of control provision is consistent with the passage of time adjustment as proposed. In contrast, if the clause calculates the compensation to the bondholder relative to the effects of change of control on the existing shareholder, such an adjustment may be consistent with the preservation adjustment as proposed.