

STAFF PAPER

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IASB® meeting

Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Financial instruments settled in own equity instruments: adjustment principle		
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This Agenda Paper was initially prepared for the Board's March 2020 meeting as Agenda Paper 5B. However, it was not discussed at that meeting. This Agenda Paper is identical to Agenda Paper 5B for the March 2020 Board meeting.

1. Introduction

1. Following the analysis of the foundation principle in Agenda Paper 5A of this meeting, this agenda paper sets out the staff's analysis of the adjustment principle in the context of the staff's preliminary views as presented in Agenda Paper 5A. Similar to the analysis in Agenda Paper 5A, the staff have further developed the analysis of the adjustment principle based on the input provided by Board members at the December 2019 Board meeting.
2. At this Board meeting, the staff asks the Board to make tentative decisions that will help set the direction for the clarified principles that are being developed.
3. This paper is structured as follows:
 - (a) Adjustment principle (paragraphs 4–24);
 - (b) Application of the proposed adjustment principle to some illustrative examples (paragraphs 26–36);

- (c) Summary of the staff's preliminary views (paragraph 37); and
- (d) Question for the Board (paragraph 38).

2. Adjustment principle

4. In December 2019, the Board discussed developing a principle to allow the following two types of adjustments to derivatives on own equity to meet the fixed-for-fixed condition:
 - (a) *Preservation adjustments*—these adjustments preserve the relative economic interests of the potential or future equity instrument holder (in the case of options or forwards respectively) and the existing underlying equity instrument holder. For example, an adjustment in a derivative is considered to be a preservation adjustment, if it compensates the potential or future equity instrument holder if there is an event that benefits the existing underlying equity instrument holder.
 - (b) *Passage of time adjustments*—these adjustments compensate either the issuer or the holder of a derivative for changes in the timing of exercise of a derivative or changes in the exercise date of the option. The passage of time adjustment must vary with the passage of time, ie the timing of settlement of the derivative. For example, the issuer of a call option on own equity could be compensated for a later exercise and the holder of the call option could be compensated for an earlier exercise of the option. However, for an option, the passage of time adjustment may also compensate for the fact that the time value of an option is affected by its duration. This is because the value of an option is affected by factors such as the intrinsic value, time remaining until expiry and volatility of the underlying. All else being equal, the longer the time left until expiry, the more valuable an option will be.
5. As noted above, a passage of time adjustment is an adjustment for a change in the timing of settlement of a derivative. Therefore, there must be variability in the timing of settlement (eg multiple possible exercise dates or a range of dates as an exercisable period) and variability in the conversion/exchange ratio that changes

with the timing of settlement. The staff acknowledge that in practice, it may not always be clear whether a particular adjustment in a derivative would be assessed as a preservation adjustment or a passage of time adjustment. If so, entities would then need to obtain more information about the rationale for the adjustment and what it is intended to compensate so that the adjustment can be assessed as either a preservation adjustment or a passage of time adjustment.

6. In this section of the paper, the staff analyse both of these types of adjustments further, as directed by the Board at the December 2019 meeting. Consistent with Agenda Paper 5A, the staff analyse the classification of derivatives on own equity, whether standalone or embedded in a non-derivative instrument. For example, when we analyse the classification using a convertible bond as an example, our classification analysis in this paper and Agenda Paper 5A is focussed on the conversion option in the bond rather than the convertible bond as a whole.

2. 1 Preservation adjustments

7. The preservation adjustments change the amount of cash (or another asset) or the number of equity instruments that will be used to settle the derivative and are aimed at preserving the economic interests of the ‘potential or future equity instrument holder’ when events specified in the contract affect the economic interests of the existing underlying equity instrument holders for example, a share split or a share consolidation. In most cases the underlying equity instruments are shares, so for ease of understanding, we have subsequently referred in our analysis to the ‘future shareholder’ when describing the party whose economic interests the adjustments aim to ‘preserve’. The following table summarises the different parties whose economic interests the adjustments aim to preserve:

<i>Type of derivative¹</i>	<i>Future shareholder</i>	<i>Reason</i>
Written call option	Holder of the option (the derivative counterparty)	The holder of the derivative is the potential shareholder because the

¹ from the perspective of the issuer of the underlying equity instruments

		holder will become a shareholder if it exercises the option in the future.
Forward to sell own shares	Buyer (the derivative counterparty)	The buyer is the future shareholder because it will become a shareholder on the settlement date.
Purchased put option	Issuer of the option (the derivative counterparty)	The issuer of the derivative is the potential shareholder if the holder exercises the option in the future.
Purchased call option	Holder of the option (issuer of the underlying equity instruments)	The issuer of the underlying equity instruments is the option holder and will be reacquiring its own shares if it exercises the option.
Written put option and forward to buy own shares	Issuer of option and buyer of the shares (issuer of the underlying equity instruments)	The issuer of the underlying equity instruments may or will be reacquiring its own shares. ²

8. Based on the analysis in the table, the preservation adjustment would be a relevant consideration in the case of a written call option, a forward contract to sell own equity instruments and, although less common, a purchased put option. That is because in these cases, the issuer may or will deliver own equity instruments in settlement, and the derivative counterparty is the future shareholder. Theoretically, a preservation adjustment may also exist in a purchased call option and the proposed principles discussed below would equally apply. In that case, the issuer (ie the option holder) may take delivery of its own equity instruments in settlement and is therefore the ‘future shareholder’.

² The specific requirements in IAS 32 for contracts that contain obligations to reacquire own equity instruments will apply.

9. The staff's analysis compares the issuer's³ obligations towards the future shareholder and the issuer's obligations towards the existing shareholders, ie the analysis is still performed from the issuer's perspective. Some preservation adjustments require the issuer to fully compensate the future shareholder for the effect of a specified event relative to an underlying equity instrument holder. In that case, the issuer's obligation to the future shareholder is the same as what the issuer distributes to the existing shareholders.⁴ Other adjustments may work in favour of the future shareholder, or in favour of an underlying equity instrument holder depending on market movements or the occurrence of a particular event. In these instances, the issuer has more or less obligation to the future shareholder compared to what the issuer distributes to the existing shareholders.
10. Based on the Board's discussion in December 2019, allowable preservation adjustments (that would not preclude equity classification) would be those that fully preserve the relative economic interests of the future shareholder and the underlying equity instrument holder. On the other hand, adjustments that favour the future shareholder compared to, or at the expense of, the underlying equity instrument holder are not allowable preservation adjustments.
11. Applying the proposed preservation adjustment principle, as long as there is a possibility that the future shareholder may benefit more than the underlying equity instrument holder in any circumstance, that adjustment would not be an allowable preservation adjustment. The assessment is therefore not a probability-based adjustment. It is based on whether there is any event or circumstance in which the future shareholder will receive a benefit at the expense of the underlying equity instrument holder.
12. Also, a derivative on own equity may contain multiple contractual provisions that affect the number of own shares or the amount of cash (or another financial asset) to be exchanged. The exchange ratio may depend on the occurrence of different events such as a payment of dividends to the underlying equity instrument

³ As defined in Agenda Paper 5A, the term 'issuer' refers to the issuer of the underlying equity instruments, and that is the entity that classifies the derivative on own equity as equity or a financial asset/a financial liability applying the classification principles discussed in this paper and Agenda Paper 5A..

⁴ This is consistent with the rationale for the foundation principle, ie the issuer' position is similar to what it would have been if it had issued (or reacquired) the underlying equity instruments for cash instead.

holders, issuance of new shares or a change of control of the issuer. An entity would need to assess the adjustments that are triggered by each specified event separately to determine whether the derivative can be classified as equity.

13. For example, consider a written call option where the issuer will deliver 100 shares for CU100 cash if the option is exercised in two years' time. Assume the current market price is CU1 per share. A contractual provision stipulates that if there is a 2-for-1 share split before the exercise date (Event 1), the issuer will deliver 200 shares for CU100 cash. Another contractual provision stipulates that if there is a subsequent issue of shares for cash before the exercise date at a price below the current market price of CU1 per share (Event 2), the issuer will deliver 100 shares at the same price per share as was transacted in that subsequent share issue. If both Event 1 and Event 2 occurs before the exercise date, the issuer will deliver 200 shares at an exercise price equal to the price the subsequent issue of shares for cash was transacted at.
14. In this example, the adjustment under Event 1 is an allowable preservation adjustment because it preserves the relative economic interests of the derivative holder and the underlying equity instruments holders. However, the adjustment under Event 2 would not be an allowable preservation adjustment because it favours the future shareholder at the expense of the underlying equity instrument holder. Any 'averaging' or 'offsetting' of the effects would not be allowed, ie adjustments with positive effects cannot be averaged or offset against the negative ones. This means that the written call option in this example would not be classified as an equity instrument because of adjustments under Event 2.
15. At the December 2019 Board meeting, the Board also discussed whether the preservation adjustment principle should work in a symmetric way or not. In other words, if an adjustment in a derivative that favours, for example, the future shareholder at the expense of the existing underlying equity holders would not be considered an allowable preservation adjustment, what about an adjustment that favours the existing underlying equity holder at the expense of that future shareholder?

16. We present below two alternatives to describe the preservation adjustments that would be allowed in an equity-classified derivative ('allowable preservation adjustments'):
- (a) Alternative A—only adjustments that require the issuer to preserve the relative economic interests of the future shareholders and existing underlying equity instrument holders to *an equal extent* would be 'allowable' (ie would not preclude equity classification). This means the preservation adjustment is applied in a symmetric way, ie any adjustment that does not treat the future shareholders and the existing underlying equity instrument holders equally would not be an allowable preservation adjustment and would result in financial asset or financial liability classification; and
 - (b) Alternative B—treat the preservation adjustment as the 'boundary' for equity classification. Within the boundary, adjustments are considered 'allowable' if they require the issuer to preserve the relative economic interests of the future shareholders to *an equal or a lesser extent* than the existing underlying equity instrument holders.
17. In many cases, the classification outcome of applying Alternative A will differ from Alternative B. Consider the following example.

Entity X writes a call option that gives the holder the right to purchase 100 ordinary shares for CU100. If the entity pays annual dividends on ordinary shares while the option is outstanding, the strike price of the option is adjusted downwards for the amount of dividends the holder would have received if the derivative had already been exercised and shares had already been received. However, if Entity X pays special dividends on ordinary shares, there are no adjustments to the amount of cash or the number of shares exchanged in the derivative.

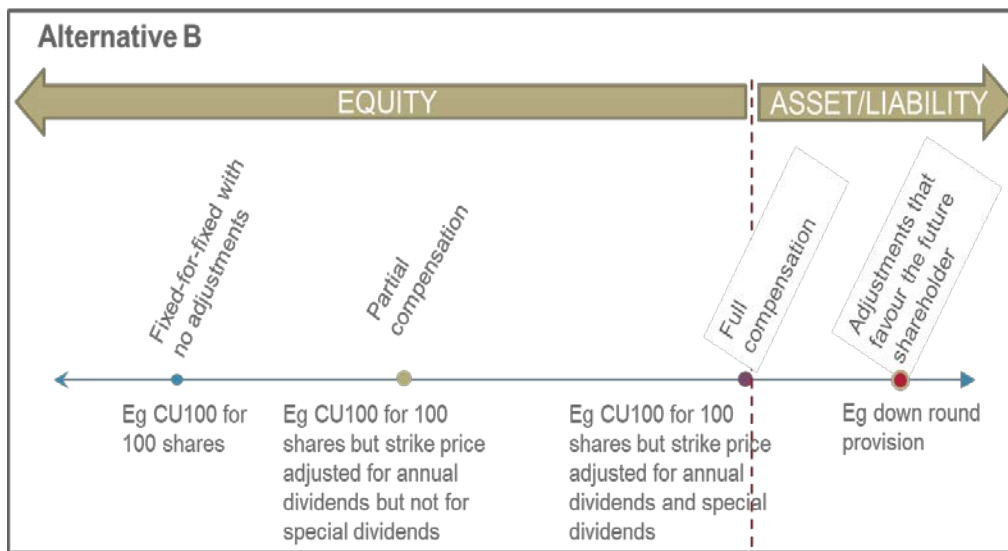
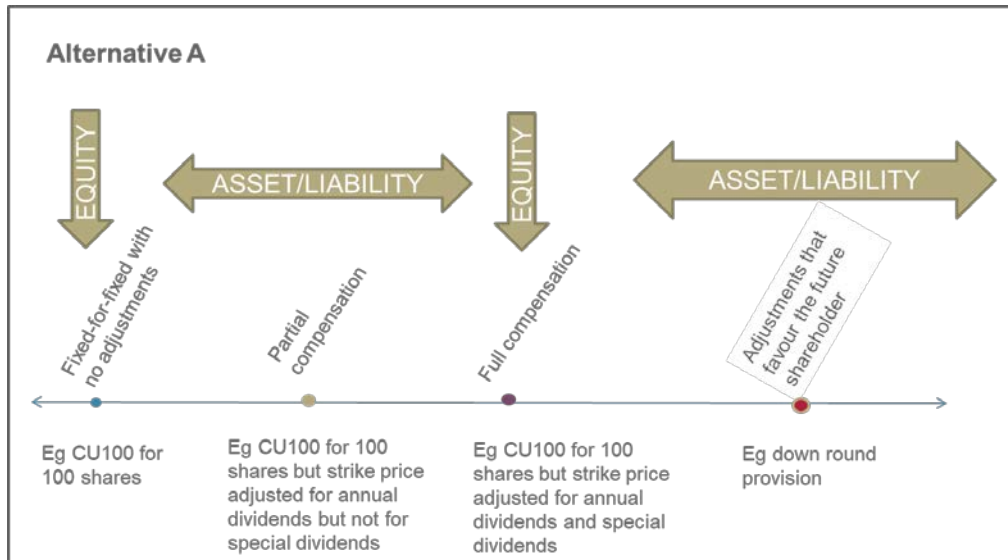
The adjustment in this example requires the issuer to only partially compensate the future shareholder—that is for the annual dividends paid to the ordinary shareholders but not for the special dividends.

Applying *Alternative A*, the derivative would be classified as a financial liability. Although the adjustment for dividends aims to preserve the relative rights of the derivative holders and ordinary shareholders, it does not treat them

equally because there is an adjustment for annual dividends, but not for special dividends.

Applying *Alternative B*, the derivative would be classified as an equity instrument. The derivative holder is not favoured at the expense of the ordinary shareholder. The issuer's obligation to the derivative holder is not more than what it would give to the ordinary shareholder. The issuer's obligation therefore does not exceed the boundary of the allowable preservation adjustments.

18. Under both alternatives, a derivative that contains an adjustment that treats the future shareholder and the underlying equity instrument holder equally would be classified as equity. Similarly, a fixed-for-fixed derivative with no adjustment (ie no compensation for the future shareholder) will be classified as equity. We can imagine these as two ends of a spectrum. However, as seen in the example in paragraph 17 of this paper, applying *Alternative A*, a derivative that contains an adjustment that only partially compensates the future shareholder would be classified as a derivative asset or a derivative liability. Therefore, *Alternative A* results in classifying something at either end of the spectrum (full compensation and no compensation) as equity while classifying something that falls between the two (partial compensation) as financial assets or financial liabilities. In the staff's view such an outcome may appear counter-intuitive and would be difficult for users of financial statements to understand. It also appears to lack a conceptual basis considering that equity represents a residual interest. The following diagrams illustrate the two alternatives using the example in paragraph 17.



19. The staff therefore prefer Alternative B because it results in classification outcomes that would provide more useful information to users of financial statements than Alternative A. Alternative B results in equity classification as long as the adjustments preserve the relative economic interests of the future shareholders to an equal or a lesser extent compared to the existing underlying equity instrument holders.

2.2 Passage of time adjustments

20. At the December 2019 Board meeting, the Board discussed the need for specifying which passage of time adjustments would be allowable in order to classify a derivative as equity. We present below four alternative ways to specify what is an allowable passage of time adjustment:

- (a) *Alternative A*—adjustment is pre-determined at the inception of the contract and varies only with the passage of time. If this is the case, there is no need to perform any further assessment. ‘Pre-determined’ in this context generally means a pre-determined fixed amount per share, ie the number of own shares and the amount of cash to be exchanged are both fixed at each predetermined exercise date. However, ‘pre-determined’ could also mean a pre-determined formula as long as the inputs to the formula only vary with time (ie time is the only input);
- (b) *Alternative B*—adjustment has the effect of fixing the cash amount per share in terms of a present value. This alternative will still require the adjustment to be pre-determined and to vary only with the passage of time, similar to Alternative A. However, the quantum of the adjustment would need to be analysed further as to whether the adjustments over time are done in a proportionate manner to represent compensation for passage of time.⁵ Although this alternative would require such further analysis, it would not question the reasonableness of the discount rate used, or the ‘fairness’ of the changes in the exchange ratio for different settlement dates (which is different from Alternatives C and D);
- (c) *Alternative C*—adjustment is pre-determined, only varies with the passage of time and is ‘reasonable’ (see paragraph 23 of this paper). Judgement would need to be applied to determine what is ‘reasonable’ taking into consideration the maturity of the derivative, time between two or more exercise dates and other relevant factors—for example, time value of money, credit risk of the counterparty with respect to the cash receive leg and liquidity risk. This alternative will still require the adjustment to be pre-determined and to vary only with the passage of time, similar to Alternative A and B, but the quantum of the

⁵ The staff acknowledge that the adjustment may not necessarily result in a fixed increment for a given period of interval between exercise dates.

adjustment would need to be analysed in more detail compared to Alternative B; and

- (d) *Alternative D*—adjustment is ‘reasonable’. Similar to Alternative C, judgement would need to be applied to determine what is ‘reasonable’ taking into consideration the maturity of the derivative, time between two or more exercise dates and other relevant factors. However, unlike Alternatives A-C, there is no requirement for the adjustment to be pre-determined and to vary only with the passage of time. An adjustment based on a formula with inputs other than time can therefore be allowable if it is considered reasonable. Under Alternative D, the scope of allowable passage of time adjustments can be broader than using Alternatives A, B and C, depending on how the Board defines what ‘reasonable’ means for this purpose. That is because Alternative D would not require the adjustment to vary only with the passage of time.

21. In many cases, applying the alternatives described above will not all result in the same classification outcome. Consider the following example.

Entity X issues a call option that can be exercised for predetermined amounts at predetermined dates as follows:

- 10 shares for CU100 at end of Year 1
- 10 shares for CU150 at end of Year 2
- 10 shares for CU500 at end of Year 3

Applying Alternative A, the adjustment to the strike price would be considered an allowable passage of time adjustment because the strike prices per share are pre-determined at the inception of the contract and only vary with the passage of time. No further assessment is required.

Applying Alternative B, the adjustment to the strike price would likely not be an allowable passage of time adjustment because the adjustment is not fixing the amount of cash to be exchanged for each share in terms of present value. The present value at inception of CU150 in year 2 is unlikely to be the same as present value at inception of CU500 in year 3 applying the same discount rate.

Applying Alternatives C or D, Entity X would need to use judgement and assess the reasonableness of the adjustment, especially whether the significant increase in the strike price in year 3 is reasonable.

22. With respect to Alternative C and Alternative D, the staff considered whether the description of ‘interest’ used in IFRS 9 could be used as a potential input in assessing the reasonableness of the adjustment. This is because issuing a derivative to sell own equity instruments in exchange for cash in the future could be likened to issuing shares for cash and simultaneously lending the same amount of cash to the counterparty with the shares held as collateral ie to be delivered to the counterparty upon receiving the cash with interest.
23. However, the staff note that the description of ‘interest’ in IFRS 9 is used for a different purpose and derivatives are affected by other risks and factors that are not considered to be components of ‘interest’ in IFRS 9. Further work would be required to assess whether the notion of interest in IFRS 9 is an appropriate notion to use in determining the reasonableness of the adjustment to derivatives on own equity, or whether it should be adapted and if so, how. The staff think that an analysis of what ‘reasonable’ means for this purpose will be useful in limiting the scope of what is regarded as an allowable passage of time adjustment, should the Board wish to limit the scope that way. Therefore, if the Board prefers to restrict the scope further than Alternative A or B ie prefers either Alternative C or Alternative D, the staff will bring an analysis to a future Board meeting on what ‘reasonable’ could mean for this purpose.
24. On balance, the staff’s preference is Alternative B. We note that the fixed-for-fixed condition in IAS 32 does not require an assessment of whether the pricing of a derivative, ie the amount of cash to be exchanged for equity instruments, is reasonable. The fixed-for-fixed condition does not require a contract to be ‘at-market’ to be classified as an equity instrument. Rather, the assessment is about whether there is variability in rights and obligations of the contract.
25. The staff think that the foundation principle set out in Agenda Paper 5A also focuses on whether there is variability in contractual rights and obligations rather than how the amount of cash to be exchanged for equity instruments has been determined. Alternative A would therefore be in line with this principle. However, Alternative B would limit the scope for abuse and ensure that there is a

relationship between how the stepped amounts were determined and time. Alternative C and D will require more subjective assessments and may have unintended consequences for example, particularly Alternative D may result in some derivatives being classified as equity instruments that goes beyond the scope of what was intended to be classified as an equity instrument.

3. Illustrative examples—adjustment principles

26. In this section, the proposed adjustment principles are applied to a number of illustrative examples of financial instruments containing features that are common in practice. To the extent applicable, the analysis below includes the different alternatives discussed earlier in this paper.
27. Most of the examples discussed are of convertible bonds that contain an embedded option that gives the bondholder the right to convert the bond into a fixed number of the issuer's own ordinary shares. This is because the adjustments discussed in this section are most commonly found in convertible bond contracts. However the analysis discussed below would be applied in the same way to standalone derivatives on own equity. Currency Unit (CU) in the examples is assumed to be the issuer's functional currency.

3.1 Change of control provisions

28. Many convertible bonds contain takeover or change of control provisions that either allow or require the holder to exercise its conversion option at an enhanced conversion ratio if control of the issuer changes. In some cases the adjustment is based on a pre-determined formula and in other cases the adjustment is a pre-determined fixed amount that depends on the date of the change in control and/or the share price of the issuer on that date.
29. A takeover or change in control may negatively affect bondholders in a number of ways. For example, the bondholder might suffer the loss of its conversion option (if conversion is required upon a change of control of the issuer), the loss of an option to convert into publicly traded shares (if the issuer's shares are no longer publicly traded) or the loss of time value in the option (in the event that the

bondholder is incentivised to exercise the conversion option early). The latter case is common in practice and contracts often contain a clause to provide the bondholder with an enhanced conversion ratio following a change of control of the issuer in order to compensate the bondholder for this loss. Such instruments often give the issuer a right to redeem the convertible bond early, at par, for a period immediately following a change of control. The issuer's call option may incentivise the convertible bondholder to convert early and receive an additional number of shares to reflect the fact that, absent conversion, the issuer will buy back the convertible bond at par and the convertible bondholder will lose the remaining value of the conversion option.

30. Considering that 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 is aimed to provide additional shares on conversion to equal the remaining time value of the conversion option on the date of change of control (as in the example discussed in paragraph 31 of this paper), 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.
31. The analysis and classification outcome would depend on which alternative in paragraph 20 of this paper applies. Consider the following example.

Entity X issues a convertible bond that gives the bondholder a right to convert the bond into ordinary shares of Entity X at maturity of the bond. The convertible bond contract includes a change of control clause. In the event of a change of control of the issuer, the conversion ratio will be enhanced as stipulated by the contract. The contract specifies predetermined conversion ratios which vary depending on when the change of control occurs during the life of the instrument. The adjustment to the conversion ratio is reduced the closer the date of the change of control is to the maturity date of the bond.

Applying the foundation principle on its own, Entity X does not know how much cash it is entitled to receive per share because the conversion ratio may change if a change of control occurs while the convertible bond is outstanding.

Consequently the entity would assess whether the adjustment to the conversion ratio is an allowable passage of time adjustment.

Applying Alternative A, the adjustment to the conversion ratio as described above would be considered to be an allowable passage of time adjustment because the conversion ratios are pre-determined at the inception of the contract and vary with the passage of time only. Although the adjustment will be triggered only upon a specific contingent event occurring which may be beyond the control of the issuer, the adjustment introduces a variability that only varies with passage of time. It is similar to a counterparty-held option which the counterparty can choose to exercise on different dates, the issuer does not have control over if and when the counterparty would exercise the option and the adjustment introduces a variability that only varies with the passage of time.

Applying Alternative B, in addition to the analysis applicable to Alternative A, the issuer would be required to assess whether the conversion ratios are specified in such a way that fixes the strike price per share in terms of a present value.

Applying Alternative C, in addition to the analysis applicable to Alternative A, the issuer would be required to assess whether the conversion ratios specified in the contract are reasonable.

Applying Alternative D, the adjustment may be an allowable passage of time adjustment if the enhancement to the conversion ratio is considered to be reasonable, for example compensates the bondholder for the remaining time value of the conversion option on the date of change of control. Further analysis would be required to determine the reasonableness of the adjustment.

32. Consider a variation of the fact pattern in the example above.

Assume the same fact pattern as the example in paragraph 31 except the manner in which the adjustments to the conversion ratio are specified by the contract differs. Instead of stipulating pre-determined conversion ratios, the contract includes a formula that will determine the conversion ratio if change of control occurs. The inputs to the formula include the share price of the issuer as well as the time remaining until the original conversion date.

Applying Alternative A, B or C, the adjustment would not be an allowable passage of time adjustment because the conversion ratio is not pre-determined as described in paragraph 20 of this paper ie it is based on a

predetermined formula but the inputs do not vary with the passage of time only.

Applying Alternative D, the adjustment may be an allowable passage of time adjustment if the enhancement to the conversion ratio is considered to be reasonable. Further analysis would be required on the reasonableness of the adjustment.

3.2 Shares to be delivered specified as fixed % of outstanding shares at the exercise/conversion date

33. Some convertible bonds give the bondholder the right to convert the bond into a fixed percentage of total ordinary shares outstanding at the time of conversion. Bondholders are therefore protected from any potential dilution that may occur from subsequent share issuances. Consider the following example.

Entity X issues a convertible bond that gives the bondholder the right to convert the bond into ordinary shares of Entity X at maturity of the bond. The number of ordinary shares to be delivered to the holder will represent 1% of the total ordinary shares outstanding at the date of conversion.

Applying the foundation principle, Entity X does not know the amount it is entitled to receive per share because the number of shares that represents 1% of total ordinary shares outstanding may change between the issue date of the bond and the conversion date.

Entity X would assess whether the adjustment to the number of shares to be exchanged is an allowable preservation adjustment.

Applying Alternative A or B, the adjustment would not be an allowable preservation adjustment as it could favour bondholders compared to the ordinary shareholders. If for example, Entity X issues additional shares between the issue date of the bond and the conversion date, the total number of ordinary shares outstanding increases, the existing shareholder's interest in Entity X would be diluted in terms of percentage of ordinary shares held whereas the bondholder would be guaranteed 1 % of ordinary shares outstanding.

The adjustment is not a passage of time adjustment because the adjustment does not vary with the timing of the exercise date. The conversion option has a single exercise date which does not vary.

The conversion option in this example would not be classified as an equity instrument.

3.3 Path-dependent options in which the number of shares to be delivered varies with the share price

34. Some convertible bonds have a conversion ratio based on a formula such that the number of shares exchanged varies depending on the average share price of the issuer over a period before the exercise date. This is an example of a path-dependent option because the payout varies based on the path the underlying asset's price takes over a period of the option's life. Consider the following example.

Entity X issues a convertible bond of CU100 containing a right for the holder to convert the bond into shares of Entity X at its maturity but the number of shares to be delivered at conversion date varies depending on the average share price of Entity X six months before the conversion date. For example, if the average share price of the six-month period is CU5, Entity X delivers 20 shares. If it is CU10, Entity X delivers 10 shares.

Applying the foundation principle, Entity X does not know the amount it will receive per share because it does not know what the average share price of the six months period will be. Entity X would assess whether the adjustment to the number of shares to be delivered is allowable.

Applying Alternative A or B of preservation adjustment, the adjustment in this example is not an allowable preservation adjustment. If the share price decreases, the bondholder would be favoured with additional shares at the expense of the shareholders. The issuer is obliged to offer protection to the bondholder against a fall in the share price that would not be available to the shareholders.

The adjustment is not a passage of time adjustment because the adjustment does not vary with the timing of the exercise date. The conversion option has a single exercise date which does not vary.

The conversion option in this example would not be classified as an equity instrument.

The staff note that this example is also similar to an example of a non-derivative financial liability instrument that is settled with a variable number of shares to the value of a specified amount where the issuer is effectively using

its own shares as currency as envisaged under paragraph 21 of IAS 32. 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.

3.4 Compensation for the loss of liquidity

35. Another relatively common feature in convertible bonds is compensation for the loss of liquidity in the underlying equity instruments. Consider the following example.

Entity X issues a convertible bond that is convertible on maturity at the option of the bondholder. The convertible bond includes a conversion ratio that is adjusted to another fixed ratio if the total number of outstanding shares in the market falls below a particular threshold while the convertible bond is outstanding.

Applying the foundation principle, Entity X does not know the amount it is entitled to receive per share upon conversion because the conversion ratio may change if the specified event occurs while the convertible bond is outstanding.

Entity X would assess whether the adjustment to the number of shares to be delivered is an allowable preservation adjustment or an allowable passage of time adjustment.

The adjustment for the loss of liquidity is not an allowable preservation adjustment because the issuer would not be obliged to compensate existing shareholders for the loss of liquidity and compensating the derivative holder would be at the expense of the existing shareholders.

The adjustment is not a passage of time adjustment because the adjustment does not vary with the timing of the exercise date. The conversion option has a single exercise date which does not vary.

The conversion option in this example would not be classified as an equity instrument.

3.5 Strike price that varies with an interest rate benchmark or an inflation index

36. Some derivatives on own equity have the strike price indexed to a variable such as an interest rate benchmark or an inflation index. This means that the strike price is determinable based on a formula specified in the contract; the strike price is not fixed until the date the derivative is settled and all inputs into the formula are known.

Entity X issues a call option that gives the counterparty the right to buy 100 ordinary shares of Entity X on any of three fixed dates over a three-year period. The strike price of the option will depend on when the counterparty exercises the option and the rate of a specified interest rate benchmark on that date. If the option is exercised one year after issuance, the strike price will be $CU100 \times (1 + \text{benchmark rate})$. If the option is exercised two or three years after issuance, the strike price will be $CU100 \times (1 + \text{benchmark rate})^2$ and $CU100 \times (1 + \text{benchmark rate})^3$ respectively.

Applying the foundation principle, Entity X does not know how much cash it will receive per share because it does not know when the counterparty will exercise the option, and what the interest rate benchmark will be at that date. Entity X would assess whether the adjustment to the strike price is an allowable passage of time adjustment.

Applying alternative A, B or C, the adjustment is not an allowable passage of time adjustment because the price per share is not a predetermined fixed amount or a predetermined formula that only varies with the passage of time.

Applying alternative D, the adjustment is likely to be an allowable passage of time adjustment and assessed as reasonable if the reasonableness test is based on the notion of interest in IFRS 9—assuming the benchmark interest rate represents the time value of money that is relevant to the derivative (considering the terms of the derivative such as the currency the strike price is denominated in).

If instead of an interest rate benchmark, the strike price was indexed to an inflation index, a similar analysis would apply. Applying alternative A, B or C, the adjustment is not an allowable passage of time adjustment because the price per share is not a predetermined fixed amount or a predetermined formula that only varies with the passage of time.

Applying alternative D, the adjustment may be considered as reasonable if, for example, assessed based on the notion of interest in IFRS 9. This is because

paragraph B4.1.13 (Instrument A) of FRS 9 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. The interest rate on the instrument reflects 'real' interest and the interest amounts are consideration for the time value of money on the principal amount outstanding. Further, paragraph B4.3.8(f) of IFRS 9 explains that an inflation-linked embedded derivative is not separated if it is not leveraged and the index relates to inflation in the entity's own economic environment. In the staff's view, based on the guidance in IFRS 9, it could be argued that linking the strike price to an inflation index does not breach the fixed-for-fixed condition as long as the inflation index is not leveraged and relates to inflation in the issuer's own economic environment.

4. Summary of the staff's preliminary views

37. The staff's preliminary views on how to articulate the adjustment principles necessary to assess the fixed-for-fixed condition are set out below.

- (a) **Adjustment principle: Preservation adjustments**—The staff prefer **Alternative B** for the reasons discussed in paragraph 19 of this paper. Applying Alternative B, preservation adjustments would not preclude equity classification of derivatives on own equity if they require the issuer to preserve the relative economic interests of the potential or future shareholders to an equal or a lesser extent than the underlying equity instrument holders.
- (b) **Adjustment principle: Passage of time adjustments**—The staff prefer **Alternative B** for the reasons discussed in paragraphs 24–25 of this paper. Applying Alternative B, passage of time adjustments would not preclude equity classification of derivatives on own equity if they:
 - (a) are pre-determined and only vary with passage of time; and
 - (b) have the effect of fixing the number of functional currency units per underlying equity instrument in terms of a present value.

5. Questions for the Board

38. The staff would like to ask the Board the following questions.

Question for the Board

1. **Preservation adjustments**—does the Board agree that Alternative B should be used to articulate allowable preservation adjustments?
2. **Passage of time adjustments**—does the Board agree that Alternative B should be used to determine what is an allowable adjustment for the passage of time?