STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Financial instruments settled in own equity instruments: fixed-for-fixed condition		
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Introduction

1. At the October 2019 Board meeting (Agenda Paper 5), the Board discussed the project plan for the FICE project. In particular, the Board discussed the practice issues that it could address in the scope of the project and an indicative project timeline outlining the expected commencement of Board deliberations on each issue.

2. At that meeting, the Board discussed the following as the preliminary list of practice issues that the Board could address in the scope of the project on making clarifying amendments to IAS 32 *Financial Instruments: Presentation*:

   (a) classification of financial instruments that will or may be settled in the issuer's own equity instruments, eg application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments;

(b) accounting for obligations to redeem own equity instruments, eg accounting for written put options on non-controlling interests (NCI puts);

(c) accounting for financial instruments that contain contingent settlement provisions, eg financial instruments with a non-viability clause;

(d) the effect of laws and regulations on the classification of financial instruments;

(e) reclassification between financial liability and equity instruments, eg when circumstances change, or contractual terms are modified; and

(f) classification of particular financial instruments that contain obligations that arise only on liquidation of the entity, eg perpetual financial instruments[1].

3. The objective of this paper is to begin the Board's discussion on the classification of financial instruments that will or may be settled in the issuer's own equity instruments (both derivative and non-derivative instruments). In particular, the staff will explore as part of this discussion what clarifications could be made to the underlying principle of the fixed-for-fixed condition. The staff understand that this is one of the main sources of accounting challenges in practice and it is arguably one of the most difficult challenges to solve. For that reason, the staff would like to start with this topic. This paper introduces possible clarifications that the staff are considering, without making any recommendations or asking the Board to make any decisions.

4. Based on the Board's feedback provided at this meeting, the staff will refine and further develop the clarified principles and bring back an analysis at a future Board meeting that illustrates their application to common practice questions. In addition, at that future meeting, the staff will analyse if there are any other enhancements that can be made to IAS 32 to clarify the classification of financial instruments that will or may be settled in the issuer's own equity instruments, for

[1] The financial instruments described in this subparagraph do not include those that are subject to the specific exception in paragraphs 16C-16D of IAS 32, ie instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

example incorporating some of the IFRS Interpretations Committee discussions into IAS 32 or into illustrative examples that accompany IAS 32. Finally, the staff will assess the proposals against the project objectives discussed at the October 2019 Board meeting before asking the Board to decide on clarifications to the classification of financial instruments that will or may be settled in the issuer's own equity instruments.

5. The rest of the topics in paragraph 2 of this paper will be analysed and discussed at future Board meetings.

6. In developing potential clarifications, the staff first considered the requirements and the rationale in IAS 32. In addition, the staff have incorporated some ideas from the 2018 Discussion Paper (2018 DP) in this paper where relevant and useful. Some respondents to the 2018 DP commented that the guidance on variables that affect the net amount of derivatives on own equity was useful in addressing some questions on classification of such derivatives. Although the project direction going forward is not to continue with the proposed classification approach in the 2018 DP, the staff believe the feedback suggests that some of the discussion in the 2018 DP on these variables may be helpful in clarifying the underlying principle of the fixed-for-fixed condition.

7. This paper is structured as follows:

   (a) Current requirements in IAS 32 (paragraphs 8–13);

   (b) A brief history of the development of the fixed-for-fixed condition (paragraphs 14-17);

   (c) Practice questions (paragraphs 18–25);

   (d) Proposed clarifications to the principle underlying the fixed-for-fixed condition (paragraphs 26–51);

   (e) Application of the proposed clarified principle underlying the fixed-for-fixed condition (paragraphs 53–63);

   (f) Summary of the staff's preliminary view (paragraph 64); and

   (g) Question for the Board (paragraph 65).

Current requirements in IAS 32

8. Paragraph 11 of IAS 32 defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

9. Paragraph 16(b) of IAS 32 contains classification requirements for financial instruments that will or may be settled in the issuer's own equity instruments including what is commonly referred to as the fixed-for-fixed condition for derivatives. Paragraph 16 of IAS 32 states that:

> […] the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met. […] (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
>
> (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
>
> (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments. […]

10. IAS 32 refers to using 'own equity instruments as a means to settle the contract' and using 'own equity instruments as currency' in explaining the rationale for the requirement in paragraph 16(b) of IAS 32 (see paragraphs 11–13 below). In these cases, such instruments are not equity instruments because they do not evidence a

residual interest in the entity's assets after deducting all of its liabilities. Such contracts represent rights or obligations of a specified amount rather than a specified equity interest. The entity does not know before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and the entity may not even know whether it will receive or deliver its own shares.

11. Paragraph 21 of IAS 32 states that (**emphasis added**):

> A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to **receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price).** Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. **It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.**

12. Paragraph BC10 of the Basis for Conclusions on IAS 32 states that (**emphasis added)**:

> […] When an entity **uses its own equity instruments 'as currency' in a contract to receive or deliver a variable**

> **number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price), the contract is not an equity instrument,** but is a financial asset or a financial liability. In other words, when a contract is settled in a variable number of the entity's own equity instruments, or by the entity exchanging a fixed number of its own equity instruments for a variable amount of cash or another financial asset, the contract is not an equity instrument but is a financial asset or a financial liability.

13. Paragraph BC13 of the Basis for Conclusions on IAS 32 states that (**emphasis added)**:

> The Board agreed that it would be inappropriate to account for a contract as an equity instrument **when an entity's own equity instruments are used as currency in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable** (eg a net share-settled derivative contract on gold or an obligation to deliver as many shares as are equal in value to CU10,000). **Such a contract represents a right or obligation of a specified amount rather than a specified equity interest.** A contract to pay or receive a specified amount (rather than a specified equity interest) is not an equity instrument. **For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and the entity may not even know whether it will receive or deliver its own shares.**

A brief history of the development of the fixed-for-fixed condition

14. When IAS 32 was first published in 1995, the financial liability definition was focused on the manner of settlement:

> A financial liability is any liability that is a contractual obligation:
>
> (a) to deliver cash or another financial asset to another enterprise; or
>
> (b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

15. This version of IAS 32 also explained equity instruments in the non-authoritative Appendix to IAS 32.

> Examples of equity instruments include common shares, certain types of preferred shares, and warrants or options to subscribe for or purchase common shares in the issuing enterprise. An enterprise's obligation to issue its own equity instruments in exchange for financial assets of another party is not potentially unfavourable since it results in an increase in equity and cannot result in a loss to the enterprise. The possibility that existing holders of an equity interest in the enterprise may find the fair value of their interest reduced as a result of the obligation does not make the obligation unfavourable to the enterprise itself.

16. When IAS 39 *Financial Instruments: Recognition and Measurement* was originally issued in March 1999 (approved by the IASC Board in December 1998), a consequential amendment was made to IAS 32 (operative when an enterprise applies IAS 39) to include the following elaboration on the definition of a financial liability (**emphasis added**):

> An enterprise may have a contractual obligation that it can settle either by payment of financial assets or by payment in the form of its own equity securities**. In such a case, if the number of equity securities required to settle the obligation varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the holder of the obligation is not exposed to gain or loss from fluctuations in the price of the equity securities.**

> Such an obligation should be accounted for as a financial liability of the enterprise.

17. The fixed-for-fixed condition (see paragraph 9 of this paper) was introduced in the revised version of IAS 32 issued in December 2003. The Board developed this revised IAS 32 as part of its project to improve IAS 32 and IAS 39. The Board's main objective was a limited revision to provide additional guidance on selected matters which included the classification of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments. In explaining the particular changes to classification of contracts settled in an entity's own equity instruments, it was stated that when an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability.

Practice questions

18. Due to the fact that there is limited guidance in IAS 32 on how the fixed-for-fixed condition in paragraph 16(b) of IAS 32 should be applied, various questions have arisen in practice about what 'fixed' means and whether there are particular types of variability that do not violate the fixed-for-fixed condition. Furthermore, as a result of a lack of clarity in the requirements and/or limited guidance on the application of the requirements we are aware that there is diversity in practice. Sources of these questions include submissions to the Committee, feedback on the 2018 DP and previous Board consultations and it is apparent that application of the fixed-for-fixed condition is a widespread practice issue.

19. In other cases, questions have arisen on the appropriateness of the classification outcome in IAS 32 even if the requirement is clear. For example, the required classification for a conversion option in a foreign currency convertible bond is clear but some stakeholders hold the view that it should be classified as an equity instrument because the amount is fixed in the foreign currency.

20. Practice questions can therefore broadly be categorised into two different types:

(a) questions on how a requirement in IAS 32 should be interpreted and applied in practice; and

(b) questions on the appropriateness of the outcome even if the requirement in IAS 32 is clear.

21. This agenda paper discusses both types of questions but focuses on the first type of questions as these are more prevalent in practice. The issues arise both in the context of standalone financial instruments (eg a written call option or a non-derivative instrument that is settled in own shares) and embedded derivatives (eg conversion option in convertible debt).

22. Broadly, the issue is whether 'fixed' means:

(a) 'never changes';

(b) 'predetermined'—and if this is the correct interpretation, whether any predetermined variability can be considered 'fixed' or only particular types of variability; or

(c) something else.

We can identify further issues if we focus on each part of the fixed-for-fixed condition separately (as described in paragraphs 23–25 below).

23. There are questions that relate to what a 'fixed amount of cash or another financial asset' is:

(a) Derivatives that are settled by exchanging a foreign currency amount with own equity instruments, for example,

(i) foreign currency call options—the written call option allows the holder to exchange a fixed amount of a foreign currency for a fixed number of shares. The written call option could be an embedded derivative for example consider a USD convertible bond that can be converted into a fixed number of the entity's equity instruments while the entity's functional currency is the Euro.

(ii) Foreign currency call options issued by a subsidiary—a subsidiary writes an option that allows the holder to exchange a fixed amount of currency

for a fixed number of shares of the parent. The subsidiary and the parent have different functional currencies. The classification in the consolidated financial statements will differ depending on whether it is based on the functional currency of the parent or the subsidiary.

(b) Derivatives on own equity instruments that are subject to adjustments to the amount of cash to be exchanged to reflect the passage of time, for example:

(i) Bermudan options with predetermined fixed but different strike prices—an option to buy or sell a fixed number of shares for a specified exercise price, but where there are a number of possible exercise prices that vary based on when the option is exercised.

(ii) Derivatives on own equity where the number of shares is fixed but the cash leg is subject to a formula for example, the cash leg increases with inflation.

(c) Derivatives on own equity instruments that are settled other than by exchanging cash, for example:

(i) A contract to exchange the entity's own equity instruments for another unrelated entity's shares (another financial asset) instead of cash.

(ii) A conversion option in convertible debt that obliges the entity to exchange its own equity instruments for the extinguishment of its liability rather than for a fixed amount of cash or another asset. In some cases, the amount of the liability that will be converted will vary with accrued interest. For example, a convertible bond where interest accrues over time with a predetermined fixed conversion ratio of 5 shares for each CU1000 outstanding at conversion.

24. There are also questions that relate to what a 'fixed number of equity instruments' is:

(a) Adjustment clauses that alter the conversion ratio to prevent dilution (commonly referred to as anti-dilution clauses)—many convertible bonds provide for a change to the conversion ratio if specified events occur such as subdivision/combination of the number of ordinary shares, rights issues or bonus issues, or dividends paid to existing shareholders that were not taken into account in setting the conversion ratio.

(b) Change of control provisions - a convertible bond may provide that on a change of control of the issuer, bondholders are entitled, or required to exercise, their conversion rights. The conversion price is adjusted, relative to what it would have been in the absence of the change of control.

(c) Down round clauses that compensate the instrument holder for fair value losses for example, the conversion ratio is adjusted if new shares are issued at a current market price that is below the conversion price.

(d) Path-dependent options – a convertible bond containing a right for the holder to convert the bond into shares of the issuer but the number of shares received at each exercise date varies depending on a formula such as the average share price of the entity six months before the exercise date.

(e) Conversion option into a fixed percentage of the issuer's outstanding shares—the number of ordinary shares on conversion will represent a fixed percentage for example, 5% of the issued and outstanding shares of the issuer when the holder exercises the option to convert.

(f) A derivative may give the entity a choice of settlement between two predetermined 'fixed-for-fixed' exchanges, for example, to deliver 100 own shares for CU110 or 50 own shares for CU55.

25. Other questions include:

(a) Contracts to exchange one type of equity instrument for a different type of equity instrument (referred to as 'share-for-share exchanges'), for example:

(i) a contract that obliges an entity to exchange a fixed number of shares of one class of own equity for a fixed number of another class;

(ii) an option that allows holders of a non-controlling interest to exchange their holding of a fixed number of shares in a subsidiary for a fixed number of shares in the parent.

(iii) an option that allows holders of a non-controlling interest to exchange their holding of a fixed number of shares in a subsidiary for a variable number of shares in the parent equal to a fixed amount.

(b) Derivatives on own equity subject to an exercise contingency—for example, a derivative on own equity that requires the exchange of a fixed number of shares for a fixed amount of cash and is mandatorily exercised if event A occurs. If event A does not occur, the derivative is not exercised. Similarly, consider a financial instrument that is mandatorily convertible into a fixed number of ordinary shares unless a non-viability event occurs. If a non-viability event occurs, the instrument is written down to zero.

(c) A variation of the Bermudan option described in paragraph 23 of this paper—both the number of shares to be delivered, and the amount of cash to be received, changes over the life of the contract, but the change is predetermined at the inception of the contract. For example, if A occurs the holder will receive 100 shares for CU100, but if B occurs the holder will receive 75 shares for CU90.

Proposed clarifications to the principle underlying the fixed-for-fixed condition

What is the rationale for the fixed-for-fixed condition?

26. As reproduced in paragraphs 11–13 of this paper, the explanation in IAS 32 for a contract that will or may be settled by a variable number of shares focuses on whether a contractual right or obligation is for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the

market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). The rationale provided by IAS 32 is that such contracts represent rights or obligations of a specified amount rather than a specified equity interest and own shares are used as currency to settle the specified amount. In these cases, such instruments are not equity instruments because they do not evidence a residual interest in the entity's assets after deducting all of its liabilities.

27. In the staff's view, this notion can be used to clarify the rationale for the fixed-for-fixed condition which underpins the concept of a specified equity interest. For example, clarification could be added to state that a derivative on own equity would meet the fixed-for-fixed condition if the fair value of the derivative at the settlement date(s) ('settlement value') is:

    (a) affected only by fluctuations in the price of the underlying equity instruments (exposed to equity price risk); and

    (b) not affected by fluctuations in other variables that the holder of the underlying equity instruments would not be exposed to (not exposed to other risks).

28. This would be mean that the entity as the issuer of a fixed-for-fixed derivative would not be exposed to other risks or other variables that it would not be exposed to by directly issuing the underlying equity instruments. If issuing a derivative exposes the entity to gains or losses from fluctuations in such other variables (including foreign currency exchange rate), the derivative should be classified as a derivative asset or derivative liability and would be subject to remeasurement through profit or loss.

29. The staff articulated the clarifications above using the fair value of a derivative on its settlement date(s) because the focus is on the net value of cash (or another financial asset) and equity instruments that will ultimately be exchanged on settlement of the derivative. Derivatives are subject to changes in fair value over their life caused by many market factors. For example, the fair value of option derivatives on an entity's own shares is affected by the probability of exercise and by general market volatility which would not be specific to the entity's share price. However, the clarified principle focuses on the settlement value so would

only consider the value of the two legs of the exchange if the derivative is exercised, ie the difference between the value of cash or another financial asset and the value of own equity instruments, and not the probability of exercise. This is because at settlement date, it is known whether the derivative is exercised or not. . Unless the entity could be required to early settle the derivative at the current market value at a point in time (see the example in paragraph 41), the staff are of the view that the fixed-for-fixed condition should be analysed based on the fair value of the cash or financial asset and own equity instruments that the entity is obliged to exchange on the settlement date.

30. To illustrate the application of the clarifications in paragraph 27, consider an example of an option that gives the holder a right to buy 100 of the entity's own shares for CU100 in cash in five years. This would meet the fixed-for-fixed condition as both the number of equity instruments and the amount of cash is fixed. The fair value of the derivative on the settlement date would only be affected by fluctuations in the price of the underlying equity instruments.

31. On the other hand, an option that gives the holder a right to buy as many of the entity's own shares as are worth CU100 in exchange for CU95 in cash would not meet the fixed-for-fixed condition because the fair value of the derivative on settlement date is not affected by fluctuations in the price of the equity instruments. The entity has an obligation to deliver CU100 on the settlement date of the derivative, albeit in shares.

If any adjustments are to be allowed, which ones would be 'acceptable'?

32. As described in paragraphs 22–25, many financial instruments settled in the issuer's own equity instruments especially derivatives are subject to adjustments. The adjustments may be made to the amount of cash or to the number of equity instruments to be exchanged, or to both. To provide clearer answers to practice questions, the Board could first clarify how the term 'fixed' should be interpreted in the requirement in paragraph 16(b) of IAS 32. Although the staff discuss what 'fixed' means in the context of the fixed-for-fixed condition for derivatives, determining what is a 'fixed number of its own equity instruments' will also affect the classification of non-derivatives, ie assessing whether an obligation in a non-

derivative instrument is not for a ‘variable’ number of shares in accordance with paragraph 16(b)(i) of IAS 32. The staff consider that the Board could, for example:

(a) clarify that ‘fixed’ means ‘never changes’. In this case, any adjustments to either the cash or the own equity instruments to be exchanged would preclude the equity classification of the derivative; or

(b) build a principle to allow some particular types of adjustments to derivatives to meet the fixed-for-fixed condition.

33. If the Board is of the view that some particular types of adjustments in a derivative, that would otherwise meet the fixed-for-fixed condition should be permitted, the question to answer would be which adjustments would be consistent with the ‘fixed-for-fixed condition’. For example, should an adjustment always affect the derivative holder and the underlying equity holder equally? Or should adjustments that favour the derivative holder at the expense of underlying equity holders also be allowed?

34. The clarification described in paragraphs 27–28 focuses on the notion that a derivative on own equity that meets the fixed-for-fixed condition should have a settlement value that is only affected by the equity price risk and the issuer of such a derivative should not be exposed to any other risks that it would not be exposed to if the underlying equity instruments had been issued instead at inception of the derivative. If there is a possibility that the issuer would need to give away more value to the derivative holder than it would have given to the underlying equity instruments holder (had it issued the underlying equity instruments instead), the staff think that such a derivative should not be classified as an equity instrument because it would expose the issuer to additional risks. In the staff’s preliminary view, applying that notion, adjustments to the amount of cash or other financial assets or the number of own equity instruments would not preclude the derivative meeting the fixed-for-fixed condition if the adjustments:

(a) preserve the relative economic interests of the derivative holder and the underlying equity instrument holder (‘preservation adjustments’); or

(b) compensate the issuer for the fact that the derivative will be settled at a future date (‘passage of time adjustments’).

Preservation adjustments

35. Some anti-dilution provisions such as ‘make-whole’ provisions are designed to compensate the holder of a derivative so that it is in the same position relative to the holder of the underlying equity instrument before and after a particular dilutive event. Such an adjustment does not preclude equity classification because it preserves the relative economic interests of the derivative holder and the underlying equity instrument holders and ensures they have the same relative residual interest in the assets of the entity after deducting its liabilities. The entity is not exposed to any additional risks by including such ‘make-whole’ provisions.

36. Consider the following example. At year 0, Entity A writes an option on its own shares that would give Entity B the right to buy 100 shares of Entity A in two years’ time for the amount of CU50 in cash. At the date of the issuance of the derivative, Entity A has 1 million shares outstanding. In the following year, Entity A decides to implement a 2-for-1 stock split. As a result, Entity A has 2 million shares outstanding. In accordance with the contractual terms of the option, an adjustment occurs so that the option now entitles Entity B to buy 200 shares for CU50 at year 2. The settlement value of the option is only affected by the price of Entity A’s equity. The adjustment to the number of shares is a preservation adjustment described in paragraph 34 because Entity B is in the same position before and after the share split and Entity A is not exposed to any additional risks. Had Entity A issued 100 shares to Entity B instead of the derivative at year 0, Entity B would have held 200 shares at year 2. The adjustment would not preclude an equity classification.

37. However, adjustments that favour the derivative holder at the expense of the underlying equity holders go beyond these purposes ie is not a ‘preservation adjustment’ or a ‘passage of time’ adjustment and would preclude meeting the fixed-for-fixed condition. By issuing such a derivative, the entity has effectively promised to give away more value than it would have if it had issued the underlying equity instrument directly. A derivative containing such adjustments would not be classified an equity instrument.

38. For example, a derivative on own equity may contain a down round feature which is a term that specifies if the entity subsequently issues ordinary shares at the current market price for less than the strike price of the derivative, the strike price of the derivative will be reduced to equal the issue price of the shares. In this case the adjustment does not preserve the relative economic interests of the derivative holder and the underlying equity holders because it compensates the derivative holder but not the underlying equity holders. Applying the clarified principle, derivatives with such a down round feature would not meet the fixed-for-fixed condition.

Passage of time adjustments

39. Some derivatives on own equity include adjustments that reflects compensation for the passage of time. For example, in the case of some Bermudan options the conversion ratio is predetermined at inception—either the number of shares is fixed but the exercise price varies solely based on the exercise date or both the number of shares and the exercise price varies solely based on the exercise date. Applying the principle in paragraph 34 of this paper, the adjustment to the amount of cash or number of own equity instruments merely compensates the entity for the fact that the derivative will be settled at a future date (ie compensation for the passage of time). Time value of money is an inherent component of derivatives which by definition are required to be settled at a future date. Unlike other variables, there is no uncertainty around the passage of time. Therefore, the staff believe that where the strike price and/or the number of shares is pre-determined at inception such that it only varies with the passage of time (ie a fixed number of shares and a fixed strike price at each exercise date is known at inception), the derivative should still meet the fixed-for-fixed condition in accordance with the proposed clarified principle. 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.

40. In contrast, if the terms of an option were such that the entity sells a fixed number of own equity instruments for a predetermined fixed exercise price that varies with the share price of the entity, the variability in the exercise price depends on the share price and is not a function of time. For example, if the share price is between X and Y, the conversion ratio is 100 shares for CU2 per share, if the

share price is between Y and Z, the conversion ratio is 100 shares for C3 per share. In this case a variable amount of cash is received for a fixed number of shares, the entity does not know before the transaction is settled, how much cash it will receive and thus the fixed-for-fixed condition is not met. Even though the settlement value of the derivative is affected by equity price risk, because the adjustment to the conversion ratio is not for the passage of time and is not a preservation adjustment, the fixed-for-fixed condition is not met. By issuing such an option, the entity is subject to risks that it would not have been exposed to had it issued the underlying shares instead.

41. In another example, consider a written call option on own shares which allows early settlement in the event of a change in control of the issuer. If settled early, the issuer is required to settle the option at a strike price which ensures that the settlement value reflects the then fair value of the option. Unlike the example in paragraph 39, the strike price is not predetermined for a fixed cash amount at the inception of the derivative and the exercise date is not fixed. By issuing such a derivative, the issuer is subject to risks that it would not have been exposed to had it issued the underlying shares instead. The derivative will require the issuer to settle the instrument by giving away value that corresponds to the fair value of the derivative at an unknown point in time, and the fair value of the derivative at a given point would be affected by general equity market volatility which would not only be specific to the issuer's share price. In this case, the adjustment is not just for the passage of time.

Consistency with IAS 32 today

42. The staff are of the view that the clarifications in paragraphs 27 and 34 would be consistent with the current principles and rationale in IAS 32 because such derivatives on own equity would:

    (a) evidence a residual interest in the entity's assets after deducting all of its liabilities because such derivatives on own equity would be classified as equity instruments because they do not expose the entity to other risks or other variables that it would not be exposed to by directly issuing the underlying equity instruments;

(b) represent the right or obligation for a specified equity interest rather than a specified amount because such derivatives would not oblige the entity to deliver more value compared to what it would deliver to the holder of the underlying equity interest; and

(c) enable the entity to know, before the transaction is settled, how many of its own shares (or how much of its equity interest, if subject to adjustments), and how much cash it will receive or deliver.

Non-derivative instruments settled in own equity instruments

43. As discussed in paragraph 32 of this paper, clarifying the principle underlying the fixed-for-fixed condition and determining what is a 'fixed number of its own equity instruments' will also affect the classification of non-derivatives, ie assessing whether there is no obligation in a non-derivative instrument for a 'variable' number of shares in accordance with paragraph 16(b)(i) of IAS 32. The staff therefore do not believe any additional clarifications are needed to the requirements for classifying non-derivative instruments.

44. In the paragraphs below, the staff merely illustrate how paragraph 16(b)(i) of IAS 32 would apply to mandatorily convertible instruments and illustrate how the proposed clarifications for the fixed-for-fixed condition discussed in this paper can be consistently applied to the classification of non-derivative instruments.

45. Paragraph 21 of IAS 32 explains that a contractual obligation to deliver a variable number of own shares equal to a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price) is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

46. In May 2014, the Committee considered the accounting for a particular mandatorily convertible instrument with a stated maturity date that is settled by delivery of a variable number of own equity instruments to the value of a fixed cash amount. The instrument also contains a cap that limits the number of shares

the entity is required to deliver and a floor that requires the entity to deliver a minimum number of shares.

47. The Committee noted that the issuer's obligation to deliver a variable number of the entity's own equity instruments is a non-derivative that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 in its entirety. Paragraph 11(b)(i) of the definition of a liability does not have any limits or thresholds regarding the degree of variability that is required. Therefore, the contractual substance of the instrument is a single obligation to deliver a variable number of equity instruments at maturity, with the variation based on the value of those equity instruments. Such a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purposes of evaluating whether the instrument contains a component that meets the definition of equity. Even though the number of equity instruments to be delivered is limited and guaranteed by the cap and the floor, the overall number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the entire obligation meets the definition of a financial liability.

48. The Committee also noted that the cap and the floor are embedded derivative features whose values change in response to the price of the issuer's equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those features and account for the embedded derivative features separately from the host liability contract at fair value through profit or loss in accordance with IAS 39 or IFRS 9.

49. Applying paragraph 16(b) together with paragraph 21 of IAS 32, a mandatorily convertible instrument is not classified as equity if a variable number of shares are used to settle a specified amount instead of paying cash. Consistent with the proposed clarified principle described in paragraph 27, the exposure to risks of an issuer of a mandatorily convertible obligation of a fixed amount settled through the issuance of a variable number of equity instruments is different to those of an issuer of an entity's equity instruments ie the value of the mandatorily convertible obligation (into a variable number of shares) is not exposed to equity price risk.

50. When the issuer entity delivers its own equity instruments, the holder will be indifferent as to whether it receives cash or shares to the same value because it

could sell the shares and receive the cash. The instrument is therefore a non-derivative financial liability. The staff are aware that in some cases the holder may be exposed to equity price risk and receiving the shares is not exactly equivalent to receiving the cash. For example, if there is a cap or floor on the number of shares to be issued in settlement to prevent dilution or there is a restriction on selling the shares or the shares are not liquid, however these features do not preclude financial liability classification and may affect the measurement of the liability or be treated as embedded derivatives instead.

51. In contrast, consider a mandatory convertible bond with a fixed term and fixed rate of interest payable annually which is mandatorily convertible at maturity into a fixed number of ordinary shares. In this case the instrument is a compound instrument. The contractually determined interest cash flows would be classified as a financial liability and the non-derivative instrument that includes an obligation to deliver a fixed number of own shares would be classified as equity as that component does not expose the entity to any additional risks compared to issuing ordinary shares.

52. In January 2014 the Committee discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument in accordance with IAS 32. The instrument discussed is similar to the one discussed in May 2014 (see paragraph 46 of this paper). In addition, the issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, it must: (a) deliver the maximum number of equity instruments specified in the contract; and (b) pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date. If the entity determines that the issuer's early settlement option to settle in a fixed number of ordinary shares is substantive, it should be factored into the classification of the instrument. If this is the case, then the non-derivative instrument includes no obligation to deliver a variable number of own shares and would be classified as equity as the entity is not exposed to any additional risks compared to issuing ordinary shares. If the issuer is obliged to make contractual interest payments, the interest obligation would be classified as a financial liability.

Application of the proposed clarified principle underlying the fixed-for-fixed condition

53. In this section of the paper, the staff consider how the proposed clarifications to the principle underlying the fixed-for-fixed condition would apply to some of the practice issues identified in paragraphs 23–25 of this paper. The staff will take into consideration the Board's comments on these proposed clarifications, update them as necessary and bring a full analysis of how they would be applied to all the practice questions discussed in this paper to a future Board meeting.

Impact of foreign currency

54. Consistent with current practice under IAS 32, by applying the clarifications described in this paper, a derivative that is settled by exchanging a fixed amount of foreign currency with own equity instruments would be classified as a derivative asset or a derivative liability unless the 'rights issue' exception applies. IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity's transactions and balances to be recorded in the functional currency of the entity. Therefore, a derivative to exchange own equity instruments for a foreign currency amount exposes the entity to future changes in the foreign currency exchange rate (ie foreign currency risk) that the entity would not have been exposed to had it issued the underlying equity instruments instead. This is the case even if the foreign currency amount is a fixed amount in that foreign currency.

55. Similarly, an entity may issue a derivative on equity instruments of another entity within the same group. For example, a subsidiary may issue a derivative on its parent's ordinary shares. When the Board was developing the 2018 DP, it considered which entity's functional currency should be the reference point when assessing the effect of foreign currency on a derivative in the consolidated financial statements. Based on previous discussions, the Board was of the view that the functional currency of the entity whose equity instruments form the underlying of the derivative should be the reference point. If for example, a subsidiary with a GBP functional currency issued a derivative on equity instruments of the parent with a strike price in GBP and the parent's functional currency was USD, using USD as the reference point (per the Board's view expressed in the 2018 DP), the group is exposed to foreign currency risk in the

consolidated financial statements. In this example, the settlement value of the derivative is exposed to foreign currency risk based on the functional currency of the subsidiary whose equity instruments form the underlying of the derivative. The staff acknowledge that 'functional currency' is assessed at an individual entity level rather than at a group level. An entity's equity is measured (indirectly) in its functional currency. Therefore, when determining whether a derivative's settlement value is subject to foreign currency risk, the functional currency of the entity whose equity instruments are subject to the exchange should matter. Applying the proposed clarified principle to the example above, the group as the issuer should classify the derivative as a financial liability because it is not just exposed to equity price risk but also foreign currency risk that it would not have been exposed to had it issued the underlying equity instruments directly.

56. As discussed in paragraph 19 of this paper, some stakeholders hold the view that a conversion option in a foreign currency convertible bond should be classified as an equity. This particular issue and the broader issue of classifying instruments denominated in a foreign currency was subject to many discussions by both the Committee and the Board in the past. In April 2005, the Committee decided that contracts that will be settled by a fixed number of own equity instruments for a fixed amount of foreign currency should be classified as liabilities based on the following, amongst others:

(a) any obligation denominated in a foreign currency represents a variable amount of cash. This is evidenced by the fact that IAS 39 allows cash flow hedge accounting for transactions denominated in a foreign currency because such transactions expose the entity to variability in cash flows.

(b) paragraph 22 of IAS 32 says that changes in the fair value of the contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Extending this exemption to changes in fair value due to changes in exchange rates would be extending a specific exemption to circumstances beyond its intent.

57. Applying the proposed clarified principle, a foreign currency convertible bond converted into a fixed number of the issuer's shares would be classified as a financial liability with an embedded derivative that is not closely related and should be separated from the host contract as a derivative liability measured at fair value through profit or loss. The embedded conversion option should be classified as a financial liability because it exposes the issuer to not only equity price risk but also foreign currency risk.

58. The staff are aware that there are concerns with this financial liability classification in practice especially where the entity is issuing equity instruments in a foreign currency for example, in order to access more liquid markets. Concerns arise because accounting for the foreign currency conversion option as a financial liability at fair value through profit or loss means that both gains and losses from changes in foreign exchange rates and gains and losses on own equity will be recognised in profit or loss which may have counter-intuitive outcomes.

59. If the Board believes there is merit in exploring the presentation alternative similar to the proposals in the 2018 DP, ie the separate presentation of gains or losses in other comprehensive income or in profit or loss where the only non-equity exposure in a stand-alone, embedded derivative or hybrid instrument is foreign currency risk, the staff can consider this further when the Board redeliberates the presentation proposals of the project.

A fixed amount of financial assets

60. Paragraph 16(b) specifically states that an instrument is an equity instrument if it is a derivative that will be settled by the issuer exchanging a fixed amount of another financial asset for a fixed number of its own equity instruments. A contract to exchange the entity's own equity instruments for another entity's shares instead of cash can also therefore meet the definition of an equity instrument. The question arises whether 'fixed amount of another financial asset' means 'fixed value, 'fixed volume' or something else. The staff's view is that a 'fixed amount of another financial asset' means a fixed fair value at the settlement date. It is not a fixed number of another entity's shares or a fixed number of units of financial assets , for example receipt of 100 units of a bond. In those cases, the

entity will not know the value of the fixed units it receives ie it would be a variable amount. In the example of the receipt of 100 units of a bond, the settlement value of the derivative is exposed to changes in the fair value of the bonds.

61. As described in paragraph 54, a derivative's exposure would be measured in the functional currency of the entity. If a derivative on own equity is settled by exchanging a financial asset other than cash and a fixed number of equity instruments, the amount of the financial asset needs to be fixed in monetary value when measured in the entity's functional currency for the derivative to meet the fixed-for-fixed condition, for example a derivative to deliver 100 own shares for receiving a variable number of government bonds that are worth CU100 at the settlement date would meet the fixed-for-fixed condition.

Anti-dilution provisions

62. Many derivatives that require delivery of a fixed number of an entity's own ordinary shares are exposed to dilution if an entity issues other ordinary shares that share in the net assets of the entity. To mitigate the consequences of dilution, some derivative on own equity such as conversion options embedded in convertible bonds, may contain an anti-dilution provision which adjusts the terms of exchange for example, the conversion ratio, in the event of dilution to keep the derivative holder in the same economic position as before the dilutive event. Some anti-dilution provisions are asymmetric and adjust the number of shares to be delivered when there is an increase in the total number of shares (ie in the event of dilution), while others are symmetric and adjust the number of shares to be delivered for both increases and decreases in the total number of shares outstanding.

63. As explained in paragraphs 35–37 of this paper, applying the proposed clarification regarding preservation adjustments described in paragraph 34, the entity would be required to assess the effects of the anti-dilution provisions to conclude whether the adjustments are consistent with the fixed-for-fixed condition. An adjustment would be consistent with the fixed-for-fixed condition if the adjustments are designed solely to preserve the relative economic interests of

the derivative holder and the underlying equity holder before and after a particular dilutive event.

Summary of the staff's preliminary view

64. At a future meeting, the staff plan to recommend adding clarifications to the requirements in paragraph 16 of IAS 32 to explain the rationale of the fixed-for-fixed condition and provide guidance on how it should be applied. At this stage, the staff are considering the following clarifications:

(a) A derivative on own equity that meets the fixed-for-fixed condition should have a fair value on the settlement date (settlement value) that is:

(i) only affected by fluctuations in the price of the underlying equity instruments (exposed to equity price risk); and

(ii) not affected by fluctuations in other variables that the holder of the underlying equity instruments would not be exposed to (not exposed to other risks).

(b) If a derivative is subject to any adjustments to the amount of cash or another financial asset, or the number of own equity instruments, the adjustments would not preclude the derivative from meeting the fixed-for-fixed condition if the adjustments:

(i) preserve the relative economic interests of the derivative holder and the underlying equity instrument holder ('preservation adjustments'); or

(ii) compensate the issuer for the fact that the derivative will be settled at a future date ('passage of time adjustments').

Question for the Board

65. The staff would like to ask the Board the following question.

Question for the Board
Do Board members have any views or questions on the staff's proposed clarifications described in paragraph 64?