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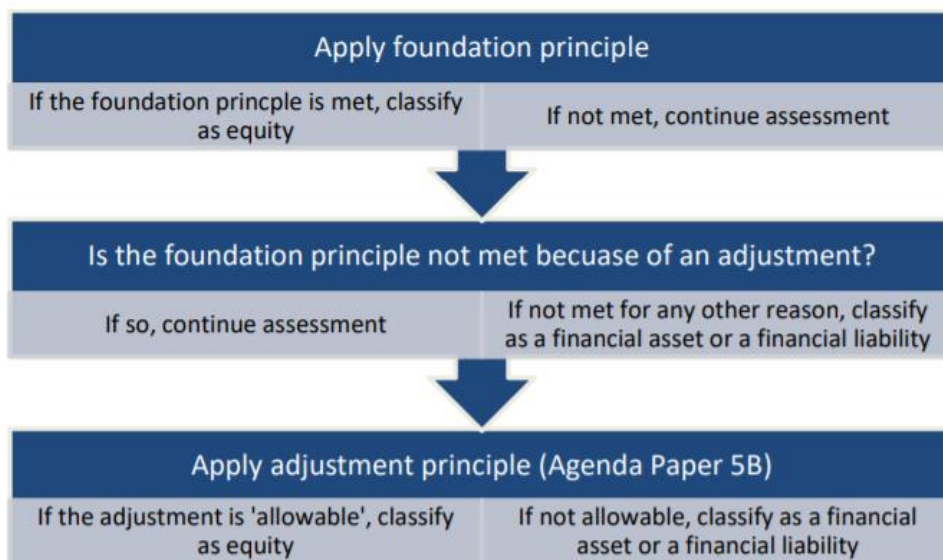
## **FICE: Fixed-for-fixed requirement Issues Paper**

### **Objective**

- 1 The objective of the paper is to update EFRAG TEG of the IASB's tentative decisions in April 2020 on the fixed-for-fixed requirement in the FICE project.

### **Fixed-for-fixed requirement**

- 2 At the April 2020 meeting, the IASB continued its discussions from December 2019 (as discussed by EFRAG [TEG](#) in January 2020) on the fixed-for-fixed requirement. The IASB discussed a foundation principle that would define whether a derivative on own equity meets the fixed-for-fixed condition. Secondly, it examined an adjustment principle whereby certain adjustments to the price or number of instruments would not necessarily preclude the derivative meeting the fixed-for-fixed requirement.
- 3 The IASB Staff indicated that the principles specify a two-stage process as follows:



### *Foundation principle*

- 4 The IASB tentatively decided that for a derivative on own equity to meet the fixed-for-fixed condition in IAS 32 *Financial Instruments: Presentation*, the number of functional currency units to be exchanged with each underlying equity instrument must be fixed or only vary with:

- (a) allowable<sup>1</sup> preservation adjustments; or
  - (b) allowable passage of time adjustments (please see also footnote 1).
- 5 The IASB Staff paper had some illustrative examples of the foundation principle – these are set out in Appendix 1. The IASB staff also indicated that foreign currency rights issues would be considered later.
- 6 The Board also tentatively decided to classify as equity a contract that can be settled by exchanging a fixed number of non-derivative own equity instruments with a fixed number of another type of non-derivative own equity instruments.

*EFRAG TEG discussions: January 2020*

- 7 In regard to the fixed-for-fixed condition for financial instruments settled in own equity instruments, EFRAG TEG members considered that further research was needed for preservation and passage of time adjustments.
- 8 EFRAG TEG members also questioned whether the IASB was going to retain the ‘foreign currency rights issue’ exception as it was considered useful.

*EFRAG Secretariat analysis*

- 9 The EFRAG Secretariat notes that the foundation principle captures the essence of the IAS 32 requirements as well as practice that has developed on this topic in practice. The foundation principle in and of itself is not expected to change current practice as is highlighted in Appendix 1 where the portrayed outcomes agree to current practice/outcomes. The possible changes to current practice could arise from the specific preservation and passage of time adjustments the IASB determines to be ‘allowable’.
- 10 The EFRAG Secretariat will continue to monitor any decisions around the ‘foreign currency rights issue’ exception.

**Questions for EFRAG TEG**

- 11 Does EFRAG TEG have comments on the IASB staff paper and the related IASB discussions?

*Adjustment principle*

Preservation adjustments

- 12 The following table summarises the economic interests of the parties the preservation adjustment aims to preserve:

|   | <b>Beneficiary, i.e., future shareholder</b> | <b>Type of derivative</b>   | <b>Reason</b>   |
|---|--|---|---|
| 1 | The derivative counterparty                  | <ul style="list-style-type: none"> <li>• Written call option</li> <li>• Forward to sell own shares</li> <li>• Purchased put option</li> </ul> | The holder of the derivative will become shareholder upon exercising the option |
| 2 | Holder of option                             | <ul style="list-style-type: none"> <li>• Purchased call option</li> </ul>   | Holder of the option may reacquire own shares if it exercises its option        |

<sup>1</sup> These adjustments would still result in equity classification and therefore not breach the fixed-for-fixed requirement.

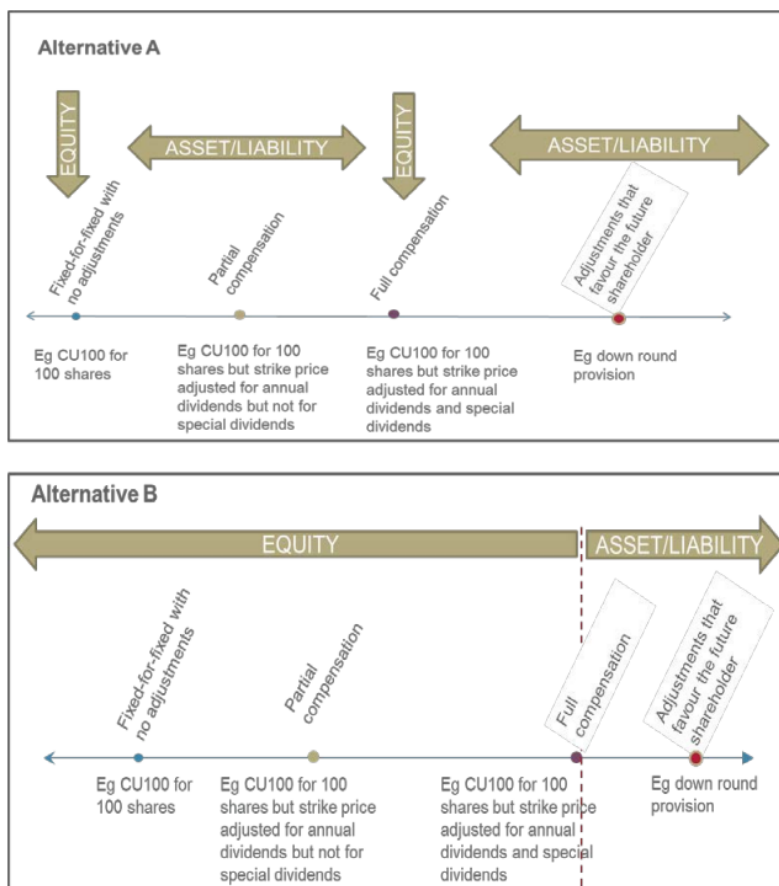
|   |   |   |  |
|---|---|---|--|
| 3 | Issuer of option and buyer of shares (issuer of underlying) | <ul style="list-style-type: none"> <li>• Written put option</li> <li>• Forward to buy own shares</li> </ul> | Issuer of underlying equity may or will reacquire own shares |
|---|---|---|--|

Source: IASB

- 13 Based on the IASB’s December 2019 discussion, preservation adjustments that would result in equity classification would be those that fully preserve the relative economic interests of the future and current shareholder.

*Symmetry of preservation adjustment principle*

- 14 The IASB decided to treat the preservation adjustment as the boundary for the equity classification. Therefore, allowable adjustments are those requiring issuer to preserve the relative economic interests of the future shareholders to an equal or lesser extent than current underlying equity instrument holders. This is Alternative B<sup>2</sup> in the schematic below:



Source: IASB

<sup>2</sup> Alternative A would result in equity classification where there are no adjustments or where the derivative holder is fully compensated for the adjustments, but financial liability classification where there is partial compensation. The IASB considered that Alternative B provides more useful information to users.

*IASB decision*

- 15 The IASB decided that adjustments that favour the future shareholder compared to, or at the expense of, the underlying equity instrument holder are not allowable preservation adjustments (i.e., would lead to liability classification).
- 16 Therefore, overall, the IASB tentatively decided that an entity would be required to classify derivatives on own equity as equity instruments if preservation adjustments require the entity to preserve the relative economic interests of future shareholders to an equal or a lesser extent than those of the existing shareholders. This assessment is not a probability-based adjustment but whether there is any possible outcome that would benefit the future shareholder at the expense of the underlying equity holder.

*Passage of time adjustments*

- 17 The Board also tentatively decided that an entity would be required to classify derivatives on own equity as equity instruments if passage of time adjustments<sup>3</sup>:
  - (a) are pre-determined and vary only with the passage of time; and
  - (b) fix the number of functional currency units per underlying equity instrument in present value.
- 18 It may not always be clear whether a specific adjustment is a preservation or a passage of time adjustment. In these cases, the focus should be on the determining the rationale for the adjustment and what the adjustment is intended to compensate.

*EFRAG Secretariat analysis*

- 19 The EFRAG Secretariat agrees that these two principles would cover the adjustments that currently do not breach the fixed-for-fixed requirement. We also note that in line with other projects, where the IASB proposals agree with the current practice of preparers and/or auditors, these decisions are likely to be welcomed. However, where this gives rise to changes, it is likely to generate some debate.
- 20 The EFRAG Secretariat has indicated a preliminary view on current practice in Appendix 1 and 2 and would welcome feedback on this as well as the outcomes from the IASB's discussions, specifically with respect to:
  - (a) Convertible bonds with accrued interest;
  - (b) Change in control clauses that reward the bondholder for its loss in optionality;
  - (c) Compensation for loss of liquidity in underlying equity; and
  - (d) Strike price in a call option accruing interest.
- 21 The IASB should clarify its reasoning for the classification in the last example of Appendix 2. Some may think that this conclusion indicates that a variable rate could not meet the passage of time adjustment which may not be the IASB's intention.
- 22 The EFRAG Secretariat has concerns about differentiating between preservation or passage of time adjustments and whether this distinction could give rise to different answers. EFRAG TEG members' contribution is this regard specifically would also be very helpful.

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<sup>3</sup> 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.

- 23 The EFRAG Secretariat agrees that the symmetry considered under Alternative A would not have provided useful information to users but would have increased complexity in financial reporting.

**Questions for EFRAG TEG**

- 24 Does EFRAG TEG have comments on the IASB staff paper and the related IASB discussions?

**Appendix 1: Foundation principle – Illustrative examples**

|   | Example   | Classification  | Reasoning   | EFRAG Secretariat comment  |
|---|---|---|---|--|
| 1 | <p><b>Multiple pre-determined fixed-for-fixed exchange:</b> Entity X issues a call option that gives the holder a choice between two predetermined 'fixed-for-fixed' exchanges, for example, to deliver 100 of its own shares for €110 or 50 of its own shares for €55.</p>   | <p>Equity (assuming no other feature that would preclude such classification)</p> | <ul style="list-style-type: none"> <li>• X knows the price it is entitled to receive, i.e., CU 1.10 per share</li> <li>• The ratio of own equity instrument delivered in exchange for an amount of cash is fixed</li> <li>• Uncertainty relating to the exercise of the option is inherent in any option derivative</li> </ul>        | <ul style="list-style-type: none"> <li>• Consider no change to current practice</li> </ul> |
| 2 | <p><b>Bonds with accrued interest that may be converted:</b> Entity X issues a convertible bond of €100 with a coupon rate of 7%. The issuer may capitalise coupons (unpaid coupons added to the principal amount). At maturity, the bondholder can choose to receive a cash amount equal to the bond's principal amount plus capitalised interest or to convert that amount into Entity X's ordinary shares. The contract sets out the conversion ratio as one ordinary share per each CU1 outstanding amount of the convertible bond.</p> | <p>Equity (assuming no other feature that would preclude such classification)</p> | <ul style="list-style-type: none"> <li>• Issuer knows the price it is entitled to receive (through the extinguishment of its financial liability) per share if conversion option is exercised.</li> <li>• Although the amount may vary due to the capitalisation of interest, the conversion ratio is fixed from inception</li> </ul> | <ul style="list-style-type: none"> <li>• Consider no change to current practice</li> </ul> |
| 3 | <p><b>Foreign currency:</b> Entity X issues a convertible bond of foreign currency amount USD100 (functional currency is €). The convertible bondholder has an option to convert the bond into 100 of Entity X's shares at maturity of the bond.</p>  | <p>Conversion option would be classified as a financial liability</p>             | <ul style="list-style-type: none"> <li>• Issuer does not know the price it is entitled to receive in its functional currency (through the extinguishment of its bond) per share it may be obligated to deliver.</li> </ul>  | <ul style="list-style-type: none"> <li>• Consider no change to current practice</li> </ul> |

**Appendix 2: Adjustment principle – Illustrative examples**

|   | Example   | Classification   | Reasoning   | EFRAG Secretariat comment  |
|---|---|--|---|--|
| 1 | <p><b>Multiple contractual provisions:</b> For example, consider a written call option where the issuer will deliver 100 shares for €100 cash if the option is exercised in two years' time. Assume the current market price is €1 per share. A contractual provision stipulates that if there is a 2-for-1 share split before the exercise date (<b>Event 1</b>), the issuer will deliver 200 shares for €100 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 €1 per share (<b>Event 2</b>), 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.</p> | <ul style="list-style-type: none"> <li>The Event 1 adjustment is an allowable <b>preservation</b> adjustment</li> <li>The Event 2 adjustment is not an allowable <b>preservation</b> adjustment</li> </ul> | <ul style="list-style-type: none"> <li>Event 1 preserves the relative economic interests</li> <li>This adjustment favours the future shareholder and therefore is not allowed.</li> <li>Furthermore, 'averaging' or 'offsetting' of effects are not allowed. Therefore, the written call option in this example would be a financial liability because of the adjustment in case of Event 2.</li> </ul> | <ul style="list-style-type: none"> <li>Consider no change to current practice</li> <li>Consider no change to current practice</li> </ul>   |
| 2 | <p><b>Change of control provisions:</b> 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</p>   | <p>Further information/analysis needed</p>   | <ul style="list-style-type: none"> <li>The adjustment to the conversion ratio would 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.</li> <li>Although the adjustment will be triggered only upon a specific contingent event occurring</li> </ul>                                  | <ul style="list-style-type: none"> <li>This may be considered a compensation to the bondholders for the loss of optionality and does not affect the relative rights of shareholders and bondholders and does not violate the fixed-for-fixed requirement.</li> </ul> |

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|   | Example  | Classification   | Reasoning  | EFRAG Secretariat comment   |
|---|--|--|--|---|
|   | <p>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.</p> |  | <p>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 the counterparty exercising the option and the adjustment introduces a variability that only varies with the passage of time.</p> <ul style="list-style-type: none"> <li>• Additionally, the issuer would also need to assess whether the conversion ratios are specified such that it fixes the strike price per share in terms of a present value.</li> </ul> |   |
| 3 | <p><b>Change of control provision:</b> Variation - as previous but 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.</p>   | <p>Liability classification, i.e., non-allowable <b>passage of time</b> adjustment</p> | <p>The adjustment is not allowable as the conversion ratio is not predetermined even though the formula is predetermined, as the inputs to the formula do not vary with the passage of time only.</p>  | <ul style="list-style-type: none"> <li>• Consider no change to current practice (would not meet fixed-for-fixed)</li> </ul> |
| 4 | <p><b>Shares to be delivered specified as fixed % of outstanding shares at the exercise/conversion date:</b> 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</p>   | <p>Liability classification, i.e., non-allowable <b>preservation</b> adjustment</p>    | <ul style="list-style-type: none"> <li>• 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.</li> <li>• The preservation adjustment is not allowable as it could favour bondholders compared to</li> </ul>   | <ul style="list-style-type: none"> <li>• Consider no change to current practice (would not meet fixed-for-fixed)</li> </ul> |



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|   | Example  | Classification  | Reasoning  | EFRAG Secretariat comment   |
|---|--|---|--|---|
|   | <p>holder will represent 1% of the total ordinary shares outstanding at the date of conversion.</p> <p>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.</p>  |   | <p>ordinary shareholders (i.e., the bondholders would be guaranteed 1% of ordinary shares and the shareholders' interests would be diluted).</p>   |   |
| 5 | <p><b>Path-dependent options in which the number of shares to be delivered varies with the share price:</b> Entity X issues a convertible bond of €100 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 €5, Entity X delivers 20 shares. If it is €10, Entity X delivers 10 shares.</p> <p>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</p> | <p>Liability classification, i.e., non-allowable <b>preservation</b> adjustment</p> | <ul style="list-style-type: none"> <li>• 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.</li> <li>• 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.</li> </ul> | <ul style="list-style-type: none"> <li>• Consider no change to current practice (would not meet fixed-for-fixed)</li> </ul> |

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|   | Example  | Classification  | Reasoning   | EFRAG Secretariat comment  |
|---|--|---|---|--|
|   | of the six months period will be. Entity X would assess whether the adjustment to the number of shares to be delivered is allowable.   |   |   |  |
| 6 | <p><b>Compensation for the loss of liquidity:</b> Entity X issues a convertible bond that is convertible on maturity at the option of the bondholder. The contract 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.</p> <p>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.</p> | Liability classification, i.e., non-allowable <b>preservation</b> adjustment    | <ul style="list-style-type: none"> <li>• The 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.</li> <li>• 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.</li> </ul> | <ul style="list-style-type: none"> <li>• Expected to fail fixed-for-fixed, therefore no change.</li> </ul> |
| 7 | <p><b>Strike price that varies with an interest rate benchmark or an inflation index:</b> 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</p>   | Liability classification, i.e., non-allowable <b>passage of time</b> adjustment | <ul style="list-style-type: none"> <li>• The price per share in the contract is not a predetermined fixed amount or a predetermined formula that only varies with the passage of time.</li> </ul>   | <ul style="list-style-type: none"> <li>• Current practice varies according to the IFRIC.</li> </ul>        |

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|  | Example  | Classification | Reasoning   | EFRAG Secretariat comment |
|--|--|----------------|---|---------------------------|
|  | <p>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 <math>\text{€}100 \times (1 + \text{benchmark rate})</math>. If the option is exercised two or three years after issuance, the strike price will be <math>\text{€}100 \times (1 + \text{benchmark rate})^2</math> and <math>\text{€}100 \times (1 + \text{benchmark rate})^3</math> respectively.</p> <p>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.</p> |                | <ul style="list-style-type: none"> <li>The same would be true if the strike price was indexed to an inflation index.</li> </ul> |                           |