IAS 32: “Fixed-for-fixed” Condition

Extract, IFRS Discussion Group Report on Meeting – September 13, 2016

Paragraph 15 of IAS 32 *Financial Instruments: Presentation* states:

> “The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.”

The definitions of financial assets, financial liabilities and equity instruments are contained in paragraph 11 of IAS 32.

Paragraph 16 of IAS 32 provides the conditions that must be met for a financial instrument to be classified as an equity instrument instead of a financial liability. Paragraph 16(b)(ii) of IAS 32 is referred to as the “fixed-for-fixed” condition. This paragraphs states, in part, that “if the instrument will or may be settled in the issuer's own equity instruments, it is 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.”

Challenges may arise in interpreting the fixed-for-fixed condition because IAS 32 contains limited guidance on this condition.

The IFRS Interpretations Committee discussed the fixed-for-fixed condition at its November 2009 meeting and issued an agenda decision in January 2010. It noted that there may be diversity in practice with respect to the application of the condition but decided not to add the topic to its agenda because the IASB’s *Financial Instruments with Characteristics of Equity* project was expected to address issues on a timely basis. However, this project has since been deferred and is now included in the IASB’s research program.

Fact Patterns

The following facts apply to the five fact patterns below:

- Besides the specific term or clause discussed, the instrument would otherwise meet the fixed-for-fixed condition.
- The instruments are all denominated in the issuer’s functional currency.

Fact Pattern 1

A share purchase option is exercisable at $0.05 per share for the first year after issue and $0.10 in the second and third year after issue before expiring at the end of year 3.

Issue 1: Is the fixed-for-fixed condition met when the exercise price is pre-determined at inception and only varies over time?

Yes, the only variable affecting the exercise price is time (i.e., when the holder exercises the share option). At any point in time, the exercise price for immediate exercise is known. Hence, the terms of the contract do not introduce variability that is unknown at the inception of the contract.

The Group's Discussion

Group members agreed that the fixed-for-fixed condition is met for this fact pattern for the reasons noted above.

Fact Pattern 2

A share purchase option is exercisable at $1 per share for one common share.

The share option agreement provides for an adjustment to the exercise price or the number of shares under the option in the event of a consolidation, special dividend, bonus issue or rights issue to all existing common shareholders. For example, if there were a two-for-one stock split, the option exercise price would be changed to $0.50 per common share.

The adjustment retains the relative rights of the existing shareholders and the option holders by preventing the option holder's interests from being diluted.

Issue 2: Is the fixed-for-fixed condition met when the relative rights of the shareholders and option holders are maintained on an equal footing?

Yes, when a fixed number of shares will or may be delivered for a fixed amount of cash, the holder of the instrument is exposed to changes in the fair value of the shares under the share option as if he or she already holds the underlying shares. Thus, the risks and rewards that the instrument holder is exposed to are similar to a shareholder.

The adjustment aligns the risks and rewards of the option holders with those of the shareholders. The variability that is introduced with each of the conditions ensures that the option holders remain exposed to the same fair value changes as the ordinary shareholders. The option holders are given the same benefit or are put in the same position as the shareholders such that their relative rights are maintained.

The Group's Discussion

Group members agreed that the fixed-for-fixed condition is met for this fact pattern for the reasons noted above.

Fact Pattern 3

A share purchase option is exercisable at $1 per share.

The share option agreement provides for a reduction to the exercise price (or increase in the number of shares delivered under the option) in the event that shares are issued below $1 per share. Such a clause is often referred to as a "down-round" or "price-protection" clause.

The intention of the adjustment clause is to protect the option holders from adverse movements in the share price. The existing shareholders do not receive a similar benefit.

Issue 3: Is the fixed-for-fixed condition met when the option holders receive protection from reductions in the share price that shareholders do not?

No, the fixed-for-fixed condition cannot be considered met when the relative rights of the shareholders and option holders are not maintained on equal footing. The down-round clause only protects the option holders from adverse movements in the share price at the expense of the existing ordinary shareholders. This adjustment clause has the potential to transfer value (in relative terms) from the existing ordinary shareholders to the option holders.

The Group's Discussion

Group members agreed that the fixed-for-fixed condition is not met for this fact pattern for the reasons noted above.

Fact Pattern 4

A share purchase option is exercisable at $1 per share. The option is exercisable by the holder only upon the occurrence of a contingent event that is outside the control of the holder and the issuer. For example, the option is mandatorily exercisable by the holder when the share price is above a certain dollar value and remains above that dollar value for a certain period of time.

Issue 4: Is the fixed-for-fixed condition met when the conversion of the instrument is based on a contingent event?

View 4A – The fixed-for-fixed condition is met.

Assuming the contingent event occurs or if the contingency is ignored, proponents of this view note that the amount of shares delivered and the amount of cash received upon exercise are both fixed. Thus, the contingency affects the value of the share option and probability of exercise, not whether the fixed-for-fixed condition is met.

View 4B – The fixed-for-fixed condition is not met.

Proponents of this view note that the contingency is financial in nature. The contingency limits the option holder's exposure to fair value increases in the share option. The ordinary shareholders and option holders are not exposed to the same relative fair value changes in the share price.

The Group's Discussion

Group members agreed that the fixed-for-fixed condition is met (View 4A) for this fact pattern.

One Group member noted that the contingency aspect is irrelevant and the limit on the variability that the option holder is exposed to is not an important point of consideration. Another Group member noted that what is relevant is when the contingency does occur, the option holder has the right to exercise a fixed number of shares for a fixed price. As a result, the fixed-for-fixed condition is met for this fact pattern.

Fact Pattern 5

A share purchase option is exercisable at a price determined as follows:

- In the event of a 1:5 share consolidation occurring before the end of Year 1, the share option will be exercisable at $0.10 per share until expiring at the end of Year 3.
- In the event of a share consolidation not occurring before the end of Year 1, the share option is exercisable at $0.05 per share in Year 2 and $0.10 per share in the third year before expiring at the end of Year 3.
- The option is not exercisable until a share consolidation has taken place or one year has passed since issuance.

The issuer intended to set the exercise price at $0.02 but the stock exchange has a minimum pricing requirement of $0.05 per share. Therefore, the terms provide an incentive for the issuer to effect a share consolidation so that the exercise price can be above the minimum pricing requirement of the stock exchange ($0.02 x 5 = $0.10 price with share consolidation).

The share consolidation is subject to approval by the directors, shareholders and stock exchange but has been initiated by the issuer at the time of issuing the instruments. The consolidation is considered highly likely but will take between six and twelve months to complete.

Issue 5: Is the fixed-for-fixed condition met when a share consolidation is a contingent event?

View 5A – The fixed-for-fixed condition is met.

Under this view, the share consolidation does not affect whether the fixed-for-fixed condition is met but rather the likelihood that one of the two options is exercised. The option contract issued can be viewed as two independent contingent options with a fixed amount of cash being exchanged for a fixed amount of equity instruments if certain contingent events arise. The exercise price in each option is pre-determined at inception and only varies over time.

View 5B – The fixed-for-fixed condition is not met.

Under this view, the condition is not met because the amount of cash that is exchanged can vary depending on whether a share consolidation has occurred at the exercise date (i.e., either one share can be issued for $0.05 or one share can be issued for $0.10 such that the amount of cash for the overall contract varies). Additionally, the exercise price varies not just over time but also depends on the outcome of a contingent event. The contingent event is not completely outside the control of the issuer because it is initiated by the entity and approved by the shareholders.

The Group's Discussion

One Group member raised a question regarding how "the terms provide an incentive for the issuer to effect a share consolidation so that the exercise price can be above the minimum pricing requirement of the stock exchange." The Group member noted that if there is no share consolidation, there will be less dilution, and if there is a share consolidation, there would be more incentive for the option holder of the instrument to exercise. It was noted that this sentence could be removed from the fact pattern and it would not affect the outcome. Implicit in the fact pattern is that the shareholders want the exercise price proceeds for a source of capital.

Group members supported the view that the fixed-for-fixed condition is not met (View 5B) and observed that the further an instrument diverges from a plain vanilla fixed-for-fixed option, the more difficult it is to support meeting the fixed-for-fixed condition.

Group members considered whether an argument could be made that the share consolidation does not have substance because the likelihood of the share consolidation not occurring is low and it is outside the control of the option holder or issuer. Group members thought that to support this argument, the "not genuine" condition in IAS 32 would need to be invoked. Group members were reluctant to apply such a condition, noting that any potentially non-genuine clauses would generally be removed from an agreement before being signed. If one or both of the parties do not agree with its removal, this is evidence that the term is in fact genuine. The share consolidation is critical to the economics in this fact pattern and the time it takes to effect the share consolidation suggests there is some element of uncertainty.

Group members also considered whether viewing the instrument as two separate options could support equity classification. If the instrument is viewed as two separate options, both the time-based element and contingency element might meet the fixed-for-fixed condition separately. However, Group members noted that the arrangement should be looked at in totality because of the interdependency of the outcomes. In this fact pattern, the outcomes are interdependent because there is only one outcome that could occur. As a result, the unit of account is the arrangement as a whole and Group members agreed that the fixed-for-fixed condition is not met for this fact pattern.

It was also noted that the IFRS Interpretations Committee considered a few issues relating to IAS 32 in 2014.[1] The IFRS Interpretations Committee considered a series of issues concerning whether an instrument convertible to a variable number of shares, subject to a cap and floor, can be bifurcated. The IFRS Interpretations Committee concluded that as the instrument has one outcome; it cannot be bifurcated.

In summary, Group members agreed that the fixed-for-fixed condition is met for Fact Patterns 1, 2 and 4 and that the fixed-for-fixed condition is not met for Fact Patterns 3 and 5. Group members observed that an underlying conceptual principle for applying the fixed-for-fixed condition is that the option holder is exposed to both the upside and downside of an arrangement (i.e., fluctuations above or below the fixed price). As a result, equity classification is appropriate if the option holder is put in the same position as an equity instrument holder. In contrast, if the option holder has a variable number of shares, he or she is often protected from such fluctuations.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

[1] For example, the IFRS Interpretations Committee considered how an issuer would account for a particular mandatorily convertible financial instrument. The IFRS Interpretations Committee's May 2014 agenda decision stated that "[s]uch 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."