# Questions

**A – What is meant by 'fixed for fixed' in the determination of an equity instrument?**

### Question 1

If a convertible bond is issued in a currency that is not the functional currency of the issuer, does this violate the 'fixed for fixed' requirement in IAS 32 paragraph 16b(ii)?

### Question 2

A subsidiary issues a convertible bond that (if converted) converts into shares of the parent, where the subsidiary and parent have different functional currencies. In the group's consolidated accounts, which currency should be looked to in determining whether the 'fixed for fixed' requirement in IAS 32 is met?

### Question 3

An entity issues an option to sell a fixed number of its own equity shares at a specified exercise price. The terms of the option state that the specified exercise price varies with the share price of the entity such that:

| Share price | Conversion ratio |
|---|---|
| 0-10 C | 10 shares at 1 C per share |
| 11-20 C | 10 shares at 1.50 C per share |

Does this breach the 'fixed for fixed' settlement requirements in IAS 32 paragraph 16b(ii)?

### Question 4

A convertible bond provides for a change to the conversion ratio upon a bonus issue of the issuer's ordinary shares for nil consideration. Does this bonus issue adjustment violate the 'fixed for fixed' requirement in IAS 32 paragraph 16b(ii)?

### Question 5

A convertible bond provides for a change to the conversion ratio upon a rights issue. Does an adjustment for a rights issue violate the 'fixed for fixed' requirement in IAS 32 paragraph 16b(ii)?

### Question 6

An entity issues a convertible with a clause that automatically adjusts the conversion ratio to compensate for some or all dividend payments on ordinary shares. Does this change in the conversion ratio upon a dividend payment violate the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii)?

### Question 7

An entity issues an option that allows the holders to exchange a fixed number of one kind of the entity's own equity for a fixed number of a different kind of equity. An example is an option for a minority shareholder to exchange its holding of shares in a subsidiary for a fixed number of equity shares in the parent. Is a contract to exchange one type of equity for another type of equity classified as equity under IAS 32?

### Question 8

Company A issues a contingently convertible bond; the debt host becomes convertible into common shares of A at a fixed ratio of 1:1.25 only if the contingent event occurs. The contingent event meets the definition of a contingent settlement event in accordance with IAS 32 paragraph 25 and is 'genuine' – for example, a change in control event (see Question B.4). There are no adjustments to the conversion ratio upon the contingent event occurring, and there are no other put or call options. Is the conversion option an equity component since it meets the 'fixed for fixed' criteria, even through it can only be exercised based on the occurrence of a contingent event?

### Question 9

Companies A, B and X are listed companies. Company A purchases an option to buy 5 per cent of the share capital of X from company B, in return for company A delivering its own equity shares to company B. The exchange ratio is fixed when the option is written (for example, company A pays B 0.8 of A's own shares for the purchase of 1 share of company X). Does the option violate the 'fixed for fixed' requirement if IAS 32 paragraph 16(b)(ii) for company A?

### Question 10

An entity issues an instrument that is settled at the end of the year by delivering shares to the value of C100 The fair value of the shares at the date of issue is C10 The instrument also contains a cap that limits the number of shares that the entity is required to deliver to 20 shares in order to prevent excessive dilution of the existing shareholders through the issue of new shares.

How should this instrument be accounted for?

### Question 11

An entity issues an instrument that is settled at the end of the year by delivering shares to the value of C100 The fair value of the shares at the date of issue is C10. The instrument also contains:

A cap that limits the number of shares that the entity is required to deliver to 20 shares.

A floor that requires the entity to deliver a minimum of at least 5 shares.

How should this instrument be accounted for?

### Question 12

An entity issues an instrument that is settled in a fixed number of shares except where the share price is in a specified range. Within that range, settlement could be in a variable number of shares to the value of a specified amount, or an adjusted number of shares determined at inception based on a sliding scale. It is unknown at inception whether the share price will be within this range and hence how many shares will be delivered in settlement. Is this instrument a financial liability on the grounds that the fixed for fixed requirement in IAS 32 paragraph 16(b)(ii)is not met?

## Question 13

An entity issues a convertible bond with a fixed conversion ratio. The terms of the instrument state that if a change of control event occurs the fixed conversion ratio will be adjusted by a predetermined amount or a formula.

The purpose of these adjustments is to compensate the bondholder for the loss of optionality. Does this adjustment to the conversion ratio violate the 'fixed for fixed' ratio?

## Question 14

An entity writes an option to company B that enables B to buy 1 equity share of the entity on the following terms:

- If the option is exercised in year 1 the strike price is C1.
- If the option is exercised in year 2 the strike price is C2.
- If the option is exercised in year 3 the strike price is C3.

Does the above adjustment to the strike price violate the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii)?

## Question 15

Company A writes a call option over its own ordinary shares to Bank B. The option grants Bank B the right to subscribe for 2.5% of the fully diluted ordinary share capital of Company A at a strike rate of $1 per share.

At grant date, Company A has 200 shares on issue. If the option were to be exercised, Bank B would obtain 5 shares in Company A (that is, 2.5%). The market share price on this date is $2 per share. Therefore, the option has an intrinsic value of $5 [($2 - $1) x 5 shares]. Subsequent to granting the option, Company A issues an additional 200 shares to existing shareholders at $2 per share (the market price). Company A now has 400 shares in issue, still worth $2 each. The existing shareholders have neither gained nor lost as a result of the issue of additional shares at market price. However, Bank B is now entitled to receive 10 shares (2.5% of 400) under the option, each of which has an intrinsic value of $1. Accordingly, the value of Bank B's option has doubled in value from $5 to $10, while the economic rights of the existing shareholders were unaffected. A buy-back of shares would reduce the value of Bank B's option in a similar manner.

Is the written call option over Company A's own shares considered an equity instrument in the hands of Company A?

**B – What is meant by 'contractual obligation'?**

### Question 1

Does a legal/statutory obligation (an obligation as result of the operation of law) to pay dividends meet the definition of a contractual obligation in IAS 32?

### Question 2

An entity has issued ordinary shares that have a legal/statutory requirement to pay dividends. The entity has also issued a second class of shares (for example, preference shares) with a fixed dividend that is required to be paid in the event a dividend is paid on the entity's ordinary shares (a dividend pusher). Does the legal/statutory obligation to pay a dividend on the ordinary share create an indirect contractual obligation to pay the dividend on the preference shares?

### Question 3

What does the term 'liquidation' mean in IAS 32 paragraph 25? Should 'liquidation' be interpreted more broadly to include all kinds of insolvency proceedings (such as receivership, administration etc) that might (or might not) result when the entity is no longer a going concern?

### Question 4

A contract between company A and a third party contains a requirement for company A to make payments to the third party on a change of control of company A, for example, company A being taken over by company B (where company B is not connected to company A). Is such a change of control outside the control of either party to the contract for the purposes of IAS 32 paragraph 25, such that the contract is a liability (given a change of control is both uncertain and genuine)?

### Question 5

An undated cumulative convertible bond, whose interest payments are at the discretion of the entity absent an Initial Public Offering (IPO), contains a clause that states that the instrument (including all unpaid cumulative interest) will become mandatorily payable if there is not an IPO. Given the IPO event is both uncertain and genuine, does it also meet the criterion of being outside the control of both issuer and holder thus making it a contingent settlement event in accordance with IAS 32 paragraph 25?

### Question 6

Is a financial instrument that includes an obligation to pay out a fixed percentage of profits, (10 per cent of profits) and is mandatorily redeemable at par after 20 years a financial liability of the issuer? If so, how is it measured?

### Question 7

An entity acquires a significant stake in a listed company. The entity is obliged, by local law, to launch a takeover bid for the remaining shares. Does this obligation result in a liability for the present value of the exercise price under IAS 32 paragraph 23 (in the same way as a put option written to a minority interest)?

### Question 8

Entity A ('the issuer') issues an instrument with the following terms:

- The instrument has a stated 5 per cent coupon that is mandatory.
- The issuer has an option to convert the instrument into a fixed number of its own shares at any time. The holder has no conversion option.
- The issuer has an option to redeem in cash the instrument at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted. The holder has no redemption option.
- The instrument has a 30 year stated maturity and, if not converted or redeemed previously, will be repaid in cash at maturity for its par value plus accrued but unpaid interest.

How should the instrument be classified by the issuer?

### Question 9

An entity has issued two instruments. The first instrument is mandatorily redeemable and pays a mandatory fixed coupon and is therefore classified as a liability in accordance with IAS 32. The second instrument has no mandatory payments other than it is mandatorily redeemable if there is an event of default on the first instrument.

Is the event of default on the first instrument a contingent settlement provision that would make the second instrument a financial liability of the issuer under IAS 32 paragraph 25?

## C – Embedded derivatives

### Question 1

Company A issues a mandatorily redeemable bond whose coupon payments are based on a multiple of EBITDA. These payments meet the definition of a financial liability under IAS 32 paragraph 25. Does the linkage to EBITDA mean that there is an embedded derivative in the host debt contract?

### Question 2

What are the components of a foreign currency denominated convertible instrument? For example, a UK company (functional currency GBP) issues a convertible bond denominated in US dollars and convertible on a number of dates into a fixed number of shares of the parent.

### Question 3

A convertible bond is convertible into a fixed number of warrants on shares in the borrower. Is the conversion option an equity component?

### Question 4

A company has issued convertible bonds whose terms include a clause giving the issuer the option to redeem in cash the bonds at their fair market value in the event of the occurrence of an uncertain future event. Does this contingent settlement option prevent the conversion option from being an equity component?

### Question 5

Company A issues a convertible bond that, if converted, converts into a fixed number of equity shares. The bond also contains a provisional call option that gives the issuer the option to redeem the bonds at par if the shares price is 130 per cent of the conversion price for at least 20 days. How should company A account for the provisional call option?

### Question 6

An entity issues an instrument on which all payments are at the entity's discretion. However, if the entity does decide to make a payment, those payments vary with reference to a specified variable, for example, FX rates or commodity prices instead of being a fixed amount or specified fixed rate. Is the entity required to separate out an embedded derivative from the host equity instrument?

### Question 7

An entity, with functional currency of HKD, issues a 5 year euro-denominated convertible bond for HKD100. The bond is puttable at the holder's option (holder's put option) after 2 years for the initial amount paid by the investor (that is, the euro amount determined at inception as the equivalent of HKD100). Based on previous IFRIC conclusions (see Question A.1), a foreign currency convertible bond such as this is accounted for as a financial liability by the issuer. The conversion option is an embedded derivative which will require separate accounting treatment. Assuming that the holder's put option meets the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii) it will be accounted for as an equity instrument Based on an option pricing model, the conversion option has a fair value on initial recognition of HKD20. The amortised cost of the host liability would be HKD87,47 after 2 years. Should the put option be viewed as closely related to the host debt instrument under ?