

AUDIT TRAINING • SESSION 11

Advanced Financial Instruments II

Convertible Debentures, Flow-Through Shares & Compound Instruments

A plain-language walk-through for all levels • 22 September 2026



PKF
Antares

"Any **contract** that gives rise to a financial **asset** of one entity and a financial **liability or equity** instrument of another entity."

A derivative is a financial instrument whose value changes in response to an underlying variable, requires little or no initial net investment, and is settled at a future date.

What We Will Cover Today

FOUR THINGS YOU WILL BE ABLE TO DO



Tell debt from equity

Using the contract, not the accounting memo



Split a convertible debenture

Into its debt part and its conversion part



Spot the hidden derivative

Price resets, ratchets, foreign-currency strikes



Follow a flow-through share to the end

From closing to renunciation

ROADMAP

01

Why this area goes wrong

02

Debt or equity? The basics

03

Convertible debentures

04

Valuation & specialists

05

Flow-through shares & warrants

06

Case study & takeaways

COLOUR CODE Blue box = what the rule says. Red box = the trap. Teal box = the question to ask.

Why This Area Goes Wrong

THE FIVE ERRORS WE KEEP FINDING IN FILES



Whole convertible booked as equity

"It will convert anyway" — but the company still owes cash until it does



Price reset ignored

A conversion price that can change is not equity — it is a derivative



Agreement never fully read

The team relied on management's memo; side letters and amendments were missed



Discount rate not challenged

The coupon rate was used instead of what a lender would really charge



Flow-through premium forgotten

All the money went to share capital; the tax obligation was never recorded

WHY IT MATTERS

- Liabilities understated → leverage and covenants look better than they are
- Interest expense wrong for the whole life of the instrument
- Fair value swings never reach the income statement
- A favourite topic of CPAB and ASC inspections on junior issuers

DISCUSSION Which of these five errors would hurt the income statement most? Which would hurt the balance sheet most?

Rule Number One: Read the Contract First

**DON'T ASK**

"What accounting did management use?"

**ASK**

"What does the company owe, and to whom?"



THE RULE An instrument is classified by the substance of the contract — what it obliges the company to do — not by its legal label or by what management intended. *IAS 32.15 & 32.18*

FOUR THINGS TO LOOK FOR IN THE AGREEMENT



Conversion price Is it fixed, or can it change?



Redemption rights Who can demand cash, and when?



Warrants attached To investors and to the broker — and in which currency?



Amendments & side letters Anything signed after closing?

THE WORKFLOW



Read the whole agreement



List what the company owes



Decide the accounting



Then read management's memo

THE TRAP Reading the memo first anchors the team on management's answer. The contract is the evidence; the memo is a claim.

Debt or Equity? Three Questions, in Order

1

Does the company have to pay cash?

Coupons, principal, a redemption the holder can demand.

YES → that part is DEBT (a financial liability)

2

If it settles in shares: is the number of shares fixed AND the price fixed?

This is the "fixed-for-fixed" test.

YES → EQUITY. NO → a DERIVATIVE LIABILITY, remeasured every period

3

Is there any other feature that behaves like an option or a bet?

Early redemption at a premium, payments linked to gold or oil prices.

YES → usually an EMBEDDED DERIVATIVE, separated and fair-valued



THE RULE Equity means no obligation to pay cash AND, if shares are delivered, a fixed number of shares for a fixed amount of cash. Anything else is a liability. IAS 32.11 & 32.16

Case Study: ABC Resources

WHAT THE COMPANY RAISED THIS YEAR (FICTIONAL)

Financing	The key terms	Amount
Convertible debenture	5 years, 5% coupon, converts at \$1.00 — but the price drops if shares are later sold cheaper	\$20M
Flow-through shares	5,000,000 shares at \$1.40, while the stock trades at \$1.00	\$7M
Broker warrants	Given to the agent as a fee; exercise price in US dollars	—
Price protection	Investors get extra shares if the price falls below \$0.80	—



MANAGEMENT SAYS

"We've booked everything as equity. The debenture will convert anyway, and the flow-through money is just share capital."

APPLY THE THREE QUESTIONS



Coupon + principal

Cash must be paid → there is DEBT here



Conversion price can drop

Number of shares not fixed → DERIVATIVE, not equity



US\$ warrants

Amount of cash not fixed in CAD → DERIVATIVE, not equity



Flow-through premium

$\$0.40 \times 5M = \$2M$ of tax deductions owed → a LIABILITY

ASK THE ROOM What worries you first — and why?

A Convertible Debenture Is Two Things in One Contract



Part 1 — A loan

Coupons every year and \$20M back at maturity. The holder can always demand the cash. This is DEBT — whatever management intends.



Part 2 — An option to convert

The right to swap the loan for shares. It has value on day one, even if converting would not make sense today. EQUITY or DERIVATIVE — the fixed-for-fixed test decides.



THE RULE The issuer must look at each part of the instrument separately and classify each one on its own. *IAS 32.28–29*

THE TRAP Asking "is the whole thing debt or equity?" — the answer is "both".

SO WHAT CAN THE RESULT LOOK LIKE?

Debt + Equity

Conversion price and number of shares are fixed. The most common textbook case. (1:1 for \$5)

Debt + Derivative liability

Conversion price can reset, or is in a foreign currency. Common on junior issuers.

Debt + Other derivative

Plus a redemption or commodity feature that behaves like a separate option.

TEACHING POINT Every convertible must be checked against all three — not just the first.

The Fixed-for-Fixed Test



A fixed number of shares

AND



for a fixed amount of cash (in the company's own currency)

If both hold → the conversion option is EQUITY. If either fails → it is a DERIVATIVE LIABILITY.

CLAUSES THAT BREAK "FIXED"

- Conversion price drops to the price of a later financing ("ratchet")
- Conversion price follows the market price
- Conversion or exercise price in US dollars for a CAD company
- Extra shares issued if the share price falls ("price protection")

NOT A PROBLEM Standard adjustments for stock splits and consolidations keep the test intact.

WHAT HAPPENS WHEN THE TEST FAILS



The option becomes a liability

Valued at fair value on day one and at every year-end



Profit or loss moves with the share price

Share price up → liability up → a loss. Counter-intuitive, but correct



A valuation specialist is usually needed

Option models, volatility, unobservable inputs

Hidden Derivatives: Three Questions for Every Feature



THE RULE A feature inside a contract that makes cash flows behave like an option must be split out and fair-valued when it is not "closely related" to a plain loan. *IFRS 9.4.3.1 & 4.3.3*

1

Does this feature make the cash flows move like an option or a bet?

2

Is it driven by something other than interest rates and the company's credit (share price, gold, oil)?

3

Would it be a derivative if it stood alone?

Three "yes" answers → separate it and measure it at fair value through profit or loss.

COMMON EXAMPLES

Feature in the agreement	Closely related to a plain loan?	Result
Conversion price that resets to a future financing price	No — driven by the share price	Separate — derivative liability
Interest that goes up when the gold price goes up	No — driven by a commodity	Separate — derivative liability
Early repayment at a big premium over the balance owed	No — the premium is a bet on rates	Separate — derivative
Repayment at par, floating-rate coupon	Yes — just interest and credit risk	Keep inside the loan

Workshop: Read This Clause



"If, within twelve months following the Closing Date, the Company issues Common Shares at a price lower than the Conversion Price then in effect, the Conversion Price shall be reduced to such lower price."

IN PAIRS — 10 MINUTES



Is the number of shares fixed?

Think about what happens if the company raises money at \$0.50 next spring



Is this an option in disguise?

Who benefits when the price resets, and at whose expense?



How would you value it?

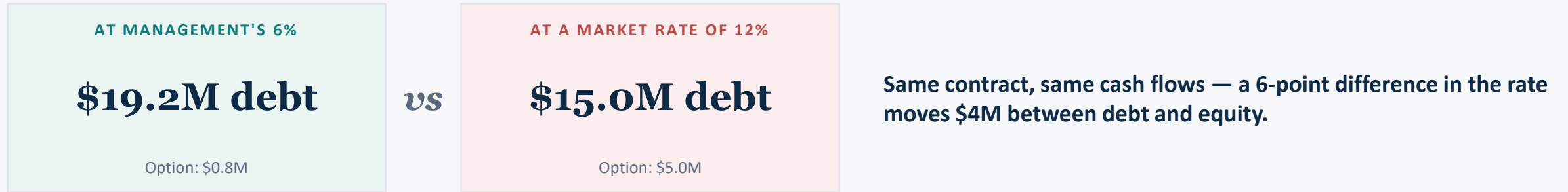
What would a specialist need to know?

SUGGESTED ANSWER — REVEAL AFTER DISCUSSION

- The number of shares depends on future financings → NOT fixed → the conversion feature cannot be equity.
- It is a derivative liability, fair-valued at every year-end, with changes in profit or loss.
- The debt is what is left after deducting the derivative.
- A simple Black-Scholes cannot model a reset — expect a specialist and a more complex model.

Splitting the \$20M: The Discount Rate Decides

HOW MUCH OF THE \$20M IS DEBT? VALUE THE LOAN AS IF IT COULD NOT BE CONVERTED — THE REST IS THE CONVERSION OPTION



 **THE RULE** Value the debt first, at the rate the market would charge this company for the same loan without a conversion option; the equity part is simply the remainder. *IAS 32.31 & AG31*

WHERE DOES 6% COME FROM?

Usually from the coupon the company chose to pay — not from what a lender would demand from a pre-revenue explorer with no cash flow. Ask for the comparable: bank term sheets, rated peers, the company's own non-convertible borrowings.

ASK How was the discount rate established? Show me the evidence and its date.

IF THE RATE IS TOO LOW



Debt understated, equity overstated



Interest expense understated every year, for five years



The error never self-corrects

Reviewing a Valuation: Complicated Does Not Mean Reasonable

SCENARIO Management's specialist values the conversion option at \$4.2M with a standard option model, volatility 70%. Raise volatility to 95% and the answer becomes \$6.0M. The reset clause was not modelled at all.

FOUR QUESTIONS TO ASK



Why this model?

Does it capture every feature in the contract — including the reset?



Why these assumptions?

Where does 70% volatility come from — peers, own history, or convenience?



What if?

How much does the answer move when one input changes?



Any sign of bias?

Were the "helpful" ends of every range chosen? Big change from last year?

USING A SPECIALIST



Check the person

Competent, capable, objective — for management's expert and for ours



Check the work

Terms agreed to the signed contract, inputs traced to sources, one scenario re-performed

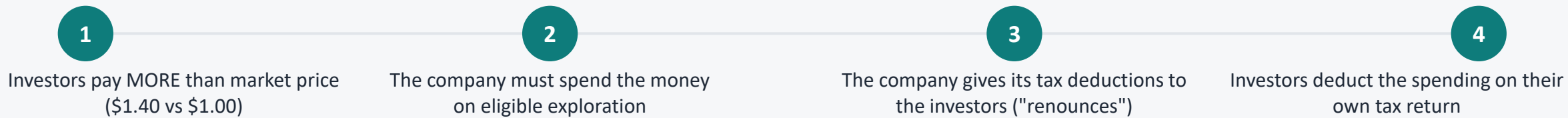


THE RULE The auditor tests the method, assumptions and data behind an estimate, and stays responsible for the conclusion even when an expert is used. *CAS 540 & CAS 620*

REMEMBER A specialist report is an input — not our conclusion.

Flow-Through Shares: Follow the Money to the End

HOW IT WORKS



 **THE RULE** The premium investors pay is the price of a promise — tax deductions still to be delivered — so it is a liability at closing, released as the money is spent and renounced; a deferred tax liability then arises. *Canadian practice under IFRS (CPA Canada Viewpoints) & IAS 12*

NORTHERN RIDGE — THE NUMBERS

	\$M
Cash raised (5M × \$1.40)	7.0
Share capital (5M × \$1.00 market price)	5.0
Premium liability (5M × \$0.40)	2.0
Spent at year-end: 60% → liability released	(1.2)
Premium liability still on the books	0.8

WHERE THE AUDIT RISK REALLY SITS — LATER

	Was the money spent on time and on eligible costs? Vouch drilling, assay and geology invoices; not overhead
	Was the renunciation actually filed? Inspect the T100 filings and CRA acknowledgements
	Was the liability released in the right proportion? Recompute: premium × (spent ÷ committed)

Two Things Teams Treat as Routine — and Should Not

BROKER WARRANTS



They are a cost of the financing

The agent was paid partly in options. Their fair value is an issue cost, split between debt and equity like the cash fees.



They take the same test as any option

CAD strike, fixed number → equity. US\$ strike or a reset → derivative liability.



They must be valued

Option model; volatility and expected life are the inputs that matter.

THE TRAP Warrants never identified — or identified but never valued — so the whole financing lands in debt and the fee is understated.

AMENDING THE CONVERSION PRICE

ORIGINAL

\$1.20

conversion price



AMENDED

\$0.60

to encourage conversion



THE RULE Sweetening the conversion terms creates a loss equal to the extra value handed to holders; a big change to the loan itself may mean the old debt is extinguished and a new one recognised. *IAS 32.AG35 & IFRS 9.3.3.2*

FOUR QUESTIONS FOR EVERY AMENDMENT

- Is the new price still "fixed" — or did the amendment create a derivative?
- Is there a loss to book for the sweetener?
- Are the loan terms changed enough to be a new loan (the 10% test)?
- What has to be disclosed?

You Are the Manager: Would You Sign Off?

AURORA LITHIUM CORP. (FICTIONAL)

- \$25M convertible, 4 years, 6% coupon; conversion price resets to any lower future issue price
- \$8M flow-through financing; 40% spent at year-end
- Broker warrants with a US\$ exercise price
- Price protection for investors for 9 months

MANAGEMENT HAS BOOKED

- The whole convertible in equity
- No derivatives — warrants "not material"
- All flow-through money in share capital

TEAM EXERCISE — List every concern. Then decide: sign off today, or not?

SUGGESTED ANSWER No — debt, two derivatives, a premium liability and deferred tax are all missing. Specialist needed.

REVIEW CHECKLIST

- ✓ Full agreement (and amendments) read
- ✓ Fixed-for-fixed tested — conversion AND warrants
- ✓ Hidden derivatives considered feature by feature
- ✓ Discount rate challenged with market evidence
- ✓ Valuation inputs tested; specialist work reviewed
- ✓ Flow-through spending, filings and liability recomputed
- ✓ Disclosures checked

FIVE THINGS TO REMEMBER

- Read the contract first — the accounting follows it
- Look at each part of the instrument separately
- Fixed number of shares for a fixed price, or it is not equity
- Value the debt first; challenge the rate
- Flow-through: follow the money until renunciation