AUDIT TRAINING SERIES

Advanced Financial Instruments I

Warrants, Share Options & Share-Based Compensation

PKF Antares

AUDIT RISK LANDSCAPE

Why This Area Creates Significant Audit Risk

Common Inspection Findings

- Equity instruments incorrectly classified
- Unsupported valuation assumptions
- Incomplete grant populations
- Undetected modifications
- Inadequate disclosure testing

Key Audit Risks — Risk Dashboard

Darker / longer bars indicate higher inherent risk exposure.

DISCUSSION QUESTION

If management's valuation were overstated by 25%, where would the misstatement appear?

KEY REMINDER

Most audit failures occur before recalculating the valuation.

Understanding the Arrangement

IFRS 2

- Share-Based Payment
- Applies when shares, options, or warrants are issued for:
  - Employee, director, or consultant services
  - Other goods or services

CAS 315

- Risk Assessment
- Understand the arrangement and identify where material misstatements could occur.

CAS 540

- Accounting Estimates
- Evaluate management's valuation methodology, assumptions, and potential bias.

Key Audit Focus

- Grant date
- Vesting conditions
- Fair value measurement

COMMON AUDIT ERROR

Testing the valuation before understanding the arrangement.

DISCUSSION QUESTION

What information would you need before concluding on management's IFRS 2 accounting?

Arrangement → **Risks** → **Valuation** → **Accounting**

Visual: Arrangement → Risks → Valuation → Accounting workflow

SCOPE & CLASSIFICATION

Is It Even IFRS 2? Warrant Scope

IFRS 2

- For Goods or Services
- Granted as consideration for:
  - Employees, directors, consultants
  - Broker / agent (compensation) warrants

IAS 32 / IFRS 9

- Financing Warrants
- Warrants issued in units or placements to raise capital, not for goods or services.

Allocating Proceeds

- Units & Placements
- Split unit proceeds between shares and warrants (residual or relative fair value).

Key Audit Focus

- Purpose of the issuance
- Counterparty and consideration
- Standard applied: IFRS 2 vs IAS 32

COMMON AUDIT ERROR

Accounting for financing warrants under IFRS 2 instead of IAS 32 / IFRS 9.

DISCUSSION QUESTION

Was the warrant issued for services or to raise capital? That answer drives the standard.

Read Terms → **Purpose?** → **Services: IFRS 2** → **Financing: IAS 32/9**

Visual: Read terms → determine purpose → apply the correct standard

Case Study - Warrant

Case Study: "NorthStar Mining Ltd." - Private Placement of Units

NorthStar (functional currency **CAD**) raises capital through a **bought-deal private placement**:

- Issues **1,000,000 units** at **$2.00 per unit** → gross proceeds **$2,000,000**
- **Each unit** = 1 common share + **½ warrant** → 500,000 whole warrants
- Each **whole warrant** lets the holder buy **1 common share at $3.00**, expiring in 24 months
- The warrants were issued to **investors to raise capital**—*not* for goods or services
- At issue date: share fair value **$1.90**; warrant fair value (Black-Scholes) **$0.40**

Case Study - Warrant

Step 1 — Classify the warrant (equity or liability?)
Apply the **"fixed-for-fixed"** test under IAS 32:

- Fixed number of shares (1 per warrant)? ✅
- Fixed amount of cash **in the functional currency** ($3.00 CAD)? ✅

→ **Fixed-for-fixed is met → warrant is EQUITY.** No remeasurement after initial recognition.

⚠️ **Contrast (the audit trap):** If the exercise price were in **USD** while NorthStar reports in **CAD**, the cash amount is *variable* in functional-currency terms → fails fixed-for-fixed → warrant becomes a **derivative liability at FVTPL**, remeasured through P&L every period.

Step 2 — Allocate the $2,000,000 proceeds
Because both components are equity here, use the **residual method** (IAS 32) — measure the share component first, warrant gets the residual. (If a component were a liability, you'd measure the *liability* at fair value first and give the residual to equity.)

Many issuers instead use **relative fair value**. Both shown:

Component	FV per unit	Total FV	Allocation	Amount
Shares (1,000,000 × $1.90)	$1.90	$1,900,000	1,900 / 2,100	$1,809,524
Warrants (500,000 × $0.40)	—	$200,000	200 / 2,100	$190,476
Total		$2,100,000		$2,000,000

RSUs vs. Options — Same Standard, Different Mechanics

What an RSU Is

- A Promise of Shares
- Key features:
  - No exercise price — the full share, delivered later
  - Granted for employee services

Applicable Standards

- IFRS 2 is the Core Standard
- IFRS 2 (recognition). Not IAS 32 / IFRS 9.

Valuation

- Usually No Black-Scholes
- Grant-date share price, less dividends foregone. A model is needed only for a market condition.

Equity vs. Cash-Settled

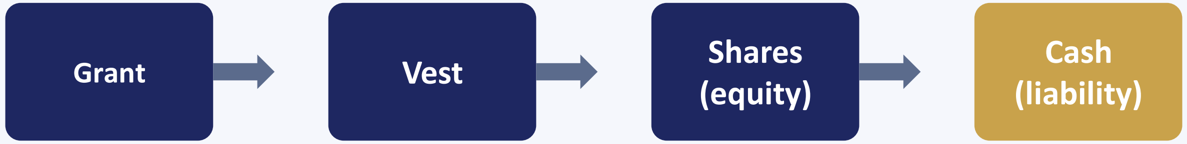
- Equity-settled: grant-date FV, no remeasurement
- Cash-settled: liability, remeasured through P&L
- Settlement type drives the classification

COMMON AUDIT ERROR

Applying an option-pricing model to a plain RSU, or missing that cash-settled RSUs are liabilities.

DISCUSSION QUESTION

A plain equity-settled RSU is granted, do you need Black-Scholes to value it?



Visual: Grant → vest → deliver shares (equity) or pay cash (liability)

Classification Framework

KEY AUDIT QUESTION

Could the issuer ever be required to transfer cash or issue a variable number of shares?

EQUITY CLASSIFICATION

- Fixed number of shares
- Fixed exercise price
- Shares-only settlement

LIABILITY CLASSIFICATION

- Cash settlement feature
- Variable share settlement
- Price reset or anti-dilution features

Examples

- Employee stock options → often equity classified
- Warrants with reset provisions → may require liability classification

Audit Focus

- Read the agreement and evaluate settlement terms before accepting management's conclusion.

DISCUSSION

Which contractual clause would most likely change an instrument from equity to liability?

Fixed-for-Fixed Test & Anti-Dilution Provisions

Equity Example — Likely Equity

- 100,000 shares
- Exercise price: $1.00
- Shares-only settlement

Liability Example — Likely Liability

- Holder receives shares worth $500,000

Common Red Flags

- Exercise price resets
- Share quantity adjustments
- Future financing protections

AUDIT RISK

Anti-dilution clauses may change classification conclusions.

AUDIT PROCEDURE

Read the agreement. Never rely solely on management summaries.

Visual: Fixed-for-fixed decision tree

Fixed shares? → Fixed price? → Shares-only settlement? → Equity

Foreign-Currency Warrants & the Classification Trap

Same Currency — Likely Equity

- Functional currency: CAD
- Exercise price fixed in C$
- Fixed number of shares

Foreign Currency — Derivative Liability

- CAD issuer, warrants exercisable in US$: fails fixed-for-fixed

Why It Fails

- Exercise price set in a foreign currency
- Proceeds vary with the exchange rate
- Remeasured at FVTPL each period

AUDIT RISK

FX pricing and reset features push warrants from equity to derivative liability.

AUDIT PROCEDURE

Compare exercise currency to functional currency; check the rights-issue exception (IAS 32.11).

Visual: Currency test within the fixed-for-fixed decision tree

Fixed shares? → Price in functional currency? → No resets or FX pricing? → Equity

Cash-Settled vs Equity-Settled Awards

Equity-Settled

- Grant-date fair value
- No remeasurement
- Equity accounting

Cash-Settled

- Fair value each reporting period
- Remeasured through earnings
- Liability accounting

AUDIT RISK

Failure to remeasure liability-classified awards.

DISCUSSION QUESTION

Which treatment creates greater earnings volatility and why?

Visual: Side-by-side comparison — Earnings Volatility Impact

Low Volatility

High Volatility

VALUATION APPROACH

Valuation Methodologies & Model Selection

Black-Scholes

- Plain vanilla awards (European style options)
- Simple fixed terms

Binomial

- Early exercise behaviour
- Greater flexibility

Monte Carlo

- Market conditions
- Share-price hurdles
- Complex vesting arrangements

Simple terms → **Early exercise** → **Market conditions**

Visual: Valuation model selection flowchart — increasing complexity →

Scenario — CEO Option Grant

- Share price exceeds $10
- Maintained for 90 consecutive days

AUDIT QUESTION

Would Black-Scholes appropriately capture this market condition?

POSSIBLE CONCLUSION

Monte Carlo may be required.

Key Assumptions, Volatility & Management Bias

Key Inputs

- Volatility
- Expected life
- Risk-free rate
- Dividend yield
- Forfeiture rate

Volatility Challenge Questions

- Historical or peer volatility?
- Appropriate look-back period?
- Consistent with prior years?
- Weighting applied?

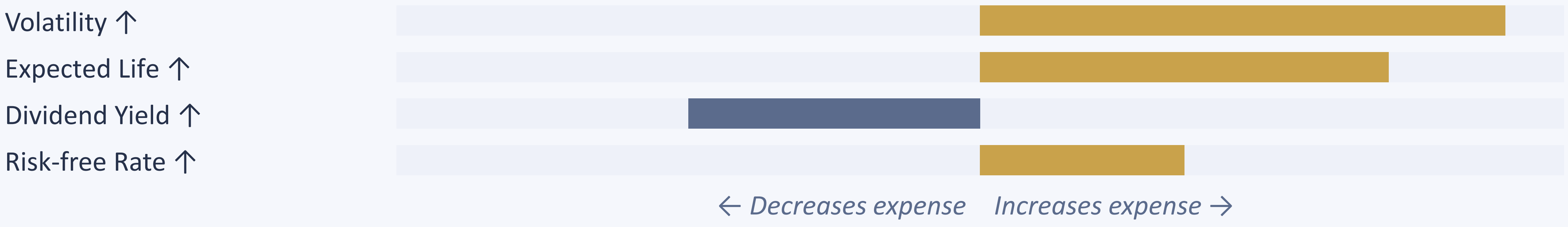
CAS 540 — BIAS INDICATORS

Assumptions consistently reduce expense • Unsupported decreases in volatility • Shortened expected life • Frequent model changes • Unexplained peer group changes

PROFESSIONAL SKEPTICISM

Consider evidence both supporting and contradicting management's estimate.

Visual: Assumptions Impact on Fair Value (direction of change on expense)



Sensitivity Analysis & Valuation Specialists

SENSITIVITY EXAMPLE

Assumption	Base	Revised
Volatility	60%	**80%**
Expected Life	3 yrs	**5 yrs**
Dividend Yield	0%	**2%**

SPECIALIST INVOLVEMENT

Evaluate

- Competence
- Capability
- Objectivity

Review

- Methodology
- Assumptions
- Sensitivity analysis
- Conclusions

IMPORTANT

A valuation report is audit evidence, not an audit conclusion.

Visual: Specialist Evaluation Workflow

Obtain Report → **Assess Specialist** → **Test Assumptions** → **Corroborate Conclusion**

Specialists, Fraud Risk & Related Parties

WHOSE EXPERT IS IT?

Consideration	Management's Expert	Auditor's Expert
Standard	CAS 500.8	**CAS 620**
Engaged by	Management	**Auditor**
Evidence role	Test the work	**Auditor's own evidence**

Engage an auditor side specialist when the valuation is complex or the risk of management bias is

HIGH

EVALUATE THE SPECIALIST

Assess

- Competence
- Capability
- Objectivity

Scrutinize

- Methodology
- Assumptions and inputs
- Source data
- Conclusions

FRAUD & RELATED PARTIES

Watch for backdated or spring-loaded grants (CAS 240 - fraud) and grants to directors or officers (CAS 550 – related parties).

Visual: Specialist Evaluation Workflow

Obtain Report → **Assess Specialist** → **Test Assumptions** → **Corroborate Conclusion**

RECOGNITION MECHANICS

Grant Date, Vesting Conditions & IFRS 2 Accounting

Grant Date

- Generally exists when:
  - Approval obtained
  - Terms communicated
  - Mutual understanding established

Audit Procedures

- Board resolutions
- Compensation committee minutes
- Grant agreements
- Exercise price verification

Vesting Conditions

- Service - Continued employment
- Non-market - Revenue, EBITDA, Production targets
- Market - Share-price targets

ACCOUNTING IMPACT

Condition Type	Impact
Service	Affects expected vesting
Non-market	Affects expected vesting
Market	Included in fair value

COMMON AUDIT ERROR

Treating all vesting conditions the same.

When Options or Warrants Expire or Lapse Unexercised

Exercised (normal route)

- On exercise:
  - Holder pays the exercise price
  - Reserve transferred to share capital as proceeds
  - Expected outcome — low judgement

Lapsed BEFORE Vesting

- A service or non-market condition is not met
- True-up: reverse the cumulative expense
- Award was never earned
- Different mechanism from expiry

Expired AFTER Vesting

- Vested, but holder chose not to exercise
- Expense stays - no reversal (IFRS 2.23)
- Any transfer is within equity and optional

WHERE DOES THE BALANCE GO?

Movement	Permitted?
Reserve → Profit or loss	Not permitted, never reversed
Reserve → Retained earnings	Optional, a policy choice
Reserve → Share capital (exercise)	Yes, the normal route

CONCLUSION

A move to P&L is never permitted; a transfer within equity is optional and a policy choice.

Modifications, Repricing & Completeness Testing

Common Modifications

- Strike (exercise) price reduction
- Expiry extension
- Accelerated vesting

Incremental Fair Value

New Fair Value

– Original Fair Value

= Additional Compensation Expense

Completeness Testing

- Board minutes
- HR records
- Legal confirmations
- Equity roll-forwards
- Transfer agent reports

KEY MESSAGE

Completeness is often a greater audit risk than valuation.

Visual: Grant Lifecycle Timeline

Grant → **Vesting Period** → **Modification** → **Exercise / Expiry** → **Disclosure**

Grant	Vesting Period	Modification	Exercise / Expiry	Disclosure
Terms set	*Service/perf. tracked*	*Reassess fair value*	*Settlement occurs*	*Financial statements*

Cancellations

Cancellations

- Recognize all remaining expense immediately
- Treated as an acceleration of vesting
- Applies to employer and employee cancellations

Downward Repricing

- Reduced fair value is ignored
- Continue the original expense
- No gain is recognized
- Floor: original fair value stands
- Disclose the modification

KEY MESSAGE

Modifications never reduce expense; they can only add to it or accelerate it.

Visual: Cancellation and settlement decision flow

Event	Cancelled?	Payment made?	Repriced down?	Account & Disclose
Change identified	*Accelerate expense*	*Equity; excess to expense*	*Keep original expense*	*Notes updated*

BRINGING IT TOGETHER

Audit Evidence and Disclosures

Key Audit Evidence

- Option agreements
- Warrant agreements
- Board approvals
- Valuation reports
- Assumption support
- Modification approvals

IFRS 2 Disclosure Areas

- Grants
- Exercises
- Forfeitures
- Expiries
- Valuation methodology
- Significant assumptions