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**International
Accounting Standards
Board**

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Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

**Project: Foreign Currency Instruments exchangeable into Equity
Instruments of the Parent Entity of the Issuer
(Agenda paper 10(vii))**

Introduction

1. The IFRIC has received a submission in connection with exchangeable instruments issued by a subsidiary of a group that provide holders with rights to convert the instruments into a fixed number of equity instruments of the parent entity of the issuer. Two situations were outlined in the submission: in one the exchangeable instruments are denominated in a currency other than the functional currency of the issuer; in the other the exchangeable instruments are denominated in a currency other than the functional currency of the parent entity of the issuer.
2. The issue raised in the submission is whether or not the conversion options embedded in the exchangeable instruments should be classified as equity in the consolidated financial statements of the parent entity. The submission

states that it is quite common for an entity to issue instruments that can be exchanged into equity instruments of the parent entity.

Staff analysis

3. Current IFRS literature does not give any direct guidance on how to classify an instrument that is exchangeable into equity instruments of the parent entity of an issuer in the consolidated financial statements of the parent entity. The only IFRS reference that may be relevant is AG 29 of IAS 32 *Treatment in Consolidated Financial Statements*¹. However, AG 29 focuses on whether the group as a whole has an obligation to deliver cash or another financial asset. By contrast, the issue in this paper is whether the conversion options embedded in the exchangeable instruments should be classified as equity in the consolidated financial statements of the parent entity.

4. The staff believe that, although raised in the context of exchangeable instruments, the issue applies equally to other contracts that entitle the holders to obtain equity instruments of the parent entity of the issuer. To focus on the classification of the conversion options of the exchangeable instruments, the following analysis uses two simpler examples in which a subsidiary entity issues call options which give holders a right to purchase a fixed number of

¹ AG 29 of IAS 32 states that, when classifying a financial instrument in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument, the group may not have discretion over distributions or redemptions. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument is classified as a financial liability in consolidated financial statements.

equity instruments of its parent entity at a fixed price. Details of the two examples are set out as follows:

- Example A – A subsidiary entity issues call options to investors. The call options provide holders with a right to purchase a fixed number of equity instruments of the parent entity of the subsidiary entity at a fixed USD exercise price. The functional currencies of the subsidiary entity and the parent entity are USD and Euro respectively.
 - Example B – Facts same as Example 1, except for the fact that the exercise price is now denominated in Euro.
5. IAS 32.22 states that a contract that will be settled by the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash (or another financial asset) is an equity instrument. In other cases, derivative contracts, such as these, are classified as financial liabilities (even though the definition of a liability under the *Framework for the Preparation and Presentation of Financial Statements* may not be met). Since the number of equity instruments that may be delivered is fixed in the above examples, the classification of the call options in the consolidated financial statements of the parent entity depends on whether the contracts are settled through the exchange of a fixed amount of cash or a variable amount of cash.
6. At its past meetings in connection with *Classification of Instruments denominated in a Foreign Currency*, the IFRIC concluded that obligations denominated in a foreign currency² represent a variable amount of cash. In addition, it concluded that contracts that will be settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency should be classified as financial liabilities. However, because the group does not have a functional currency, a question then arises

² IAS 21.8 defines foreign currency as a currency other than the functional currency of the entity.

as to which currency should be the reference point in determining whether the call options are in a foreign currency.

7. There are three different views as to which currency should be the reference point in determining whether the call options are denominated in a foreign currency.

View 1 – The currency in which the equity instruments that may be delivered are denominated

8. Supporters of View 1 believe that, because the call options (if exercised) are equity instruments of the parent entity, the reference point should be the currency in which the equity instruments are denominated.
9. [Omitted for observer notes purposes]

View 2 – Always the functional currency of the group entity that equity instruments may be issued (i.e. the functional currency of the parent entity in Examples A and B)

10. Supporters of View 2 argue that, since the equity instruments that may be issued in settlement are those of the parent entity, the functional currency of the parent entity should always be the reference point to determine whether the call options are denominated in a foreign currency. Potential classifications of the call options in Examples A & B are as follows:

	Functional currency of the parent entity	Functional currency of the subsidiary entity	Call option currency	Classification in the consolidated financial statements of the parent entity
Example A	Euro	USD	USD	Financial liabilities
Example B	Euro	USD	Euro	Equity

11. [Omitted for observer notes purposes]

View 3 – The functional currency of the group entity that is contractually obliged to deliver equity instruments to the holders (focusing on the contractual arrangement with holders)

12. Paragraph 15 of IAS 32 states that classification of a financial instrument should be based on the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. In addition, as explained above, whether or not a derivative contract is classified as an equity instrument depends on whether the contract is settled through the exchange of a fixed or a variable amount of cash at the time of settlement (i.e. at the time when the holders exercise options). Therefore, supporters of View 3 believe that classification of call options in the consolidated financial statements of the parent entity should focus on contractual arrangements with the holders. F.2.14 of Guidance on Implementing IAS 39 – *Intragroup and intra-entity hedging transactions* is consistent with this approach. The guidance focuses on hedging the exposure from transactions with third parties.
13. Furthermore, proponents of View 3 believe that the party that is contractually obliged to deliver equity instruments is the one that is principally exposed to variability in cash flows from the holders. They, therefore, believe that the reference point should be the functional currency of the party that is contractually obliged to deliver equity instruments. If the functional currency of that party is the same as the call option currency, the call options are classified as equity in the consolidated financial statements of the parent entity. Alternatively, if the functional currency of that party is different from the call option currency, the call options are classified as financial liabilities in the consolidated financial statements of the parent entity.

14. For Examples A & B, assuming that the subsidiary entity is the only party that contractually agrees to deliver equity instruments, the reference point should be the functional currency of the subsidiary entity. Potential classifications of the call options in Examples A & B are as follows:

	Functional currency of the parent entity	Functional currency of the subsidiary entity	Call option currency	Classification in the consolidated financial statements of the parent entity
Example A	Euro	USD	USD	Equity
Example B	Euro	USD	Euro	Financial liabilities

15. Proponents of View 3 state that, in a situation in which the subsidiary entity purchases equity instruments from the parent entity in order to settle its obligation, the reference point should still be the functional currency of the subsidiary entity. Their rationale is that how the subsidiary decides to meet its obligation to deliver the equity instruments is irrelevant. It should not be linked to the transactions with call option holders.
16. Supporters of View 3 further state that, in a situation in which the parent entity is also a contractual party to call options (i.e. the parent entity is obliged to deliver the equity instruments if the holders exercise the options), the reference point is the functional currency of the parent entity.
17. Similarly, in the examples of exchangeable instruments, the reference point in determining the classification of embedded conversion options in the consolidated financial statements of the parent entity is the functional currency of the group entity that is contractually obliged to deliver equity instruments. If the subsidiary entity is the party that has the contractual obligation to deliver the equity instruments, the reference point is the functional currency of the subsidiary entity. Alternatively, in a tri-party arrangement in which the parent entity is obliged to deliver the equity

instruments (if the holders exercise their conversion options) and the subsidiary entity is obliged to deliver cash (if the holders do not exercise the conversion options), the reference point in determining the classification of the conversion options embedded in the consolidated financial statements of the parent entity is the functional currency of the parent entity.

18. [Omitted for observer notes purposes]

Staff recommendation

[Paragraphs 19 through 21 are omitted for observer notes purposes.]