

A financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares

The Interpretations Committee discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument in accordance with IAS 32 Financial Instruments: Presentation. The instrument has a stated maturity date and at maturity the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount, subject to a cap and a floor. The cap and the floor limit and guarantee, respectively, the number of equity instruments to be delivered. The issuer is required to pay interest at a fixed rate. The issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, it must:

- (a) deliver the maximum number of equity instruments specified in the contract; and
- (b) pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

The Interpretations Committee noted that the definitions of financial asset, financial liability and equity instrument in IAS 32 are based on the financial instrument's contractual rights and contractual obligations. However, paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the Interpretations Committee noted that if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument.

The Interpretations Committee noted that the issuer cannot assume that a financial instrument (or its components) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of its own equity instruments. The Interpretations Committee noted that judgement will be required to determine whether the issuer's early settlement option is substantive and thus should be considered in determining how to classify the instrument. If the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument.

The Interpretations Committee noted that the guidance in paragraph 20(b) of IAS 32 is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment. Specifically, the example in that paragraph describes an instrument that the issuer will settle by delivering either cash or its own shares and states that one of the settlement alternatives should be excluded from the classification assessment in some circumstances.

The Interpretations Committee noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. In making that assessment, the issuer could consider, along with other factors, whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms. The Interpretations Committee also noted that factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share price could be relevant to the assessment of whether the issuer's early settlement option is substantive. For example, the early settlement option may be less likely to have substance—especially if the instrument is short-lived—if the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor (ie the minimum). That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, neither an interpretation nor an amendment to a Standard was necessary and consequently decided not to add the issue to its agenda.