Project **Tentative agenda decision**

Topic **IAS 32 *Financial Instruments: Presentation* – 'Fixed for fixed' condition**

Purpose of this paper

1. The purpose of this paper is to provide the IFRIC with an overview of questions that constituents have asked about the application of the 'fixed for fixed' condition in paragraph 22 of IAS 32 *Financial Instruments: Presentation*. This paper provides a follow up to the Preliminary discussion paper that was presented to the IFRIC in July 2009.
2. The questions raised consider whether certain instruments that will be, or may be, settled in the issuer's own equity instruments should be presented as equity instruments rather than as financial liabilities. This paper:
   (a) provides background information on this issue;
   (b) analyses the issue within the context of IFRSs;
   (c) provides preliminary agenda criteria assessment;
   (d) makes a staff recommendation on the tentative agenda decision; and
   (e) asks the IFRIC whether they agree with the staff recommendation.

Background information

3. In July 2009 the IFRIC discussed two submissions relating to the classification of rights and options in accordance with IAS 32.

4. In relation to the first submission, the IFRIC decided to recommend that the Board should amend IAS 32 to permit rights issued pro rata to existing shareholders to be classified as equity instruments, if the exercise price is fixed in any currency. The Board accepted the IFRIC's recommendation and has since modified IAS 32 to address this specific, narrow issue.

5. In relation to the second submission, the IFRIC directed the staff to prepare a paper for the November IFRIC meeting discussing other questions that constituents have raised about application of the 'fixed for fixed' condition in IAS 32. These questions were in addition to the issues discussed in the July 2009 meeting.

6. The IFRIC have previously considered application of the 'fixed for fixed' condition relating to whether a fixed amount of foreign currency is considered to be a fixed amount of cash. In April 2005, the IFRIC 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 are liabilities. In June 2005, the IFRIC recommended that the Board should consider amending IAS 32 so that, for classification purposes only, a fixed amount of foreign currency would be considered to be a fixed amount of cash.

7. However, in September 2005, the Board decided not to proceed with such an amendment, because it would require arbitrary rules and additional detailed guidance to avoid structuring opportunities.

Staff analysis

Fixed for fixed condition

8. Paragraph 22 of IAS 32 states that *'except as stated in paragraph 22A, a contract that will be settled by the entity (receiving or) 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'*.

9. This notion in paragraph 22 of IAS 32 is referred to throughout this paper as the fixed for fixed condition.

Fixed for fixed condition interpretation issues

10. As discussed in the July 2009 IFRIC meeting, many questions have been raised by constituents on how the fixed for fixed condition in IAS 32 should be applied.

11. These questions include consideration of how parts of the fixed for fixed condition should be interpreted and applied to the following situations:

What is a 'fixed amount of cash or another financial asset'?

(a) **Foreign currency call options -** the written call option allows the issuer to exchange a fixed amount of a foreign currency for a fixed number of shares.

(b) **Foreign currency call options issued by a subsidiary -** a subsidiary writes an option that allows the holder to exchange a fixed amount of currency for a fixed number of shares of the parent. The subsidiary and the parent have different functional currencies.

(c) **Variable premium options** - the exercise of the option will result in the exchange of a fixed number of the issuer's own equity instruments in return for the payment of a fixed strike price, but the option's premium varies. For example, the entity may enter into an option to buy a fixed number of its own shares for a fixed strike price. The entity may pay an initial fixed premium, plus an additional premium calculated as interest on the strike price of the option. This additional premium varies with the time at which the option is exercised, but if the option lapses unexercised, the premium must still be paid.

(d) **Bermudan options with fixed but different strike prices -** an option to buy or sell a fixed number of shares for a specified exercise price, but where there are a number of possible exercise prices that vary based on variables such as when the option is exercised or with the share price of the entity.

2. What is a 'fixed number of equity instruments'?

(a) **Conversion obligation to deliver a variable number of own equity instruments subject to a cap and a floor –** as discussed in the July 2009 IFRIC meeting, an entity may issue a financial instrument that includes a maximum (cap) and a minimum (floor) amount of its own equity instruments that would be issued if the financial instrument is converted.

(b) **Change of control provisions -** a convertible bond may provide that on a change of control of the issuer, bondholders are entitled, or required to exercise, their conversion rights. The conversion price is adjusted, relative to what it would have been in the absence of the change of control.

(c) **Other adjustment clauses** - many convertible bonds provide for a change to the conversion ratio if other specified events occur. Such events may include subdivision/combination of the number of ordinary shares, bonus issues, dividends or any event at the discretion of the Directors.

(d) **Contracts to exchange a fixed number of equity instruments for a specified minority interest -** for example, an option that allows holders of a minority interest to exchange their holding of shares in a subsidiary for a fixed number of shares in the parent. Such contracts exchange a fixed number of one type of equity instrument for a fixed number of a different type of equity instrument.

3. Other

(a) **Written call options -** the number of shares to be delivered, and the amount of cash to be received, changes over the life of the contract, but the change is predetermined at the inception of the contract. For example, if A occurs you will get 100 shares for CU100, but if B occurs you will get 75 shares for CU90.

12. The staff also understands that divergence and uncertainty may exist in practice in application of the fixed for fixed condition to situations in addition to those included in paragraph 11 above.

Common themes

13. Although concerns relating to the application of the fixed for condition have been identified in many situations, the staff consider that the majority of these can be classified into two broad categories:

(a) **Foreign currency situations –** situations where a fixed number of shares are being exchanged for a fixed amount of a foreign currency that is not an entity's functional currency.

(b) **Predetermined condition situations –** situations where the amount of cash or another asset, or the number of equity instruments to be issued in an exchange is predetermined. However the amount of cash or another asset, or the number of equity instruments to be issued depends on the outcome of specific predetermined conditions (eg based upon the passage of time or changes in the entity's share price).

14. The staff have analysed these two categories below.

Foreign currency situations

15. As noted in paragraphs 6 and 7 above, in 2005 the IFRIC previously considered application of the 'fixed for fixed' condition to foreign currency situations. In September 2005, the Board decided not to proceed with an amendment proposed by the IFRIC on these situations because it would require arbitrary rules and additional detailed guidance to avoid structuring opportunities.

16. The IFRIC also considered application of the 'fixed for fixed' condition in 2009 in relation to rights issues denominated in a foreign currency. The IFRIC noted that, consistent with its 2005 conclusion, IAS 32 would not permit entities to classify the rights as equity instruments. Consequently, the IFRIC recommended that the Board amend IAS 32 to permit rights issued pro rata to existing shareholders to be classified as equity instruments if the exercise price is fixed in any currency.

17. In forming its basis for conclusions for the *Classification of Rights Issues* (Amendment to IAS 32), the Board confirmed its agreement with the conclusion reached by IFRIC in 2005 that a contract with an exercise price denominated in foreign currency would not result in the entity receiving a fixed amount of cash. The Board also decided that a financial instrument that gives the holder the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency is an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.

18. During redeliberations, the Board also rejected proposals made by some comment letters respondents to expand the scope of the Amendment to IAS 32 to include transactions such as foreign currency denominated convertible debt.

Predetermined condition situations

19. The staff believe, that in applying paragraph 22 of IAS 32 to these predetermined condition situations, that these instruments would be presented as liabilities as they do not meet the fixed for fixed condition.

20. The staff believes that this conclusion is consistent with the conclusions reached by the IFRIC in 2005 in relation to certain foreign currency situations.

21. The staff consider that if the IFRIC decided to address whether predetermined condition situations meet the fixed for fixed condition that there are three alternatives available:

    (a) conclude and accept that predetermined condition situations are not considered fixed for fixed as the amount of cash or another financial asset or the number of an entity's own equity instruments to be exchanged may change in accordance with specific conditions. This would be consistent with the IFRIC's conclusions on certain foreign currency situations in 2005 and 2009.

    (b) recommend that the Board amend IAS 32 in relation to specific predetermined condition situations to permit certain instruments to be classified as equity.

    (c) acknowledge that these predetermined condition situations indicate a concern with the overall concept of the fixed for fixed condition and recommend that the Board address this as part of a separate, broader scope, project.

22. If the IFRIC does decide to address these situations, the staff believes that difficulties may arise in defining an appropriate principle to be applied to identifying predetermined condition situations. Specifically concerns may arise in identifying whether certain conditions are in substance predetermined or variable.

Financial Instruments with Characteristics of Equity (FICE) project

23. The staff noted that the Board has a current joint project with the FASB on FICE. The objective of the FICE project is to improve and simplify the financial reporting requirements for financial instruments with characteristics of equity. Specifically, this project is intended to:

    (a) Develop a better distinction between equity and non-equity instruments

    (b) Converge IFRS and US GAAP in this area.

24. On 28 February the IASB published a discussion paper *Financial Instruments with Characteristics of Equity* (FICE DP). The FICE DP contained an IASB Invitation to Comment and the FASB Preliminary Views document. The goal of the FICE DP was to solicit the views of interested parties on whether the proposals in the FASB document would be a suitable starting point for the IASB's deliberations, or whether there are alternative approaches.

25. The IASB and FASB are working together to develop and publish an exposure draft (FICE ED). The FICE project team propose issuing the FICE ED in the first quarter of 2010, with an IFRS due to be published in the first half of 2011.

26. The staff notes that following the recommendation by the IFRIC in paragraph 4 above, the Board has amended IAS 32 to permit rights issued pro rata to existing shareholders to be classified as equity instruments if the exercise price is fixed in any currency. The staff notes that the basis of the Board's conclusions identifies the following as reasons for the amendment:

    (a) such rights were being issued frequently in the current economic environment.

    (b) they are usually relatively large transactions that can have a substantial effect on entities' financial statement amounts.

    (c) this exception to the fixed for fixed condition in IAS 32 is for a narrowly-targeted transaction with owners (shareholders) in their capacity as owners.

Staff recommendation

Agenda criteria assessment for the IFRIC

27. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*

    Yes. The staff notes that application of the fixed for fixed condition in IAS 32 has resulted in a number of interpretation questions being raised by constituents.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)? The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

    Yes. The staff understands that significant divergent interpretations of the fixed for fixed condition exist in practice.

    (c) *Would financial reporting be improved through elimination of the diversity?*

    Yes. Financial reporting for many transactions involving settlements through delivery of an entity's own equity instruments would be improved through elimination of diversity in applying the fixed for fixed condition.

    (d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*

    No. Constituents have requested interpretation guidance relating to application of the fixed for fixed condition to many specific situations. The staff considers that the range of situations identified in relation to this issue indicates a concern with the overall concept of the fixed for fixed condition. Consequently, the staff considers that these issues could only be addressed through:

    (i) the issuance of application guidance;

    (ii) amendments and improvements to existing guidance, such as by the identification of additional exceptions to the fixed for fixed condition; or

    (iii) a full scope project, such as the current FICE project.

(e) *It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis?*

Yes. It is probable that the IFRIC would be able to reach consensus in interpreting how the fixed for fixed condition should be applied to specific situations.

(f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

No. Many of the issues in interpreting the fixed for fixed condition identified in paragraph 11 above were communicated in responses by constituents to the FICE DP, and in subsequent discussions with the joint FICE project team.

The staff considers that it is unlikely that any guidance on the application of the fixed for fixed condition to any specific fact pattern could be provided before the issuance of the FICE ED in the first quarter of 2010. Specifically, the staff notes that the Annual Improvements 2009/11 Project exposure draft is not expected to be published until August 2010, with finalisation in the first half of 2011.

28. Based on the assessment of the agenda criteria in paragraph 27 above, the staff recommends that the IFRIC should not add the issue to its agenda.

Question 1 for the IFRIC
1. Does the IFRIC agree with the staff's recommendation not to add this issue to its agenda? If not, how does the IFRIC recommend the staff to proceed? 2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix A?

[Appendix A is omitted from this observer note]