STAFF PAPER

July 2013

IFRS Interpretations Committee Meeting

Project	New item for initial consideration
Paper topic	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

CONTACT(S) Liz Figgie efiggie@ifrs.org +44 (0)20 7246 6410

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Background

1. The IFRS Interpretations Committee (the Interpretations Committee) received two requests to address the accounting for a financial instrument that is mandatorily convertible into a variable number of the issuer's own shares (subject to a cap and a floor on the number of shares to be delivered) but gives the issuer the contractual right to settle the instrument at any point before maturity by delivering the maximum number of shares (fixed and capped).

2. The submissions asked how the issuer of such an instrument should classify it in accordance with IAS 32 *Financial Instruments: Presentation*. Specifically, the submissions focused on the issuer's option to settle the instrument before maturity by delivering the maximum number of its own shares—and asked how that particular feature should be assessed for the purposes of applying the definitions of a *financial liability* and an *equity instrument* in IAS 32.

3. The two submissions are attached to this agenda paper as Appendix C and Appendix D.

Description of the instrument

4. The instruments described in the submissions had the same key features; however there were some differences in the numerical details, as set out below:

    (a) An entity issues a debt instrument for CU1000. The instrument has a stated maturity date. At maturity, the issuer must deliver a variable number of its own equity shares to equal CU1000—subject to a maximum of 130 shares and a minimum of 80 shares. That means the holder of the mandatorily convertible instrument is not exposed to equity price risk if the share price is between CU7.70 and CU12.50 per share at maturity.

        [The other submission described an instrument with a larger value, and a proportionately narrower range of shares to be delivered at maturity. Specifically, this submission stated that at maturity, the issuer must deliver a variable number of its own shares to equal CU99,000—subject to a maximum of 660 shares and a minimum of 550 shares. That means the holder of the mandatorily convertible instrument is not exposed to equity price risk if the share price is between CU150 and CU180 at maturity.]

    (b) When the instrument was issued, the fair value of the issuer's equity share was CU10.

        [The other submission noted that when the instrument was issued, the fair value of the issuer's equity share was CU160. Therefore, in both submissions, when the instrument is issued, the fair value of the issuer's equity share would equate to the delivery of a number of shares that is within the range between the cap and the floor.]

    (c) The instrument has a fixed interest rate and interest is payable annually.

        [The other submission noted that the issuer can choose to defer interest on the instrument in particular circumstances. However, deferred interest must be paid when the instrument is settled. Therefore, in both submissions, the issuer is **required** to pay interest on the instrument.]

(d) The issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise its early settlement option, it must:

(i) deliver the maximum number of shares specified in the contract (ie 130 shares in one submission and 660 shares in the other); **and**

(ii) pay (in cash) all of the interest that would have been payable if the instrument had remained outstanding until its maturity date. This has been called a 'make-whole provision.'

5. Neither submission specified the term of the instrument (ie when the mandatory conversion will occur). However, we understand that these types of instruments generally have short lives; for example, one such instrument issued in 2012 had a term of three years.

6. We also understand that in some cases the make-whole provision is computed as the *present value* of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

A note about the scope of this paper

7. Both submissions noted that the financial instrument described in paragraph 1 of this paper is a new variation of an instrument that has existed in practice for some time. Specifically, the submitters noted that they have considered in recent years the accounting for a mandatorily convertible instrument that obliges the issuer to settle the instrument by delivering a variable number of its own shares, subject to a cap and a floor (but the issuer does **not** have the early settlement option described in paragraph 4(d) of this paper)—and one submitter stated that it is aware that there is some diversity in the accounting for that 'simpler' instrument. Neither submission asked the Interpretations Committee to address the accounting for that 'simpler' instrument—but rather asked only about the accounting for a mandatorily convertible instrument that **includes** the new (additional) feature that gives the issuer the early

settlement option described in paragraph 4(d). Therefore, this paper focuses only on how the issuer should analyze that new feature when it is classifying the financial instrument. However, at the end of this paper, we ask the Interpretations Committee if it wants to consider the accounting for the 'simpler' instrument. We think that question might be particularly relevant if the Interpretations Committee believes that the issuer's early settlement option would not affect the classification of the instrument (in some or all cases), for example because it lacks substance.

Accounting treatment described in the submissions

8. Both submissions discussed alternative views on how IAS 32 should be applied. We have summarized both analyses below. For simplicity, we have labelled the submissions as 'Submission 1', which is reproduced in Appendix C and 'Submission 2', which is reproduced in Appendix D. This numbering reflects only the order in which the submissions were received.

Submission 1

9. In its analysis, Submission 1 asked two questions to assess how IAS 32 should be applied.

Should the issuer's option to settle the instrument before maturity by delivering the maximum number of its own shares be assessed under the guidance in paragraph 20(b) of IAS 32?

10. Paragraph 20(b) of IAS 32 notes that an instrument is a financial liability if the entity can settle the instrument either in cash (or another financial asset) or by delivering its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

11. Specifically, paragraph 20 of IAS 32 states (in part):

> A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:
>
> (a) …
>
> (b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:
>
> (i) cash or another financial asset; or
>
> (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.
>
> Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21).

12. In the example set out in Submission 1, the issuer has the contractual right to choose to deliver either:

    (a) the maximum number of shares (660) at any time, which is a fixed number of shares; or

    (b) a variable number of shares at maturity, between 550 and 660 shares depending on the share price at that time.

13. Submission 1 asked whether paragraph 20(b) in IAS 32 should apply to that instrument, given that the assessment will be a comparison of two different share settlement alternatives rather than a comparison of a cash settlement alternative and a share settlement alternative. Submission 1 stated that those who would apply

paragraph 20(b) to the instrument described in the submission would do so by analogy.

14. Assuming that the requirements in paragraph 20(b) are relevant to the instrument in the submission, Submission 1 noted that the next question is how to assess whether the delivery of 660 shares (which is a fixed number of shares) **substantially exceeds** the other share settlement alternative (which is the delivery of a variable number of shares subject to a cap and floor). This question is important because if the delivery of 660 shares is determined to substantially exceed the delivery of a variable number of shares between 550 and 660, then the instrument could meet the definition of a financial liability in accordance with paragraph 20(b).

15. In assessing the meaning of *substantially exceed*, Submission 1 questioned whether the fixed number of shares (660 in its example) should be compared to:

    (a) the fair value of the **minimum** number of shares that could be delivered (550 in this example); or

    (b) the fair value of the number of shares **expected** to be delivered.

16. Submission 1 noted that some have suggested that it may be appropriate to analogize to paragraph AG62 in IAS 39 *Financial Instruments: Recognition and Measurement* (which was carried forward as paragraph B3.3.6 in IFRS 9 *Financial Instruments*). Such an analogy could suggest that if the difference in the number of shares is greater than 10%, then that would be 'substantial' for the purposes of applying paragraph 20(b) in IAS 32. But Submission 1 noted that this interpretation would not appear to be required by IFRSs. A similar view is described in more detail in paragraphs 35-37 of this paper.

17. Submission 1 noted that one of the challenges in considering this instrument is understanding the rationale for the inclusion of the issuer's early settlement option, given that the instrument does not have a cash settlement alternative and the make-whole provision requires the issuer to pay (in cash) all of the interest that would have been payable if the instrument had remaining outstanding until its maturity date.

18. Submission 1 noted that some have suggested that as long as it is possible to conclude that the maximum number of the issuer's own shares does not 'substantially exceed' the minimum number of its own shares, then there is no need to make a further assessment of the likelihood that the issuer will exercise its early settlement option. Indeed some would argue that since the Interpretation Committee (formerly called the IFRIC) indicated in March 2006 that economic compulsion does not give rise to a liability,[1] the substance of the issuer's early settlement option does not need to be considered.

19. However, Submission 1 noted that others have suggested that it is necessary to assess the issuer's commercial rationale for exercising its early settlement option or alternatively to determine whether that option is 'genuine' (by analogizing to the guidance for contingent settlement provisions in paragraphs 25 and AG28 in IAS 32[2]). Submission 1 noted that such a view means that it is necessary to look at the specific facts and circumstances to assess whether there could be other incentives for the issuer to exercise the option (for example, rating agency considerations or regulatory capital implications).

---

[1] Excerpt from the IFRIC Update (November 2006): At its meeting in March 2006 the IFRIC discussed a submission for a possible agenda item relating to the role of contractual obligations and economic compulsion in the classification of financial instruments. At that meeting and the following meeting in May, the IFRIC agreed not to add the item to the agenda but did not agree on reasons to be given for that decision. At the IFRIC meeting in July, the Chairman reported the Board's discussions on the issue at its meeting in June 2006. As stated in the June 2006 IASB Update, the Board discussed whether so-called economic compulsion should affect the classification of a financial instrument (or a component of a financial instrument) under IAS 32. This issue had previously been debated at the IFRIC meetings in March and May 2006. For a financial instrument (or a component of a financial instrument) to be classified as a financial liability under IAS 32, the issuer must have a contractual obligation either to deliver cash or another financial asset to the holder of the instrument, or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. (Different requirements apply to financial instruments that may or will be settled in the issuer's own equity instruments.) The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32. The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument. In view of the Board's discussion, the IFRIC believed that it could not achieve anything substantial by adding the issue on the agenda.

[2] Paragraphs 25 and AG28 of IAS 32 state that a contingent settlement feature does not affect classification if that feature is 'not genuine'. A contingent settlement feature is not genuine if it is extremely rare, highly abnormal and very unlikely to occur.

*How should the instrument be classified if there is **not** an indirect obligation under paragraph 20(b) of IAS 32?*

20. Submission 1 asked about the appropriate accounting **<u>if</u>** the issuer's option to deliver 660 shares indeed has commercial substance and/or does not give rise to an indirect obligation under paragraph 20(b) of IAS 32.

21. Submission 1 noted that some believe that the issuer has the contractual right (via its early settlement option) to avoid delivering a variable number of shares. This view is based on the wording in paragraph 16(b)(i) and paragraph 19 of IAS 32. Paragraph 16(b)(i) states (in part) that a non-derivative financial instrument is an equity instrument if the instrument will be settled in the issuer's own equity instruments and includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments. Submission 1 notes that under this view, the instrument would be accounted for as a compound instrument—comprised of a liability component for the present value of the interest payments (which must be paid in cash irrespective of whether the issuer chooses to settle the instrument before or at maturity) and a large residual equity component to reflect the issuer's contractual right to settle the instrument by delivering a fixed number of shares.

22. Submission 1 noted that others have suggested that it is inappropriate for the issuer's early settlement option to take precedence over (ie 'trump') the other features in the instrument. Proponents of this view state that essentially this instrument requires settlement in a variable number of shares and the issuer's early settlement option is a 'settlement option' as described in paragraph 26 of IAS 32. [Paragraph 26 of IAS 32 states that when a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.] Submission 1 notes that under this view, the instrument would be a liability in its entirety; ie there would be no equity component.

Submission 2

23. Submission 2 described three alternative views on how IAS 32 should be applied. Consistent with the analysis set out in Submission 1, the three alternative views consider the relevance and application of paragraph 20(b) in IAS 32 (that paragraph is reproduced in paragraph 11 of this paper).

View 1

24. View 1 focuses on the issuer's ability to avoid settling the instrument in such a way that it would meet the definition of a financial liability. Submission 2 noted that proponents of View 1 express the view that:

    (a) The manner of settlement that occurs at the instrument's maturity —ie delivery of a variable number of the issuer's own shares to equal a value of CU1000, subject to a cap and floor—meets the definition of a financial liability.

    (b) **But,** the issuer has a contractual right to settle the instrument at any time before maturity by delivering a fixed number of its own equity instruments and this meets the definition of equity.

25. Proponents of View 1 express the view that the analysis set out above is consistent with the Interpretations Committee's discussion in May 2013 on the classification of financial instruments that give the issuer the contractual right to choose the form of settlement (agenda paper 16 for that meeting). At that meeting, the Interpretations Committee noted that if the issuer has the contractual right to choose to settle a non-derivative financial instrument in cash or a fixed number of its own equity instruments, that financial instrument would meet the definition of an equity instrument in IAS 32 as long as the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions. The Interpretations Committee further noted that paragraph 20 of IAS 32 states that such an indirect contractual obligation would be established if the value of the fixed

number of the issuer's own equity instruments exceeds substantially the value of the cash.

26. Proponents of View 1 acknowledge that paragraph 20(b) describes an instrument that gives the issuer the option to settle its obligation either in cash or in its own shares — whereas the instrument in the submission gives the issuer two share settlement alternatives (one fixed and one variable). However, they noted that both instruments have one settlement alternative that (in isolation) would meet the definition of a financial liability and one settlement alternative that would (in isolation) meet the definition of an equity instrument—and, in both cases, the question is how to classify the instrument as a result of those settlement alternatives. Therefore proponents of View 1 believe that paragraph 20(b) is relevant to the instrument described in the submission.

27. Proponents of View 1 believe that paragraph 20(b) should be assessed in the context of whether it might be 'economically desirable' for the issuer to exercise its option to settle the instrument before maturity by delivering the maximum (fixed) number of its own shares. This assessment would take into account whether the issuer might exercise its early settlement option because of the positive effect on its regulatory capital requirements or debt covenants, or in the context of its credit rating.

28. Therefore View 1 states that even if at the date of initial recognition (which is when the issuer would assess the classification of the instrument) the early settlement option is in monetary terms worth substantially more than the fair value of the shares that would (based on the share price at that point) be delivered to the holder if the instrument remained outstanding until maturity, the requirements set out in paragraph 20(b) create a high hurdle. That means that it would be inappropriate to disregard the fact that the issuer has the contractual right to settle the instrument by delivering a fixed number of shares unless it is 'commercially unviable' for the issuer to exercise its early settlement option. (View 1 labelled this as 'non-substantive.')

29. Consequently, under View 1, the instrument would be classified as a compound instrument that is comprised of the following components:

(a) a financial liability for the interest payments, which must be paid in cash irrespective of whether the issuer chooses to settle the instrument at or before maturity; and

(b) an equity component for the residual value of the instrument.

30. Proponents of this view note that the equity component will be fairly substantial relative to the fair value of the instrument in its entirety.

View 2

31. Submission 2 noted that the analysis described under View 1 is also relevant under View 2. However, proponents of View 2 focus on the meaning of the following phrase in paragraph 20(b)(ii) of IAS 32—'its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.' [The relevant portion of paragraph 20 in IAS 32 is reproduced in paragraph 11 of this paper.]

32. In contrast to View 1, proponents of View 2 believe that paragraph 20(b) in IAS 32 requires the issuer to assess the difference between:

(a) the fair value of the cash and shares that would be delivered to the holder of the instrument if the instrument remained outstanding until maturity, and

(b) the fair value of the cash and shares that would be delivered to the holder if the issuer exercises its option to settle the instrument before maturity.

33. This assessment would be carried out on the initial recognition of the financial instrument and would be based on the share price at that date.

34. Within View 2, there are two different approaches that might be applied to determine the meaning of 'substantially exceed':

Approach 1

35. IAS 32 provides the relevant guidance for determining whether a financial instrument meets the definition of a financial liability or an equity instrument.

However, IAS 32 does not provide guidance on the **measurement** of financial instruments—those requirements are in IAS 39 (or IFRS 9).

36. Paragraph 40 of IAS 39 (which was carried forward as paragraph 3.3.2 of IFRS 9) uses the term 'substantially different' in the context of derecognizing a financial liability. Paragraph AG62 of IAS 39 (which was carried forward as paragraph B3.3.6 of IFRS 9) provide guidance on the meaning of that term:

> For the purpose of paragraph 40 [of IAS 39 or paragraph B3.3.6 of IFRS 9], the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability….

37. View 2 notes that if the threshold described in IAS 39 (and carried forward to IFRS 9) was used for the purposes of assessing the classification of the instrument in the submission, at initial recognition the issuer would compare the present value of each of the two settlement options (based on the share price at that date). If the difference between the two amounts was 10% or more, then that would be regarded as being 'substantially different' for the purposes of applying paragraph 20 in IAS 32.

Approach 2

38. Although the '10% test' in IAS 39 (and IFRS 9) might be a factor in the analysis, Approach 2 notes that there is nothing in IFRSs that requires the issuer to apply that threshold. Consequently, while the issuer should consider whether the difference between the present values of the two settlement alternatives is 10% or more, it is not determinative. Under Approach 2, other factors need to be taken into account, including (as with View 1, which described in paragraphs 24–30 of this paper) an assessment of whether the issuer—from a commercial perspective— might exercise the early settlement option because of its effect on regulatory capital requirements or debt covenants, or in the context of its credit rating (in other words, whether there

might be a 'substantive business purpose' for the issuer to exercise its early settlement option option). The issuer would also assess factors such as the volatility of its share price, in order to consider the possibility that it will become economically viable (from a present value perspective) for it to exercise its early settlement option.

View 3

39. View 3 acknowledges the assessment that is described in paragraph 20(b) of IAS 32. However, View 3 notes that in addition to that assessment—which is clearly identified as being **only an example** of how a financial instrument may establish an obligation indirectly through its terms and conditions—further guidance is provided at the end of paragraph 20 (reproduced below with emphasis added):

> …Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. **In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21 [of IAS 32]).**

40. Therefore, in addition to considering whether there is a substantial difference in value between the possible settlement alternatives, proponents of View 3 believe that the issuer must consider whether it will—regardless of the settlement alternative that actually occurs—deliver an amount that is at least equal to the amount that would be delivered under the variable-share settlement option (ie the settlement alternative that meets the definition of a liability). In other words, View 3 argues that the holder has in effect 'been guaranteed receipt of an amount that is at least equal' to the variable-share settlement alternative. That is because if the issuer exercises its early settlement option, it will deliver at least as many shares—and potentially more (but never fewer)—as it would if the instrument remains outstanding until maturity.

Outreach request

41. We sent a request for information to the International Forum Accounting Standard Setters and particular securities regulators including the International Organization of Securities Commissions (IOSCO) and the European Securities and Markets Authority (ESMA). We asked whether the instrument described in the submissions was common in the respondent's jurisdiction and, if so, how the instrument was classified. If there is diversity in practice in the respondent's jurisdiction, we asked for further explanation. We also asked Interpretations Committee members if they had experience with this instrument in practice.

42. We received 18 responses, which represented informal feedback and did not necessarily represent the formal views of any organization.

43. About a third of the respondents stated that the instrument described in the submissions is not common in their jurisdictions and therefore those respondents did not provide a view on the accounting. However one respondent noted that there are 'endless variations of facts and circumstances' related to convertible instruments and cautioned the Interpretations Committee against attempting to address each variant. Indeed two respondents asked about a possible variant —that is, in addition to the issuer's early settlement option, the **holder** of the instrument has the contractual right to settle the instrument at any time before maturity. If the holder chooses to exercise its early settlement option, it will receive the **minimum** number of shares (ie the fixed floor).

44. A small number of respondents noted that there is diversity in views in their jurisdictions, but did not provide any additional details. A few others noted that there is diversity in practice and views in their jurisdictions —and specifically noted that some instruments are classified as financial liabilities in their entirety while others are classified as compound instruments (ie with a financial liability component for the interest payments and a large residual equity component) but noted that the diversity could be largely due to differences in the specific terms of the instruments.

45. Some respondents had differing views about whether paragraph 20(b) in IAS 32 (reproduced in paragraph 11 of this paper) is relevant to the instrument described in the submissions and if so, how that paragraph should be applied. Some of those who believed that the paragraph is relevant noted that judgement is required to determine whether the issuer has an indirect obligation to deliver a variable number of shares, which would meet the definition of a financial liability—although a few respondents explicitly noted that the 10% threshold in paragraph AG62 of IAS 39 (and paragraph B3.3.6 of IFRS 9) is not relevant. Another respondent expressed the view that an indirect obligation would arise only if the value of the fixed-share settlement alternative was structured to **always exceed** the value of the variable-share settlement alternative.
46. Nonetheless, respondents who believed that paragraph 20(b) is relevant to the instrument described in the submissions agreed that if such an indirect obligation does **not** exist, the instrument should be recognized as a compound instrument, comprised of a liability component for the interest payments and an equity component for the residual value of the instrument.
47. Similarly, a few respondents noted that the guidance in paragraphs 25 and AG28 of IAS 32, which discuss whether a contingent settlement feature is 'genuine', is relevant to determining whether the issuer's early settlement option is substantive. (Footnote 2 of this paper discusses the meaning of the term 'genuine' in IAS 32.)
48. A few respondents expressed the view that the financial instrument described in the submissions seems to meet the definition of a financial liability in its entirety. Those respondents generally felt that the issuer's early settlement option was not substantive (although they acknowledged that this determination would require judgement) and therefore should not affect the classification of the instrument. For example, one respondent noted that the issuer's early settlement option requires it to deliver a potentially **larger** quantity of shares at an **earlier** point in time—and thus questioned whether such a feature should be relevant to assessing the substance of the instrument. That respondent also pointed out that the instrument holder has in effect been guaranteed receipt of an amount that is at least equal to the variable-share

settlement alternative because if the issuer exercises its early settlement option, it will deliver at least as many shares—and maybe more (but never fewer)—as it would if the instrument remained outstanding until maturity.

49. One respondent offered another possible view—that the instrument cannot have an equity component because the instrument has settlement alternatives and those alternatives do not result in the delivery of a fixed number of the issuer's own shares in all circumstances. The rationale is that, even if the issuer chooses to deliver the fixed (maximum) number of shares, the consideration that it 'pays' in exchange is the avoidance of a variable share obligation, which means that the arrangement is not fixed-for-fixed.

50. Finally, one respondent expressed the view that the instrument described in the submissions is comprised of the following three components—(a) an obligation to pay interest, which is a financial liability; (b) a non-derivative requiring the issuer to deliver a fixed number of its own shares (ie the minimum number of its own shares that the issuer must deliver), which is an equity instrument; and (3) an obligation requiring the issuer to deliver a variable number of its own shares depending on the ultimate share price, which is a derivative financial liability.

Staff analysis

The issue

51. As discussed throughout this paper, the instrument described in the submission has two settlement alternatives:

    (a) At maturity, the issuer must deliver a variable number of its own equity shares to equal a fixed cash amount—subject to a cap and a floor, which respectively limit and guarantee the number of shares that the issuer must deliver.

    (b) At any time before maturity, the issuer has the contractual right to settle the instrument by delivering the maximum number of shares specified in

the contract (ie the fixed cap) and paying (in cash) all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

52. Expressed simply, we think the question is whether the issuer's early settlement option—described in paragraph 51(b)—has substance. That is because 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. That determination will have a significant effect on the instrument's accounting:

    (a) If the issuer's early settlement option **is substantive**, we think that portion of the financial instrument would meet the definition of an equity instrument. That is because paragraph 16(b)(i) of IAS 32 states (in part) that a non-derivative financial instrument is an equity instrument if the instrument will be settled in the issuer's own equity instruments and includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments. (The interest payments on the instrument would meet the definition of a financial liability—and would be separately classified—because they are payable (in cash) in all cases.)

    (b) However, if the issuer's early settlement option **is not substantive**, it would be disregarded for the purposes of classifying the instrument in accordance with paragraph 15 of IAS 32. Therefore, many would argue that the instrument must be classified as a financial liability in its entirety to reflect the issuer's obligation to deliver a variable number of its own shares at maturity.[3]

Assessing the substance of a contractual arrangement

53. 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.

[3] As noted in paragraph 7, we are aware that there is some diversity in practice related to this accounting.

However, paragraph 15 of IAS 32 is clear that the issuer of a financial instrument must classify the instrument consistently with the **substance** of the contractual arrangement. Therefore, the issuer of a financial instrument cannot assume that an instrument is an equity instrument simply because the issuer has the contractual right to settle the obligation by delivering a fixed number of shares; in other words, we do not think that IAS 32 permits a fixed-share settlement alternative to always 'trump' the other contractual terms of the instrument.[4]

54. While the Standard does not address explicitly the circumstances described in the submissions, some paragraphs indeed discuss circumstances in which a contractual term should be disregarded for the purposes of classifying a financial instrument.

A feature that is 'not genuine'

55. Paragraphs 25 and AG28 in IAS 32 state than an issuer must disregard a contingent settlement feature if it is 'not genuine'—ie if it is extremely rare, highly abnormal and very unlikely to occur. We think it is reasonable to consider that guidance when assessing the issuer's early settlement option. That is, if that feature is not genuine, we think it clearly does not reflect the substance of the contractual arrangement—and thus should be disregarded for the purposes of classification.

A feature that indirectly establishes a contractual obligation to deliver a variable number of shares

56. Paragraph 20 of IAS 32 states that a financial instrument may establish a contractual obligation to deliver cash (or another financial asset) indirectly through its terms and conditions. As an example, paragraph 20(b) notes that a financial instrument is a financial liability if the issuer will settle the instrument by delivering either cash (or another financial asset) or its own shares —and the value of the shares is determined to exceed substantially the value of the cash (or other financial asset).

[4] In May 2013 the Interpretations Committee considered three instruments that gave the issuer the contractual right to choose the form of settlement. That submission was different because it explicitly stated that the fixed-share settlement feature was substantive.

57. Paragraph 20 explains that although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

58. We think this paragraph is relevant because it discusses circumstances in which the financial instrument's terms and conditions indirectly establish an obligation that meets the definition of a financial liability. However, we think the following choices are notably different:

    (a) the choice between delivering a fixed number of shares **or cash** (the example set out in paragraph 20(b); and

    (b) the choice between delivering a fixed number of shares **or a variable number of shares** (the example set out in the submissions).

59. That is because the issuer may have valid reasons for preferring to deliver a fixed number of its own shares instead of cash, even if the value of the shares is greater than the value of the cash (eg cash management, liquidity, etc). But those reasons are not applicable if the issuer is choosing between delivering a fixed number of its own shares and a variable number of its own shares.

60. The issuer's early settlement option simply guarantees the holder of the instrument the receipt of the maximum possible number of the issuer's shares (ie an amount that is at least equal to (and perhaps greater than) the variable-share settlement alternative)—**and** if it exercises that option, the issuer would deliver that value **earlier** than it would otherwise be obliged. Therefore we think it is necessary to assess whether the issuer receives sufficient benefit from that early settlement option, given the costs of exercising it.

61. We acknowledge that there are benefits to issuing equity, but the issuer will receive those benefits irrespective of whether it exercises its early settlement option or waits until the instrument's maturity date. That is, in all circumstances, the issuer will have more outstanding equity, the only question is **when** it will deliver those

shares—and **how many** shares it is obliged to deliver. We question whether the marginal benefits of issuing equity instruments at an earlier point in time are sufficient to warrant the costs of doing so; in particular the obligation to pay (in cash) all of the interest that would have been payable if the instrument had remained outstanding until its maturity date **and** the obligation to potentially deliver more shares than would have been otherwise required.

62. That assessment may depend on 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. For example, in many circumstances, we think the issuer will be unlikely to benefit from its early settlement option if that range is wide because the issuer could deliver significantly more shares than it would otherwise be obliged to deliver at maturity—especially if the instrument is short-lived. Indeed one respondent to our outreach request queried whether there would be legal barriers that would affect the issuer's ability to exercise its early settlement option because it would involve paying more than is necessary to the holders of the instrument. That respondent noted that company law or corporate governance requirements might restrict the arguably preferential treatment of a particular class of instrument holder.

63. Some have suggested that the issuer might have other reasons to exercise its early settlement option, including considerations related to its credit rating. However, based on our understanding of the treatment of these instruments by the credit rating agencies, we understand that the instrument described in the submissions likely could be assigned a high level of equity credit even prior to conversion (ie it would be considered quite 'equity-like' for the purposes of determining the issuer's credit rating)—depending on factors such as the width of the range between the cap and the floor, which would determine how much equity risk the instrument holder has assumed, and the instrument holder's claim in liquidation. Therefore in some cases we question whether there would be a notable effect on the issuer's credit rating if the issuer chose to exercise its early settlement option.

64. Finally, we do not think that the requirements related to the derecogniton of financial liabilities in paragraphs 40 and AG62 of IAS 39 (and paragraphs 3.3.2 and B3.3.6 of

IFRS 9) are relevant to the analysis of the instrument in the submission. We note that the only similarity between those paragraphs and paragraph 20(b) of IAS 32 appears to be the use of the term 'substantially' and we do not believe that that creates a sufficient link between the two pieces of guidance (or their objectives) to warrant an analogy.

Conclusion

65. We think that judgement is required to determine whether the issuer's early settlement option is substantive. The issuer will need to consider whether there are any real economic or business reasons that the issuer would exercise its option.

66. However, on the basis of the facts provided in the submission, we think it is unlikely that the issuer's contractual right to settle the instrument at any point before maturity by delivering the maximum number of shares (fixed and capped) has substance. We question whether there is sufficient benefit in exercising the settlement option because to do so the issuer must deliver a potentially larger number of its own shares —plus all of the interest (in cash) that would be payable over the contractual life of the instrument—at an earlier point in time. We are concerned that the primary (or only) driver for including that feature in the instrument was to achieve a desired accounting outcome—ie equity classification.

A final note on economic compulsion

67. We think the assessment of **substance** that is discussed in this paper is different from previous discussions about **economic compulsion**:

    (a) Both the IASB and the Interpretations Committee (formerly called the IFRIC) discussed economic compulsion in 2006. During those meetings, they assessed whether a **non-contractual feature** should be considered when an issuer classifies a financial instrument. Specifically, the instrument discussed in 2006 did not contractually oblige the issuer to pay a dividend to the holder, nor did it oblige the issuer to ever redeem the

instrument—however, it could be argued that the issuer was economically compelled to pay dividends on the instrument and redeem the instrument on the specified date. However, as noted in footnote 1 of this paper, the IASB confirmed that IAS 32 does not require or permit factors **not within the contractual arrangement** to be taken into consideration in classifying the financial instrument.

(b) In contrast, the submissions discussed in this paper are asking whether a **contractual feature** (ie a factor that is **within the contractual arrangement**) has substance. In other words, the analysis in this paper discusses whether a contractual feature should be disregarded for the purposes of classifying the financial instrument if the feature does not reflect the substance of the contractual arrangement.

68. Therefore we think the conclusions in 2006 related to economic compulsion are not relevant to the instrument described in the submissions. Indeed the Board itself made this distinction in 2006 when it stressed that IAS 32 requires an assessment of the substance of the contractual arrangement—but does not permit factors that are not within the contractual arrangement to be taken into consideration in classifying a financial instrument (even if those non-contractual factors may economically compel the issuer to behave in a particular manner).

Staff recommendation

69. We think the appropriate classification can be derived from IAS 32 without need for further guidance. Consequently we do not think that any changes to or formal interpretation of IAS 32 are required.

70. Therefore, we think that the Interpretation Committee's agenda criteria (attached to this paper as Appendix B for reference) are not met and we recommend that the Interpretations Committee should not take this issue onto its agenda. We have included proposed wording for a tentative agenda decision as Appendix A.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff's analysis of how an issuer should assess the substance of the feature described in paragraph 4(d) for the purposes of classifying an instrument in its entirety in accordance with IAS 32? 2. Does the Interpretations Committee agree with the draft tentative agenda decision? 3. Does the Interpretations Committee want to take any other action (ie other than publishing a tentative agenda decision), for example does the Interpretations Committee want to consider the accounting for the instrument described in paragraph 7 of this paper?

Appendix A—Proposed wording for tentative agenda decision

A1. We propose the following wording for the tentative agenda decision:

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

The IFRS 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 shares to equal a fixed cash amount—subject to a cap and a floor, which limit and guarantee, respectively, the number of shares 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:

1. deliver the maximum number of shares specified in the contract; and
2. 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 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. Therefore the issuer cannot assume that a financial instrument meets the definition of an equity instrument simply because the issuer has the contractual right to settle the obligation 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. The issuer will need to determine whether there are real economic or business reasons that the issuer would exercise its option—or whether the primary reason for including the feature in the contract was to achieve a desired accounting outcome.

However, on the basis of the facts provided in the submission, the Interpretations Committee noted that it is unlikely that the issuer's contractual right to settle the instrument at any point before maturity by delivering the maximum number of shares has substance. The Interpretations Committee questioned whether there is sufficient benefit in exercising the settlement option because to do so the issuer must deliver a potentially larger number of its own shares—plus all of the instrument (in cash) that would have been payable over the instrument's life—at an earlier point in time.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements an interpretation was not necessary and consequently [decided] not to add the issue to its agenda.

Appendix B—Agenda criteria

We should address issues:

1. that have widespread effect and have, or are expected to have, a material effect on those affected.

2. where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.

3. that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.

The requirements in IAS 32 relevant to this submission are clear. Therefore we recommend that the IFRS Interpretations Committee should not add this item to its agenda.

In addition:

4. Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs?.

5. Will the solution developed by the Interpretation be effective for a reasonable time period? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.)

Appendix C—Submission 1

Potential agenda item request: Classification of mandatorily convertible instruments with an issuer option to convert into the maximum fixed number of shares

Over recent years we have considered the accounting for mandatory convertible instruments that are not redeemed in cash but are settled by delivering shares, where there is a cap and floor linked to the share price that limits or guarantees, respectively, the number of shares to be delivered. We are aware there is some diversity in the accounting for these instruments under IAS 32 *Financial Instruments: Presentation.* However, in recent months we have become aware of a new feature included in these instruments, an issuer option to settle the instrument by issuing the maximum fixed number of shares ('issuer option'), thus creating even further diversity in the possible ways to account for these instruments.

For the purposes of this request, we have described a simplified fact pattern below. We note the actual terms of the instruments may vary in practice.

Example instrument

- Instrument is settled at maturity by delivery of issuer's ordinary equity shares to the value of C99,000.
- The instrument also contains a cap that limits the number of shares that the issuer is required to deliver to 660 and a floor that requires the issuer to deliver a minimum number of 550 shares.
- The issuer also has an option to issue the 660 shares (i.e. fixed maximum number of shares) at any time before maturity.
- If the issuer chooses to settle the instrument by issuing the maximum number of shares early (in this case 660) all interest must be paid for the entire period of the instrument (i.e. make whole provision).
- The fair value of the shares at the date of issue is C160 which would equate to the issue of 620 shares.
- Interest of 5% is payable annually, but can be deferred if the issuer does not pay dividends on its ordinary shares. However, deferred interest must be paid upon settlement.

Alternative treatments

While mandatorily convertible bonds are often structured with a variety of features, the issuer option in the example instrument above (that is, the option to deliver 660 shares) is becoming more prevalent. This submission is concerned with how to assess this feature in relation to the instrument as a whole.

Should the issuer option be assessed under the guidance in IAS 32 paragraph 20(b)?

Paragraph 20(b) of IAS 32 indicates that an instrument is a financial liability if the entity can settle the instrument either in cash (or another financial asset) or by delivering "its own shares whose value is determined to exceed substantially the value of the cash or other financial asset". In our example, the issuer can either deliver the maximum 660 shares at any time (a fixed number of shares) or at maturity deliver a variable number of shares between 550 or 660, depending on the share price at that time. One question is whether paragraph 20 should apply to this instrument, given it will be a comparison of two different share settlement outcomes rather than cash. Those who support the application of IAS 32.20(b) to the example instrument would apply this guidance by analogy.

Assuming the instrument should be considered under paragraph 20, the next question is how to assess whether the delivery of 660 shares (a fixed number of shares) substantially exceeds the other share alternative (which is the delivery of a variable number of shares subject to a cap and floor). This question is important because if 660 shares does substantially exceed the variable share alternative, then the instrument could be considered a financial liability in accordance with paragraph 20.

With regard to this assessment, we question for example, whether in assessing 'substantially exceeds' the fixed number of shares (660 in this example) should be compared to the fair value of the minimum alternative (550 in this example) or the fair value of the shares expected to be delivered. Another suggestion is that an analogy to AG62 of IAS 39 could suggest that if the difference in number of shares is greater than 10% then this would be substantial, but this would not appear to be a required interpretation.

One of the challenges in considering this instrument is the rationale for the insertion of the issuer option, given that there is no cash settlement alternative and the make whole interest provision that requires the issuer to pay all interest due through to maturity of the instrument. Some have suggested that as long as it is concluded that the maximum number of shares does not "substantially exceed" the alternative minimum number of shares then there is no need to make any further assessment of the likelihood of the issuer exercising the option. Indeed some would argue that since the Interpretation Committee in March 2006 indicated that economic compulsion does not give rise to a liability, the substance of the option does not ever need to be considered. Others have suggested that there would need to be a further assessment of the commercial rationale for the option ever being exercised or whether the issuer option is considered 'genuine' (by analogy to the guidance for contingent settlement provisions in IAS 32 paragraph 25 and AG28 to assess the likelihood of a feature being triggered). That means that one would have to look at the specific facts and circumstances to assess whether there could be other incentives for the issuer to exercise the option (for example, rating agency considerations or regulatory capital implications).

How should the instrument be classified if not an indirect obligation under IAS 32 paragraph 20(b)?

Assuming that it is concluded that the issuer option to deliver 660 shares at any time has commercial substance and/or does not become an indirect obligation under paragraph 20 of IAS 32, how should the instrument be accounted for? One view is that the issuer option gives the issuer the ability to avoid delivering a variable number of shares. This view is based on the wording in paragraph 16b(i) and paragraph 19 of IAS 32. The issuer has an unconditional right to avoid delivering a variable number of shares. The instrument would therefore be separated into a liability for the present value of the interest payments with a large residual equity component given that the issuer always has the discretion to settle the instrument by delivering a fixed number of shares.
Others have suggested that it is inappropriate for the issuer option to take precedence over the other features in the instrument and that essentially this instrument is for the settlement of a variable number of shares with the issuer early redemption option being a settlement option under paragraph 26 of IAS 32. This would result in the instrument having no equity component.

Reasons for the IFRS Interpretation Committee to address the issue

We set out below consideration of this issue against the IFRS IC criteria a potential agenda item.

a) ***Is this issue widespread and practical?***

Yes. These types of instruments are being issued in the current economic environment and we believe they will be issued more frequently in the future if they result in equity accounting treatment for the instrument (apart from the financial liability for the stream of interest payments). The application of the guidance in IAS 32 to these instruments has continued to give rise to questions and divergent views have emerged.

b) ***Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?***

As noted above, we believe there are divergent views in practice in classifying instruments with such clauses.

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

Depending on which view is applied the financial statements will look significantly different. For example, if the issuer option 'trumps' all other terms then the instrument will be almost entirely classified as equity except for a small liability component for the interest payments. However, if the clause is disregarded then the conversion into a variable number of shares will, in our view, require the instrument to be treated as a liability with embedded derivatives for the cap and floor which then require re-measurement to fair value through profit or loss in each reporting period based on the issuer's share price.

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?***

We believe this issue is sufficiently narrow in scope as it could be addressed by answering the following questions:

1. How should paragraph 20 of IAS 32 be read with regards to an indirect obligation to settle a financial instrument with its own shares whose value is determined to exceed substantially the alternative settlement option? That is, does paragraph 20 apply to the fact pattern in this paper and if it does, can it be concluded that the fixed share alternative does not 'substantially exceed' the other share alternatives? Can we automatically conclude that having considered paragraph 20 the issuer option has substance?
2. Does the issuer option take precedence over the other share settlement features of the instrument so that since the issuer can always issue a fixed number of shares the instrument is largely equity (apart from the financial liability for interest payments)?

Guidance provided by the IFRS IC on these questions will eliminate diversity for instruments with issuer options to convert into a fixed number of shares.

e) ***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?***

We are aware that the Board was previously working on the *Financial instruments with characteristics of equity* ('FICE') project and thus interpretations relating to IAS 32 were not being considered. However, given that the FICE project is no longer on the Board's current agenda and its timing is uncertain (albeit we appreciate that the Board is now working on the conceptual framework for which the definition of liabilities and equity is being considered), we suggest that the IFRS IC should consider providing guidance as it relates to these types of instruments in order to reduce diversity in practice.

Furthermore, we believe that this issue would not involve any fundamental changes to existing guidance and therefore can be resolved on a timely basis.

We hope that the Interpretations Committee will give due consideration to including this issue on their agenda for interpretation.

Appendix D—Submission 2

Potential agenda item request: Classification of mandatorily convertible instruments with an issuer option to convert into a fixed number of shares

We have recently become aware of a new type of mandatorily convertible bond, which adds a feature to bonds that are otherwise mandatorily convertible into a variable number of shares (with a cap and a floor on the number of shares to be issued). The additional feature permits the issuer of the instrument to convert the instrument into equity shares at any point by issuing the maximum (capped and fixed) number of shares and settling in cash any coupons that would, in the absence of the early settlement, have been paid up to the instrument's maturity. At the date of issue, the number of shares that would be issued on conversion is within the range of the cap and floor.

A simplified illustration of the instrument is:

- An entity issues a debt instrument for CU 1,000 which pays a fixed annual coupon at a market rate.
- On maturity, the instrument is settled through the issue of equity shares equal in value at that point to CU1,000, subject to a maximum number of shares of 130 and a minimum of 80.
- The market value of one equity share at the date of issue of the instrument is CU 10.
- The issuer has an option to settle the instrument early. If the issuer chooses to exercise its early settlement option, it will issue the maximum number of shares specified in the contractual agreement (130) and pay all of the remaining coupons in cash that would have been payable if the instrument had remained outstanding up its original maturity date.

Although it might appear uneconomic for the issuer to exercise its early settlement option, it is possible that the issuer might choose to do so in order to comply with regulatory capital requirements or debt covenants, or in the context of its credit rating.

A number of different views are emerging about the appropriate accounting approach.

Alternative 1

Under this view, the focus is on the issuer's ability to avoid settlement of the debt instrument in such a way that it would be settlement of a financial liability. The manner of settlement on maturity of the instrument (shares to the value of CU 1,000 subject to a cap and floor on the number of shares issued) would give rise to a financial liability. However, the issuer early settlement option permits the issuer to settle the instrument in such a way that this feature would meet the definition of equity as the issuer will issue a fixed number of shares in order to extinguish a fixed financial liability.

This analysis above is consistent with the IFRS Interpretations Committee's view in respect of the debt/equity classification of the instruments set out in agenda paper 16 of the May 2013 meeting, and indicates that the early settlement option may result in the instrument being classified largely as equity, with a financial liability component being recorded for the coupons.

At its May 2013 meeting, the IFRS Interpretations Committee considered the requirements of IAS 32.20, in the context of whether an issuer's option to settle a financial instrument through the issue of a fixed number of shares would result in the issue of shares whose value would exceed substantially the value of the cash (or other financial asset) that would otherwise be required to be transferred to the holder of the financial instrument. Although an obligation for an entity to deliver a variable number of its own equity instruments does not give rise to an obligation to deliver cash or another financial asset, it does give rise to a financial liability. Consequently, it would appear appropriate for IAS 32.20 to be applied to financial instruments that result in different manner of delivery of an entity's own equity instruments, one or more of which would result in classification as a financial liability and one or more of which would result in classification as an equity instrument.

IAS 32.20 notes that:

> 'A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions…..'

IAS 32.20 contains a number of examples of instruments that are considered indirectly to give rise to a financial liability. These examples include, at IAS 32.20(b):

> 'a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:
> 1. Cash or another financial asset; or
> 2. Its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Supporters of alternative 1 consider that the threshold to be applied for the purposes of IAS 32.20(b)(ii) should be in the context of whether it might economically be desirable for the early settlement option to be exercised. This assessment takes into account whether the issuer might, at some future point, exercise the early settlement option because of its effect on regulatory capital requirements or debt covenants, or in the context of its credit rating. Therefore even if, at the date of initial recognition of the financial instrument which is the point at which the liability/equity classification is determined, the early settlement option is in monetary terms worth substantially more than the fair value of the shares that would (based on the share price at that point) be transferred to the holder if the instrument remained in issue to its maturity, the test in IAS 32.20(b)(ii) is a high hurdle which means that it must be commercially unviable for the early settlement option to be exercised (that is, the early settlement feature would need to be non substantive).

Consequently, under this view, the instrument would give rise to a financial liability for the coupons component, with the (fairly substantial) residual being classified as equity.

Alternative 2

Under this view, the analysis set out above under Alternative 1 remains relevant but a different view is taken of the requirements of IAS 32.20. The focus is on the meaning of 'its own shares whose value is determined to exceed substantially the value of the cash or other financial asset' [IAS 32.20(b)(ii)]

In contrast to Alternative 1, those who support Alternative 2 consider that IAS 32.20(b)(ii) requires focus to be placed on the amount of the difference between the fair value of the cash and shares that would be transferred to the holder of the instrument if it remained in issue until maturity, and the fair value of the cash and shares that would be transferred on exercise of the issuer's early settlement option. This assessment would be carried out on the initial recognition of the financial instrument, based on the share price at that point.

There are then different approaches that might be applied in determining the meaning of 'substantially exceed'.

Approach 1

IAS 32 determines whether a financial instrument gives rise to a financial liability or an equity instrument. It does not deal with the measurement of financial instruments, which is within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

IAS 39 does include guidance about what constitutes 'substantially different' in the context of the modification of debt (see in particular IAS 39.40). IAS 39.AG62 notes that:

> '…the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.'

This indicates that, as at initial recognition of the mandatorily convertible bond outlined above, a comparison would be made of the present value of each of the two settlement options. If the difference between the two amounts was 10% or more, then this would be regarded as being 'substantially different' for the purposes of IAS 32.20.

Approach 2

Although the '10% test' in IAS 39 might be a factor in the analysis, there is nothing in IFRS that requires that approach to be followed. Consequently, while a difference in present

value between the two settlement alternatives of 10% or more is a factor to take into consideration, it is not determinative. Other factors need to be taken into account, including (as with Alternative 1 above) an assessment of whether the issuer might from a commercial perspective exercise the early settlement option because of its effect on regulatory capital requirements or debt covenants, or in the context of its credit rating (in other words, whether there might be a substantive business purpose for the issuer to exercise its option). Other factors would include an assessment of the issuer share price volatility, in order to consider the potential for the issuer early settlement feature to become economically viable (from a present value perspective) to be exercised.

Alternative 3

This view acknowledges the analysis that is carried out under IAS 32.20(b)(ii). However, it is noted that in addition to this test (which is clearly identified by the introductory text of IAS 32.20 as being only an example of how a financial instrument may establish an obligation indirectly through its terms and conditions), further guidance is included towards the end of IAS 32.20:

> 'Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. **In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option**.' [emphasis added]

This indicates that IAS 32.20, in addition to consideration of whether there is a substantial difference in value between possible settlement alternatives, requires consideration of whether an issuer will, regardless of the settlement alternative that arises is practice, transfer an amount that is at least equal to the amount that would be transferred under the option that would be classified as a financial liability.

Reasons for the IFRS Interpretations Committee to address the issue

Is the issue widespread and practical?

Yes. Although few of these new types of instrument have been issued to date, we believe that in the current economic environment their issue will become more frequent if the addition of an early settlement option, as outlined above, results in equity classification for substantially all of the instrument (with only the coupon payments being classified as a financial liability).

Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

Yes. We have outlined above a number of different approaches that might be taken in determining the appropriate accounting approach which might be followed.

Would financial reporting be improved through elimination of diversity?

Yes. Depending on the view taken about the accounting analysis, the same instrument could be accounted for almost entirely as equity or wholly as a financial liability (with remeasurement of the financial liability being linked to the issuer share price with amounts potentially being recorded in profit or loss depending on whether the cap or floor became effective).

We also believe that, if the simplified fact pattern outlined above were to be considered by the IFRS Interpretations Committee to result in an instrument that is classified in its entirety as a financial liability (which we understand is not the intention of the instrument, as the issuer's early settlement option is designed to obtain a significant equity component), other instruments with slightly different terms (for example, an issuer early settlement option that is not set at such an economically extreme amount) would quickly be issued into the market in an effort to change the analysis to one in which the instrument qualifies largely for equity classification. Consequently, an improvement in financial reporting, which takes account of likely future developments, would require any guidance to be issued by the IFRS Interpretations Committee (or the IASB itself) to be sufficiently broad to deal with likely variations in contractual terms.

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?

We believe that the issue is sufficiently narrow in scope, as it requires the following key questions to be addressed:

- Should IAS 32.20 be read to include among instruments that require delivery of cash or another financial asset, those instruments that require delivery of an entity's own equity instruments in such a way that the 'fixed for fixed' requirement is not met, meaning that the settlement feature would itself give rise to a financial liability?

- Should IAS 32.20 be applied to an instrument which will be settled through the issue of an entity's own equity instruments on terms which fail equity classification, where that instrument also contains an issuer early settlement feature under which the 'fixed for fixed' requirement is met?

- Assuming the answers to the previous questions are yes, how should IAS 32.20 be read when considering an issuer early settlement option, which meets the 'fixed for fixed' requirement for equity classification, where that option exceeds the present

value on issue of the other settlement feature(s) of the instrument which would all be classified as financial liabilities?

- What is meant in IAS 32.20 by ‘exceed substantially’? Should this take into account qualitative as well as quantitative features? Should the quantitative analysis be based on the IAS 39.40 / IAS 39.AG62 determination of what represents ‘substantially different’?

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

Although the IASB was previously working on the Financial Instruments with Characteristics of Equity (FICE) project, this is no longer on the IASB’s agenda. Although the IASB is now working on revisions to the conceptual framework, which include consideration of the definitions of liabilities and equity, we believe that the IFRS Interpretations Committee would be able to issue guidance substantially in advance of the completion of that project.

In our view, the issue can be resolved on a timely basis as it could be addressed through existing accounting literature.

However, if the IFRS Interpretations Committee considers that this is not an issue that is appropriate to add to its agenda, if this is because it is considered that existing IFRSs do not contain sufficient guidance or the current guidance is unclear, we consider that the IASB should undertake a limited scope project that considers amendments to existing requirements as a matter of urgency. We are concerned that the addition of a settlement feature of the type outlined above, which is exercisable at the option of the issuer, might result in an instrument that contains features that would otherwise be accounted for as financial liabilities being accounted for as containing a significant equity component and a minimal liability component.