IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	New item for initial consideration		
Paper topic	Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event		
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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 a request to address the accounting for a particular financial instrument that converts into a variable number of the issuer's own equity instruments in the event of the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument.

2. The submission notes that in the wake of the financial crisis, regulators are looking to strengthen the capital base of financial institutions, particularly in the banking sector. Some financial institutions are complying with these new regulatory requirements by issuing financial instruments that convert into a variable number of the issuer's own ordinary shares if the institution breaches a minimum regulatory requirement. This type of contingent event is called a 'non-viability' event. The submission asked how the issuer should classify such a contingently convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation*.

3. The submission is attached to this agenda paper as Appendix C.

Description of the instrument

4. These instruments vary in practice because national regulators have discretion in specifying particular terms and conditions—but the submission described the key features:

    (a) The instrument does not have a stated maturity date. However the issuer may choose to call the instrument for cash (equal to its par amount) on specific dates, subject to the regulator's approval and particular other restrictions.

    (b) The instrument has a stated interest rate (eg 10%) but the issuer may cancel any interest payment for any reason on a non-cumulative basis; ie interest on this instrument is paid at the issuer's discretion. In addition, the regulator may require the issuer to cancel interest payments in some circumstances.

    (c) If the issuer breaches the 'Tier 1 Capital ratio' (the contingent non-viability event), the instrument mandatorily converts into a variable number of the issuer's own ordinary shares. The value of the shares delivered at conversion equals the fixed par amount of the instrument; ie the number of shares delivered varies on the basis of the current share price.

5. The submission states that the contingent non-viability event is 'genuine'[1] and therefore cannot be ignored for the purposes of applying IAS 32. The submission also notes that the instrument is issued at par and the issuer receives the full proceeds upon issuance.

Alternative accounting treatments

6. The submission sets out five alternative views that are being applied in practice (or that are considered to be acceptable views).

[1] 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.

View 1: The instrument is a liability in its entirety

7. Proponents of View 1 point out that the issuer has a contractual obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs (ie if the issuer breaches the Tier 1 Capital ratio)—and therefore they believe that the instrument must be classified as a financial liability in its entirety in accordance with paragraphs 11 and 25 of IAS 32.
8. Paragraph 11 sets out the definition of a *financial liability* and, within that definition, bullet (b)(i) specifically discusses a non-derivative instrument that obliges the issuer to deliver a variable number of its own equity instruments:

> A *financial liability* is any liability that is:
>
> …
>
> (b) a contract that will or may be settled in the entity's own equity instruments and is:
>
> …
>
> (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments…

9. Furthermore, paragraph 25 sets out the requirements for contingent settlement provisions and states that a financial instrument is a financial liability if it obliges the issuer to deliver cash or another financial asset —**or otherwise settle the instrument in such a way that it would be a financial liability**—upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder:

> A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income

> or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:
>
> (a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;
>
> (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or
>
> (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B [of IAS 32].

10. In accordance with View 1, if the issuer pays any interest on the instrument, those payments would be recognized in profit or loss pursuant to paragraph 35 of IAS 32, which states:

> Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity…

View 2: The instrument is a compound instrument—a debt host with an equity component for the discretionary interest payments

11. Proponents of View 2 believe that the instrument is a compound instrument that is comprised of the following two components:

    (a) a liability component, which reflects the issuer's obligation to deliver a variable number of its own ordinary shares if the contingent non-viability event occurs; and

(b) an equity component, which reflects the issuer's discretion to pay interest.

12. According to View 2, the issuer must first consider the requirements in paragraph 28 of IAS 32 for compound financial instruments—which require the issuer of a non-derivative financial instrument to evaluate the terms of the instrument to determine whether it contains both a liability and an equity component—before applying the requirements in paragraph 25 of IAS 32 for contingent settlement provisions (reproduced in paragraph 9 of this paper).

13. When measuring the liability component, proponents of View 2 believe that the issuer must consider the expected timing of the contingent non-viability event occurring—and discount the liability accordingly. Therefore, if the issuer believes that the contingency will not occur in the near-term, the liability component likely would be recognized at an amount significantly less than par. In accordance with paragraph 31 of IAS 32, the difference between the fair value of the compound instrument in its entirety and the measurement of the liability component would be assigned to the equity component; ie the equity component is measured as a residual.

14. Under View 2, the liability component would be remeasured in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* to reflect any changes in the expected timing of the contingent non-viability event, and the changes in the measurement of that liability component would be recognized in profit or loss. If the issuer pays any interest on the instrument, those payments relate to the equity component and, accordingly, would be recognized in equity pursuant to paragraph 35 of IAS 32 (reproduced in paragraph 10 of this paper).

View 3: The instrument is a compound instrument—a debt host with an equity component for the discretionary interest payments measured at zero

15. View 3 is similar to View 2 but the liability component would be measured differently. Proponents of View 3 consider the fact that the contingent non-viability event could occur immediately (ie it is beyond the control of the issuer) and hence they believe that the liability component would be measured at the

amount that the issuer could be required to repay immediately (ie par). Under View 3, the instrument would be accounted for as a compound instrument but the equity component (a residual, as described above) would have a value of zero.

16. Consistent with View 2, if the issuer pays any interest on the instrument, those payments relate to the equity component and, accordingly, would be recognized in equity pursuant to paragraph 35 of IAS 32 (reproduced in paragraph 10 of this paper).

View 4: The instrument is a compound instrument—an equity host with an embedded derivative for the conversion feature

17. Proponents of View 4 believe that the instrument is a compound instrument that is comprised of the following two components:

    (a) an equity component, which reflects the fact that the instrument does not have a stated or pre-determined maturity date and represents a residual interest in the entity's net assets; and

    (b) a non-equity derivative, which reflects the conversion feature that obliges the issuer to settle the instrument by delivering a **variable** number of its own ordinary shares.

18. Proponents of View 4 express the view that the host is an equity component due to the guidance in paragraph AG27 of IAS 39 (or paragraph B4.3.2 of IFRS 9), which states:

> If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

19. Furthermore, proponents of View 4 note that the conversion feature does not meet the definition of an equity instrument (because it does not meet the ‘fixed for fixed’ principle in IAS 32) and therefore must be analysed in accordance with IAS 39 (or IFRS 9) to see if it should be separated from the equity host and accounted for as a derivative.

20. IAS 39 (and IFRS 9) state that an embedded derivative must be separated from the host and accounted for separately if, and only if:

    (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

    (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

    (c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss.

21. Proponents of View 4 state that since the conversion feature violates the ‘fixed for fixed’ principle in IAS 32, the nature of the conversion feature is more similar to a debt instrument—and thus is not closely related to the equity host contract. Furthermore, the conversion feature meets the definition of a *derivative* on a standalone basis and the entire instrument cannot be measured at fair value through profit or loss under the fair value option (ie because the host instrument is not a financial asset or financial liability). Therefore, under View 4, the issuer is required to account for the conversion feature separately from the equity component.

View 5: The instrument is equity in its entirety

22. Similar to View 4, proponents of View 5 express the view that the host instrument has no stated or pre-determined maturity date and represents a residual interest in the entity's net assets—and therefore, it should be classified as an equity instrument. Proponents of View 5 believe that the conversion feature obliges the issuer to exchange one form of its own equity (ie an instrument with no stated or predetermined maturity date) for another form of its own equity (ie ordinary shares). While they believe that the conversion feature is an embedded derivative

(as described in View 4), proponents of View 5 believe that that embedded derivative is closely related to the host instrument because it contains similar equity characteristics —and, therefore, paragraph AG27 in IAS 39 and paragraph B4.3.2 of IFRS 9 (reproduced in paragraph 18 of this paper) would preclude the derivative from being separated from the host instrument.

23. Accordingly, proponents of View 5 believe that the financial instrument should be classified as an equity instrument in its entirety.

Outreach request

24. 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 submission 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.

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

26. About a third of the respondents stated that the instrument described in the submission is not common in their jurisdictions and therefore they did not provide a view on the accounting. 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.

27. A few respondents noted that there is diversity in practice and/or views in their jurisdictions. One respondent noted that it received feedback from one of its constituents that all of the alternative views set out in the submission seem to have merit. Others thought that only some of the alternatives have merit (but had differing views on which alternatives those were).

28. The remaining respondents were roughly split between the view that the financial instrument was a liability in its entirety (View 1) or the view that it was a

compound instrument (Views 2 and View 3). All of these respondents agreed that the obligation to deliver a variable number of shares meets the definition of a financial liability—but they had different views on whether the discretionary interest payments should be recognized as an equity component and if so, what its value would be.

Staff analysis

Classification

29. Paragraph 2 of IAS 32 states that the Standard applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments. Paragraph 11 of the Standard provides the relevant definitions for those elements and other paragraphs provide application guidance for applying the definition to particular instruments or in particular circumstances. Therefore we think IAS 32—not IAS 39 or IFRS 9—provides the relevant requirements for determining how an issuer should classify a financial instrument. In contrast, IAS 39 and IFRS 9 provide relevant recognition and measurement requirements for financial assets and financial liabilities; ie only those instruments that the issuer has already determined to be non-equity are within the scope of IAS 39.

30. On the basis of that guidance in IAS 32, we agree with View 2 and View 3 that the instrument described in the submission is a compound instrument with the following components:

    (a) a liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and

    (b) an equity component, which reflects the issuer's discretion to pay interest.

The liability component

31. The definition of a financial liability states that a financial instrument is a financial liability if the issuer is obliged to deliver a variable number of its own equity instruments (the relevant section of that definition is reproduced above in paragraph 8). In other words, the issuer must classify an obligation to deliver a variable number of its own ordinary shares in the same way that it would classify an obligation to deliver cash.
32. Paragraph 25 in IAS 32 (reproduced above in paragraph 9) provides guidance on applying the definition of a financial liability to instruments with contingent settlement provisions. That paragraph states that a financial instrument is a financial liability if it obliges the issuer to deliver cash or another financial asset —**or otherwise settle the instrument in such a way that it would be a financial liability** (eg by delivering a variable number of its own equity instruments)— upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder.
33. Therefore we think it is clear the issuer's obligation to deliver a variable number of its own equity instruments (if the contingent non-viability event occur) meets the definition of a financial liability.

The equity component

34. Paragraph AG37 of IAS 32 provides guidance for the classification of discretionary distributions:

> …Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in profit or loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised as a distribution of profit or loss. A similar treatment would apply if the redemption was not

> mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ordinary shares calculated to equal a fixed amount...

35. We acknowledge that this paragraph does not explicitly discuss circumstances in which the redemption or conversion of the financial instrument is contingent on an uncertain future event that is beyond the control of both the issuer and the holder of the instrument—that is, the paragraph discusses only instruments that are certain to be redeemed or converted and that are redeemable at the option of the holder. However we think that fact is irrelevant to the classification of the discretionary distributions. Indeed, we think the objective of paragraph AG37 is to set out the accounting for discretionary distributions in circumstances in which the issuer is obliged to settle the instrument in a way that meets the definition of a financial liability. We think paragraph AG37 is clear that such instruments must be classified as a compound instrument, with the discretionary distributions being the equity component.

Measurement

36. We agree with View 3. We think the issuer must consider the fact that the contingent non-viability event could occur immediately (ie it is beyond the control of the issuer) and hence the liability component must be measured at the amount that the issuer could be required to repay immediately (ie par). That is, we think IAS 32 requires the liability component to be measured on the basis of the earliest date that the issuer could be obliged to settle the instrument.
37. This is consistent with the treatment of instruments that are redeemable at the option of the holder, which are measured at an amount that is not less than the amount that is payable on demand (or discounted from the first date that the holder could exercise the put)—even if the issuer expects the instrument to remaining outstanding for a period of time.
38. Paragraph BC12 of IAS 32 discusses the similarities between these two types of instruments (emphasis added with bold):

> Some respondents to the Exposure Draft suggested that when an entity writes an option that, if exercised, will result

in the entity paying cash in return for receiving its own shares, it is incorrect to treat the full amount of the exercise price as a financial liability because the obligation is conditional upon the option being exercised. **The Board rejected this argument because the entity has an obligation to pay the full redemption amount and cannot avoid settlement in cash or another financial asset for the full redemption amount unless the counterparty decides not to exercise its redemption right or specified future events or circumstances beyond the control of the entity occur or do not occur. The Board also noted that a change would require a reconsideration of other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity's control. These include, for example, (a) the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation,** (b) the treatment of preference shares that are redeemable at the option of the holder as financial liabilities for the full amount of the conditional obligation, and (c) the treatment of financial instruments (puttable instruments) that give the holder the right to put the instrument back to the issuer for cash or another financial asset, the amount of which is determined by reference to an index, and which therefore has the potential to increase and decrease, as financial liabilities for the full amount of the conditional obligation.

39. The equity component —ie the discretionary distributions—would be measured as a residual and thus would have a value of zero. Nevertheless, if the issuer pays any interest on the instrument, those payments relate to the equity component and,

accordingly, would be recognized in equity pursuant to paragraph 35 of IAS 32 (reproduced in paragraph 10 of this paper).[2]

Staff recommendation

40. 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.
41. 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 the classification of a financial instrument that that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event? 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)?

[2] Some might argue that the equity component does not exist if its value is zero. We do not agree. Consider the accounting for embedded derivatives—although some have an initial fair value of zero (such as embedded forwards or swaps), such features certainly exist and thus are not ignored for accounting purposes.

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 upon a contingent 'non-viability' event**
>
> The IFRS Interpretations Committee discussed how an issuer would classify a particular mandatorily convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation*. The financial instrument did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments if the issuer breached the Tier 1 Capital ratio (ie defined as a 'contingent non-viability event'). Interest payments on the instrument are payable at the discretion of the issuer.
>
> The Interpretations Committee noted that IAS 32 sets out the relevant requirements for classifying financial instruments (or their components), from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments.
>
> The Committee noted that that the instrument is a compound instrument that is comprised of the following two components:
>
> (a) a liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and
>
> (b) an equity component, which reflects the issuer's discretion to pay interest.
>
> To measure the liability component, the Committee noted that the issuer must consider the fact that the contingent non-viability event could occur immediately (ie it is beyond the control of the issuer) and hence the liability component must be measured at the amount that the issuer could be required to repay immediately.
>
> The equity component would be measured as a residual and thus may have a value of zero. Nevertheless, the Interpretations Committee noted that if the issuer pays any interest on the instrument, those payments relate to the equity component and, accordingly, would be recognized in equity.

The 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 assessment

We should address issues:

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

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

- 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:

- 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?.

- 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

Potential agenda item request: Classification of instruments to convert into a variable number of shares upon a 'non-viability' contingent event

In the wake of the financial crisis, regulators are looking to strengthen the capital base of financial institutions, particularly in the banking sector. For example, the European Banking Authority (EBA) has set new regulatory capital requirements where a bank must be capitalised to a certain threshold. If these minimum capital requirements are breached, a wider range of investors and lenders of the bank should 'absorb the loss' if the bank suffers severe financial distress. A common way financial institutions are complying with these new capital requirements is to cancel or forgive the instrument or to issue instruments that convert into a variable number of ordinary shares of the entity upon a breach of the minimum regulatory capital requirement. This type of contingent feature is referred to as a 'non-viability' clause. Such clauses give rise to complex accounting questions. We have identified below one issue that has arisen for the IFRS Interpretations Committee ('IFRS IC') to consider clarifying through an interpretation.

The issue

This request for consideration by the IFRS IC is specifically focusing on the classification under IAS 32 *Financial Instruments: Presentation* of 'hybrid instruments' being those that are issued as a type of capital security but convert into a variable number of shares upon a non-viability event.

The actual terms of the instruments in practice could vary as national regulators are permitted to specify the required terms at their discretion as long as the instrument meets the minimum regulatory requirements. For the purposes of this request, we have described a simplified fact pattern below and discussed the possible views of how to classify this instrument. Note this is one example of a non-viability clause that we have seen in practice, however we are aware these clauses can arise in various forms.

A simplified example of an instrument with a non-viability clause – key features:

- Term: None, the instrument is perpetual.
- Issue price: Par, proceeds received in full upon issuance.
- Coupon: Fixed at 10%; however, the issuer may, at its sole discretion at all times, elect to cancel any interest payment on a non cumulative basis. Any coupon not paid is no longer due and payable by the issuer. Upon breach of minimum capital requirements, the regulator may force the issuer to cancel interest payments.
- Issuer call*:* The issuer may at its election choose to redeem the instrument at the par amount on the 5th anniversary of issue or an interest payment date thereafter subject to approval by the regulator provided the issuer is not in breach of its 'Tier 1 Capital ratio'.

- Conversion: Mandatorily convertible if there is a breach of the 'Tier 1 Capital ratio' (defined as the 'contingent non-viability event') into a variable number of ordinary shares (depending on the current price of the shares) equal to the fixed par amount of the instrument. When the contingent non-viability event occurs, the investors give up their right to coupons on par and instead receive ordinary shares.

When analysing the instrument, we assume that the issuer call option and payment of interest is discretionary. Further, it is assumed that the contingent non-viability event is 'genuine' (IAS 32.25(a)) and therefore cannot be ignored for the purposes of classification.

Current practice

We believe that there are five alternative views being applied in practice (or being considered acceptable views to apply in practice) to classify this instrument.

View 1: The entire instrument is classified as a liability.

The issuer has a contractual obligation to deliver a variable number of its own equity instruments if the contingent event arises as defined by IAS 32.25. According to the financial liability definition in IAS 32.11(b)(i), the instrument is a financial liability due to this settlement in a variable number of shares. The implication of this is that any dividends paid (which are at the discretion of the entity) are recognised in profit or loss (not equity) in accordance with IAS 32.35.

View 2: The instrument is a compound instrument: a debt host with an equity component for discretionary dividends.

The instrument is comprised of a debt host for the obligation to deliver a variable number of shares in accordance with the financial liability definition in IAS 32.11(b)(i) and an equity component representing the issuer's discretion to pay dividends. This is because one would first consider whether there is an equity component as prescribed by IAS 32.28 before applying the contingency guidance in IAS 32.25. From a measurement perspective, one could factor the timing of the contingent event occurring into the measurement of the liability. Upon discounting the liability, there would be a residual equity component.

The implication of this is that any discretionary dividends paid would be recognised in equity in accordance with IAS 32.35. Any change in the expected timing of the contingency would be recognised as an IAS 39.AG8 cumulative catch-up on the debt host through profit or loss.

View 3: The instrument is a compound instrument: a debt host with an equity component for discretionary dividends measured at nil.

This view is similar to view 2. However, in terms of measurement, it is necessary to consider that the contingent event may occur immediately and hence the debt host is

carried at the amount repayable on demand. In this case the instrument would be a compound but the residual equity component would be recognised at zero.

In this view, the equity component would have an initial value of nil. Nevertheless, discretionary dividends paid shall be recognised in equity in accordance with IAS 32.35 since the payments relate to the equity component of the instrument.

View 4: The instrument is a compound instrument: an equity host with an embedded derivative for the conversion option.

Because the host contract has no stated or pre-determined maturity and represents a residual interest in the entity's net assets as defined in IAS 39.AG27, the host instrument is an equity instrument.

However, as noted earlier, the conversion option fails the fixed for fixed condition and therefore is a derivative as defined in the financial liability definition in IAS 32.11(b)(ii). As such, the derivative is in scope of IAS 39 and should be assessed as to whether it should be accounted for separately from the host contract as prescribed by IAS 39.11.

The first criterion in IAS 39.11 is whether the economic characteristics of the conversion option are closely related to the equity host contract. As the conversion feature violates the "fixed for fixed" requirement, the nature of the option is more similar to that of a debt instrument rather than the equity characteristics of the equity host. Therefore, the conversion option is not closely related to the equity host contract. The embedded conversion option would meet the first criteria to be bifurcated and accounted for separately from the host contract. In addition, the second and third criterion are met as this option would meet the definition of a derivative on a standalone basis and the hybrid instrument is not measured at fair value through profit or loss under the fair value option because the host instrument is not a financial asset or financial liability, respectively. As all three criteria for bifurcation of an embedded derivative are met, the issuer is required to separate the conversion option from the equity host contract.

View 5: The instrument is equity in its entirety.

Similar to view 4, the host instrument has no stated or pre-determined maturity and represents a residual interest in the entity's net assets; therefore, it is considered an equity instrument. The conversion option is the right to convert one form of equity into another form of equity. While it is an embedded derivative as described in view 4, the embedded derivative contains equity characteristics similar to that of the host instrument. The application of IAS 39.AG27 precludes this derivative being separated from the host as it is closely related. Accordingly, the instrument is an equity instrument in its entirety.

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 will continue to be issued more frequently in the future. 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)?*

We believe there are divergent views in practice in classifying instruments with contingent non-viability clauses as described in this simplified fact pattern. We are aware of each of the five views expressed above being applied in practice (or being considered acceptable views to apply in practice).

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 instrument is defined as a liability host, the impact to profit or loss over the life of the instrument is an adjustment to the expected cash flows based on the likelihood that the mandatory conversion occurs (and the classification of dividends will follow the classification of the instrument either through profit or loss or equity). However, if the host is defined as an equity instrument and the conversion option as a net derivative, then the only impact to profit or loss is re-measurement of the derivative to fair value through profit or loss in each reporting period.

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 a series of questions as follows:

a. Should an entity only look to the guidance in IAS 32 when classifying an instrument from the issuer's perspective or should the entity first consider the IAS 39 guidance on determining what is the host contract?
b. If it is appropriate to consider the host contract under IAS 39 from the issuer's perspective in Q(1) and the host contract is determined to be an equity host, is an embedded derivative to deliver a variable number of shares closely related or not?
c. If the entity should only look to the guidance in IAS 32, should an entity assess whether there are any equity components (IAS 32.28) before considering whether there are any contingent settlement provisions (IAS 32.25)?
d. If there are contingent settlement provisions, is it appropriate to factor the expected timing of a contingent settlement event into the initial measurement

of a liability or should an entity assume that the contingent event could happen immediately and therefore is an ‘on demand’ liability?

Guidance provided by the IFRS IC on these questions will eliminate diversity for instruments with equity type features but that can be settled in a variable number of shares upon a contingent event.

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, 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.