

STAFF PAPER

May 2013

IFRS Interpretations Committee Meeting

Project	New item for initial consideration
Paper topic	Classification of financial instruments that give the issuer the contractual right to choose the form of settlement
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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 financial instruments that give the issuer the contractual right to choose the form of settlement. Specifically, the issuer can choose to deliver either cash or a fixed number of its own equity instruments.
2. The submission described three financial instruments and asked whether IAS 32 *Financial Instruments: Presentation* would require the same accounting treatment for those instruments and if so, what that accounting treatment would be. The submission asks only about the classification from the issuer's perspective.
3. The three financial instruments are as follows:
 - **Instrument 1** is puttable for cash by the holder but the issuer has a contractual right to choose instead to deliver a fixed number of its own ordinary shares instead of cash.
 - **Instrument 2** is convertible by the holder into a fixed number of the issuer's ordinary shares but the issuer has a contractual right to choose to pay cash instead of delivering its own shares.
 - **Instrument 3** is puttable by the holder and, upon the holder's exercise of that put, the issuer has the contractual right to choose to deliver either cash or a fixed number of its own ordinary shares.

4. The submission also provided the following additional facts, which apply to all three financial instruments:
 - (a) None of the instruments have a stated maturity date. However, the issuer may call the instruments for cash at any time. The holder's redemption rights are described in paragraph 3.
 - (b) The issuer is not required to pay dividends on the instruments but may do so at its discretion.
 - (c) If the issuer decides to settle any of the financial instruments by delivering a fixed number of its own ordinary shares, the value of those shares does not exceed substantially the value of the cash settlement alternative.

5. Moreover, for the purposes of this paper, we have assumed that each of the equity settlement features described in paragraph 3 meets the 'fixed for fixed' principle set out in paragraph 16(b) of IAS 32. In other words, this paper does not address the meaning of 'fixed'.

Accounting treatment described in the submission

6. The submission expressed the view that the three instruments described in paragraph 3 have the same contractual substance; that is, in all three cases, the issuer has an unconditional right to choose the form of settlement if the holder chooses to 'redeem' the instrument (ie cash or a fixed number of its own equity instruments). However, the submitter stated that IAS 32 seems to require that the three financial instruments are classified differently and such differences could give rise to an opportunity to structure a financial instrument to achieve a desired accounting outcome.

7. The submission described the customary accounting practice in its jurisdiction for each of the three financial instruments. A summary of that accounting treatment is set out below. The submission is attached as Appendix C to this paper.

Instrument 1

8. The submission stated that Instrument 1 is customarily classified as a compound instrument, whereby the cash settlement feature is classified as a financial liability component and the equity conversion feature is classified as an equity component. According to the submission, this treatment is based on the requirements set out in paragraph 28 of IAS 32:

The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15 [of IAS 32].

9. The submission expressed the view that the effect of issuing Instrument 1 is substantially the same as issuing a debt instrument with an early settlement provision and simultaneously purchasing a put option that gives the issuer the right to deliver a fixed number of its own ordinary shares and receive a fixed amount of cash in exchange. The submission analogised to the accounting for convertible debt.

Other factors to consider

10. The submission acknowledged an alternative view on Instrument 1—that it is inappropriate to separately classify the equity conversion option because that feature gives the issuer an unconditional right to avoid delivering cash. This is different from convertible debt because the issuer of convertible debt does not have the unconditional right to avoid paying cash; ie it is the holder of convertible debt who ultimately decides whether the instrument is settled in cash or shares. The submission acknowledged that this alternative view would conclude that Instrument 1 should be classified as equity in its entirety.
11. The submission also queried whether the fact that Instrument 1 does not have a stated maturity date should affect whether a liability component exists.

Instrument 2

12. The submission stated that Instrument 2 is customarily classified as equity in its entirety. That is because the instrument is convertible by the holder into a fixed number of the issuer’s own ordinary shares —and the cash settlement feature is triggered only by the issuer’s choice. The submission noted that because the issuer has an unconditional right to avoid delivering cash (and also can avoid any other settlement method that would meet the definition of a financial liability), there is no basis to classify the instrument (or a component thereof) as a liability.

13. The submission also pointed to paragraph 20 of IAS 32, which states:

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).

14. The submission expressed the view that it can be inferred from that paragraph in IAS 32 that if the issuer has the right to deliver either cash or its own shares and the value of the shares does **not** exceed substantially the value of the cash, then

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the instrument may be classified as equity (subject to the other guidance in IAS 32 on classifying financial instruments as financial liabilities or equity).

Other factors to consider

15. However, the submission acknowledged an alternative view—that it is inappropriate to ignore Instrument 2’s cash settlement feature, irrespective of the fact that the issuer has an unconditional right to avoid delivering cash. The submission pointed to the discussion in the Basis for Conclusions and Illustrative Examples in IAS 32, which discuss the accounting for derivatives with settlement options. For example, paragraph BC20 of IAS 32 states:

...The Board concluded that entities should not be able to circumvent the accounting requirements for financial assets and financial liabilities simply by including an option to settle a contract through the exchange of a fixed number of shares for a fixed amount...

16. The alternative view described in the submission expressed the view that it is inappropriate to ignore the cash settlement feature just because the issuer can settle the contract by delivering a fixed number of its own equity instruments. According to the submission, this would circumvent the accounting requirements for financial liabilities.

Instrument 3

17. The submission stated that Instrument 3 is customarily classified as a hybrid instrument, whereby the host is classified as a financial liability and the settlement option (ie the issuer’s right to choose to settle the instrument in cash or a fixed number of its own ordinary shares) is classified as a derivative asset.
18. According to the submission, Instrument 3 should be classified on the basis of the requirements in paragraph 26 of IAS 32:

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.

19. A similar view mentioned in the submission is that the host would be classified as equity because it has no stated maturity date. In this case, the settlement option would still be accounted for as an embedded derivative.

Other factors to consider

20. However, the submission acknowledged an alternative view—that it is inappropriate to separately account for the settlement feature in Instrument 3. This view stated that that settlement feature is an indispensable redemption characteristic of the instrument because the instrument otherwise does not have a maturity date.
21. If the settlement feature is not accounted for separately, the submission described two views about the resulting accounting treatment:
- (a) Instrument 3 would be equity in its entirety. That is because paragraph 26 of IAS 32 (reproduced in paragraph 18 of this paper) applies only to derivatives and Instrument 3 is not a derivative in its entirety. When Instrument 3 is analysed in its entirety, it would meet the definition of equity because the issuer has an unconditional right to deliver a fixed number of its own shares (and thus can avoid delivering cash or otherwise settling the instrument in a manner that meets the definition of a financial liability).
 - (b) Instrument 3 would be a liability in its entirety. That is because, as discussed in paragraphs 15 and 16 of this paper, it is inappropriate to circumvent the requirements for financial liabilities simply by asserting that the issuer can deliver a fixed number of its own equity instruments instead of cash. That is, the submission suggests that the scope of paragraph 26 of IAS 32 is unclear (ie whether that paragraph applies only to standalone derivatives)—and further expresses the view that it is unclear whether the discussion in paragraph BC20 in the Basis for Conclusions to IAS 32 (reproduced in part in paragraph 15 of this paper) is limited to derivatives.

Staff analysis

Does IAS 32 require the same accounting for the three financial instruments?

22. We think IAS 32 would require the same classification for the three financial instruments described in the submission. That is because the substance of the three contracts is the same, namely:
- (a) The instruments are non-derivatives and do not have stated maturity dates. The issuer can choose to call the instruments (for cash) but is not required to do so.
 - (b) The holder has the contractual right to put the instruments back to the issuer. However, if the holder exercises that right, the issuer has the contractual right to choose to deliver either:
 - (i) cash; or
 - (ii) a fixed number of its own equity instruments.
 - (c) The issuer is not required to pay dividends on the instruments.
23. In other words, while each of the three financial instruments may describe differently the issuer's unconditional right to choose the form of settlement, there is no substantive difference in the issuer's contractual rights and obligations. Paragraph 15 of IAS 32 is clear that the issuer of a financial instrument must classify the instrument in accordance with the substance of the contractual arrangement—and therefore we think it would be inappropriate for the classification of a financial instrument to depend simply on how the contractual arrangement is worded.

How would IAS 32 classify the three financial instruments?

24. We think the three financial instruments described in the submission should be classified as equity in their entirety.

25. In all circumstances, the issuer has the unconditional (contractual) right to settle its obligation by delivering a fixed number of its own equity instruments. In other words, the issuer has an unconditional right to avoid delivering cash (or otherwise settling the instrument in a manner that meets the definition of a financial liability). Paragraph 16 in IAS 32 is clear that a non-derivative financial instrument is an equity instrument if the issuer does not have a contractual obligation to deliver:
- (a) cash (or another financial asset) or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable; or
 - (b) a variable number of the issuer’s own equity instruments.
26. We observe that the three financial instruments described in the submission are different from convertible debt. That is because the issuer of convertible debt does not have an unconditional right to avoid delivering cash; ie the holder of convertible debt ultimately decides whether the instrument is settled in cash or the issuer’s own equity instruments.
27. In contrast, the issuer of the three financial instruments described in the submission does indeed have an unconditional right to avoid delivering cash; ie the issuer ultimately decides how the financial instrument is settled and has the contractual right to settle it by delivering a fixed number of its own equity instruments. As noted in paragraph 25 of this paper, this distinction is critical for determining whether a financial instrument meets the definition of a financial liability or equity in accordance with IAS 32.
28. We acknowledge that IAS 32 contains requirements for separating compound financial instruments into equity and non-equity components—and in particular circumstances, it may be difficult to determine whether an instrument should be separated and if so, what the resulting components should be. We are aware that interested parties often have different views on how some financial instruments should be ‘sliced and diced’ into components due to differing views on the substance of a particular instrument.

29. However, we think the requirements for compound instruments are not relevant to the three financial instruments described in the submission. As noted in paragraph 25 of this paper, those three financial instruments meet the definition of equity in their entirety (unlike an instrument such as a convertible bond); and therefore we think it would be inappropriate to separate those instruments into components that do not faithfully or holistically reflect the issuer's contractual rights and obligations.
30. Furthermore, we agree with the analysis set out in paragraphs 13 and 14 of this paper. We think paragraph 20 in IAS 32 clearly indicates that if the issuer can choose to settle a non-derivative financial instrument by delivering cash or its own shares—and the value of its shares does not exceed substantially the value of the cash—that financial instrument is classified as equity (as long as all the criteria for classifying a financial instrument as equity are met).

Would the analysis change if the instruments had a stated maturity date?

31. The submission also asked whether the analysis under IAS 32 would change if the three financial instruments had stated maturity dates.
32. To summarise, under these new set of circumstances:
- (a) The instrument has a stated term. At the maturity date, the issuer is required to deliver cash to the holder.
 - (b) As described in more detail in paragraph 3 of this paper, the holder has the right to redeem the instrument before maturity. If the holder exercises that right, the issuer has a contractual right to deliver either cash or a fixed number of its own equity instruments to the holder.
 - (c) The issuer may call the instruments at any time before maturity. If the issuer exercises its call option, it must deliver cash to the holder.
 - (d) The issuer is not required to pay dividends on the instruments but may do so at its discretion.
33. We think the analysis under IAS 32 would indeed change because, under these new circumstances, the issuer has a contractual obligation to deliver cash to the

holder at maturity. That is a critical difference from the three instruments described in paragraph 3 of this paper. That contractual obligation to deliver cash is a financial liability. The issuer can choose whether to deliver cash or a fixed number of shares only if the holder chooses to request early repayment. The issuer would also need to analyse the instrument to determine whether it has any equity components (eg whether the discretionary dividends meet the definition of equity).

Staff recommendation

34. 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.
35. 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.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff’s analysis of the classification of financial instruments that give the issuer the contractual right to choose the form of settlement?
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)?

Appendix A—Proposed wording for tentative agenda decision

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

Classification of financial instruments that give the issuer the contractual right to choose the form of settlement

The IFRS Interpretations Committee discussed how an issuer would classify three financial instruments in accordance with IAS 32 *Financial Instruments:*

Presentation. None of the financial instruments had a maturity date but each gave the holder the contractual right to redeem at any time. If the holder exercised its redemption right, the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments.

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, if the substance of particular financial instruments is the same, the issuer cannot achieve different classification results simply by describing those contractual arrangements differently.

Paragraph 11 in IAS 32 sets out the definition of a *financial liability* and an *equity instrument*. Paragraph 16 describes in more detail the circumstances in which a financial instrument meets the definition of an equity instrument.

The 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 shares, that financial instrument would meet the definition of an equity instrument in IAS 32 as long as the value of the fixed number of the issuer's shares did not exceed substantially the value of the cash. However, if the issuer has a contractual obligation to deliver cash, that financial instrument is a financial liability.

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

1. The issue has widespread effect and has, or is expected to have, a material effect on those affected.
2. Financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.

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.

3. The issue can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.
4. The Interpretations Committee can address this issue in an efficient manner.
5. The Interpretation will be effective for a reasonable time period. Take on a topic of a forthcoming Standard only if short-term improvements are justified.

Appendix C—Submission

Background

We find that the securities in which the issuer has a choice over how it is settled (e.g., cash payment or share issuance) commonly take one of the following three forms in practice¹²³⁴:

- <Type 1> Upon the holder’s call for early redemption, the issuer, in response, has the option to settle in a fixed number of ordinary shares of the issuer instead of paying back in cash.

- <Type 2> Upon the holder’s exercise of conversion option (into a fixed number of ordinary shares of the issuer), the issuer, in response, has the option to pay back in cash instead of share issuance.

- <Type 3> Upon the holder’s call for settlement (the holder does not specify how to settle), the issuer, in response, has a choice over how it is settled [e.g., cash payment or (a fixed number of) share issuance].

¹ It is assumed there is no maturity date in all of the three types of securities. There are no other provisions of redemption other than the holder’s right to call early payment, right to convert into a fixed number of ordinary shares of the issuer, or right to call settlement. (We find that the case related to our inquiry can be regarded as having a form similar to perpetual bond because continuous revolving is possible at the discretion of the issuer.)

² In the cases where the contracts are settled through the exchange of a fixed number of shares, the number of shares to deliver is determined at the date of issue so that the value of the shares does not exceed substantially the value of the cash to deliver.

³ Additionally, the issuer can call the instruments before maturity, and if so, the issuer delivers cash.

⁴ It is assumed that the issuer can decide at the issuer's discretion whether to pay the interest or not, even if the contracts include interest payment provisions.

Summary of securities holder's rights and corresponding obligations of the issuer

	Holder's rights	Issuer's obligations
Type 1	Right to call early payment	Obligation to settle in cash (However, the issuer has an option to settle a contract through the exchange of a fixed number of shares.)
Type 2	Right to convert into a fixed number of ordinary shares of the issuer	Obligation to settle the contract through the exchange of a fixed number of shares (However, the issuer has an option to settle in cash instead of share issuance.)
Type 3	Right to call settlement	Obligation to settle the contract [It is the issuer who has a choice over how it is settled (e.g., cash payment or share issuance)]

Issue

It may be regarded that the three types of contracts above may have the same contractual substance regarding their redemptions in the sense that it is the issuer who ultimately has a choice over how it is settled (e.g., cash payment or share issuance) regardless of the intention of the holder.

Nevertheless, IAS 32 seems to lead to different accounting treatments for the three types of contracts above in practice depending on the type of these financial instruments.

Customary practice of accounting

<Type 1> Classify as a compound instrument - separate the financial liability component and the equity component

Basis

The equity conversion option held by the issuer is deemed as an equity instrument component, separate from the debt instrument portion (financial liability component). Thus each components shall be separated as equity and financial liabilities.

According to paragraph 28 of IAS 32, the issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.

The economic effect of issuing a financial instrument like Type 1 is substantially the same as simultaneously issuing a debt instrument with an early settlement provision and buying a put option from the investor which gives the issuer the right to sell the issuer's equity instrument for a fixed amount of cash. The issuer's right to issue a fixed number of its own equity instruments in exchange for a fixed amount of cash is an equity instrument of the entity. Therefore, the issuer in this case should separately present the liability and equity components in its statement of financial position. This is in the same line of logic as the one described in paragraph 29 of IAS 32 which requires separate recognition of the components of a financial instrument that grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

Factors to consider

1) Is the issuer's conversion right an equity component?

According to paragraph 29 of IAS 32, an entity recognizes separately the components of a financial instrument that (a) creates financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. In other words, only the conversion right of the holder is illustrated as the separately recognized equity component, and thus the issuer's conversion right is not an equity component that should be separately recognized. From this perspective, the issuer's conversion right is not an independent component separable from the financial instrument but an inseparable component that gives the issuer the right to avoid the redemption obligation, e.g., in cash, from the redemption structure aspect.

However, what is presented in paragraph 29 of IAS 32 is merely an equity component found in typical convertible bonds. As shown in paragraph 16 of IAS 32, an equity instrument is the instrument which will or may be settled in the issuer's own equity, and the issuer do not need to consider whether the right to settlement lies with the issuer or the holder when the issuer determines whether a financial instrument is an equity instrument rather than a financial liability instrument. Thus, it is reasonable to separate the issuer's conversion right as an equity component.

If it is not possible to separate the issuer's conversion right as an equity component, then it would be appropriate to classify the entire financial instrument as an equity instrument without considering the following issue. However, if it is appropriate to separate the issuer's conversion right as an equity component, then the following issue is additionally considered.

2) Is the rest of the instrument, other than the issuer's conversion right, a liability component?

When the rest of a financial instrument, other than the issuer's conversion right, has no maturity date as shown in Type 1 (while the holder has the right to call early payment), whether the rest of the financial instrument may be viewed as a liability component becomes at issue. That is, questions are raised about whether accounting treatments

should differ depending on the existence of a maturity date for the rest of the instrument, excluding the issuer's conversion right.

Upon analysis, the rest of the instrument may be viewed as a component that incurs a financial liability because when the holder exercises his/her right to call early payment, the issuer has a contractual obligation to deliver cash, even if there is no maturity date.

Even if there is no maturity date as described in paragraph 9, if the rest of the instrument excluding the issuer's conversion right is seen as a liability component due to the holder's call option and if the issuer's conversion right is determined as an equity component as in paragraph 7, it would be appropriate to separate the two components and account for them as a compound instrument. However, if the rest of the instrument excluding the issuer's conversion right may not be viewed as a liability component because there is no maturity date, then both of the components are equity components regardless of the determination made in paragraph 7. Thus, it would be appropriate to account for them as one equity instrument without separation.

<Type 2> Classify the entire financial instrument as equity

Basis

Since the settlement method in principle is conversion to equity instruments of the issuer upon the request of the holder and redemption in cash is only an option of the issuer, the issuer does not have an obligation to pay back in cash.

Because the issuer has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, or to avoid any other settlement method that may cause the instrument to be classified as a financial liability, there is no reason to classify the instrument as a financial liability. (Refer to paragraph 19 of IAS 32)

Factors to consider

- 1) Could issuing shares to settle a contractual obligation be viewed as an unconditional right to avoid cash redemption when there is another settlement option of paying in cash available for the same contractual obligation?*

Paragraph BC20 of IAS 32 clearly states "The Board concluded that entities should not be able to circumvent the accounting requirements for financial assets and financial liabilities simply by including an option to settle a contract through the exchange of a fixed number of shares for a fixed amount."

Furthermore, paragraph IE16 of IAS 32 describes in detail that the financial instrument presented in the illustrative example "does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset."

The above paragraphs show that it is not appropriate to assume the issuer's option to issue a fixed number of its own shares to settle a contractual obligation as having an unconditional right to circumvent the obligation and thereby classify the financial instrument as an equity instrument, when there is another settlement option of paying in cash available for the same contractual obligation.

However, some may argue that, according to the contract, paying in cash is not an obligation but a right of the issuer and the issuer can choose not to pay in cash at his/her discretion. Therefore, paying in cash should not be viewed as part of the issuer's obligations.

Consequently, only the settlement method of issuing shares, which is stated as a contractual obligation of the issuer, should be taken into consideration when classifying

the financial instrument into liabilities or equity in accounting. Accordingly, it should be interpreted as that the issuer has an unconditional right to avoid payment in cash.

Furthermore, according to Paragraph 20 of IAS 32, 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.

So, a financial instrument in which the issuer has a choice over how it is settled (e.g., cash payment or share issuance) on settlement, but the number of shares to deliver is determined at the date of issue so that the value of the shares does not exceed substantially the value of the cash to deliver cannot be deemed to establish a contractual obligation to deliver cash or another financial asset indirectly through its terms and conditions.

<Type 3> View as a hybrid (combined) contract and separate the settlement option as an embedded derivative

Basis

Paragraph 26 of IASB 32 sets out that "when a derivative financial instrument gives one party a choice over how it is settled (e.g., 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."

The settlement option of the instrument should be treated a separable component from the debt instrument, and classification of each component into liabilities or equity is performed separately.

Consequently, the financial instrument is accounted for as a compound financial instrument that includes a host contract, which is a debt instrument, and a settlement option which should be separated as an embedded derivative.

In this case, the debt instrument portion is naturally classified as a financial liability and the settlement option portion is viewed as a derivative at fair value (classified as a financial asset).

Factors to consider

1) Is a settlement option separable from a financial instrument where there is no settlement provision such as redemption of the host contract at maturity, other than the settlement option in the financial instrument?

The settlement option in such instruments may not be deemed as an embedded derivative which is separable from the host contract, i.e., the debt instrument because the settlement option constitutes the indispensable redemption characteristics of such instruments not having a maturity date – the settlement option may not be seen as not being closely related to the economic characteristics and risks of the host contract. However, from another point of view, the settlement option may be deemed as a component separable from the economic characteristics and risks of the host contract because the settlement option in principle is a separate derivative added to the host contract having no maturity date (i.e., to the part regarded as a perpetual bond). According to such a perspective, the settlement option needs to be separated from the rest of the instrument regardless of whether there is a maturity date.

If the settlement option is not to be separated, then the issue of whether applying the settlement option provision of paragraph 26 of IAS 32 to the entire instrument is appropriate should be considered as shown below. If it is appropriate to separate the settlement option, it is separated as a financial asset of the issuer rather than equity in accordance with the settlement option provision of paragraph 26 of IAS 32. The rest of

the host contract is classified as an equity instrument of the issuer because, similar to perpetual bond, it has no redemption obligation.

2) Is it appropriate to apply the settlement option provision of paragraph 26 of IAS 32 to a non-derivative financial instrument having a settlement option?

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," meaning that it may be applied only to a derivative instrument. Thus, paragraph 26 of IAS 32 is not applicable to a non-derivative financial instrument including an inseparable settlement option.

Therefore, the entire instrument, without separating the settlement option, may be classified as a whole. In this case, it may be regarded that the issuer has the option to issue its shares instead of paying in cash, and this may be regarded as having an unconditional right to avoid payment in cash. Accordingly, it might be reasonable to classify the financial instrument as an equity instrument.

However, some argue that as already discussed above, it is not appropriate to assume the issuer's option to issue a fixed number of its own shares to settle a contractual obligation as having an unconditional right to circumvent the obligation and thereby classifying the financial instrument as an equity instrument, when there is another settlement option of paying in cash available for the same contractual obligation. From this, we may conjecture that there is no reason to apply paragraph 26 which prohibits a settlement option being accounted for as equity to derivative instruments only, and it would be more reasonable to classify the entire instrument which contains a settlement option as a financial liability.

Moreover, paragraph BC20 in the Basis for Conclusions on IAS 32 regarding settlement options states that "if one of the parties to a contract has one or more options as to how it is settled (e.g., net in cash or by exchanging shares for cash), the contract is a financial asset or a financial liability", implying that the requirement is applied to financial contracts and is not limited to derivative instruments.

Questions

- (1) Should the issuers of the three types of financial instruments above view the contractual substance of the three different types of instruments regarding settlement as being substantially the same and therefore apply the same accounting treatment to all of the three types of instruments? Or, should the issuers apply different accounting treatments to each of the three types of instruments?

- (2) If you answered it is appropriate to apply the same accounting treatment to all of the three types of instruments to Question (1), please describe the accounting treatment that you consider appropriate and explain the basis for your conclusion in detail.

- (3) If you answered it is appropriate to apply different accounting treatments to each of the three types of instruments to Question (1), please describe each of the accounting treatments that you consider appropriate and explain the basis for your conclusion in detail.

- (4) If the instrument at issue has a maturity date, would the accounting treatments you provided for the above questions be changed?