STAFF PAPER

10–11 September 2013

IFRS Interpretations Committee Meeting

Project	**IAS 32 *Financial Instruments: Presentation***
Paper topic	Classification of financial instruments that give the issuer the contractual right to choose the form of settlement

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Introduction

1. Earlier in 2013, the IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify 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 instrument gave the holder the contractual right to redeem at any time. The holder's redemption right was described differently for each of the three financial instruments; however if the holder exercised its redemption right, in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments.

2. Specifically, the submission described the three financial instruments 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 own 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.

3. 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 2.)

   (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. In other words, none of the financial instruments indirectly establish a contractual obligation to deliver cash, as described in paragraph 20(b) of IAS 32.

4. The submission expressed the view that the three instruments described in paragraph 2 have the same contractual substance but stated that IAS 32 seems to require different classification.

Summary of the Interpretation Committee's discussion in May 2013

5. At its May 2013 meeting, the Interpretations Committee tentatively decided not to add this issue to its agenda and noted the following:

   (a) Paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, if the contractual substance of financial instruments is the same, the issuer cannot achieve different classification results simply by describing those contractual arrangements differently.

   (b) Paragraph 11 in IAS 32 sets out the definitions of both 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.

   (c) 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. For example, 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.

   (d) If the issuer has a contractual obligation to deliver cash, that obligation meets the definition of a financial liability.

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

Comments received

7. We received three comment letters on the Interpretations Committee's tentative agenda decision, which are attached to this paper as Appendix B. We have analysed the comments in the following paragraphs.

8. The first letter (Deloitte Touche Tohmatsu Limited) agreed with the Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision.

9. The second letter (Canadian Accounting Standards Board (AcSB)) also agreed with the Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision. The AcSB provided some drafting suggestions. We have carefully considered those suggestions and reflected them as appropriate in the proposed final agenda decision, which is attached to this paper as Appendix A.

A fixed versus a variable amount of cash

10. The third letter (KPMG IFRG Limited) expressed the view that the description of the fact pattern and the Interpretations Committee's response in the tentative agenda decision should be revised to clarify that the cash settlement alternative represents settlement in a **fixed amount of cash**. Specifically the respondent pointed to the final

sentence in the first paragraph of the tentative agenda decision, which states (in part, with emphasis added):

> … however if the holder exercised its redemption right, in each case the issuer had the contractual right to choose to <u>settle the instrument in cash</u> or a fixed number of its own equity instruments.

11. While the respondent acknowledged that this sentence is consistent with the fact patterns that were submitted to the Interpretations Committee, the respondent noted that the sentence is ambiguous as to whether the amount of cash to be paid under the cash settlement alternative is fixed or variable. The respondent expressed the view that it is important to reflect the assumption that the cash settlement alternative represents a fixed amount of cash, to prevent the agenda decision from being used to support conclusions under other fact patterns that require a more complex analysis.

12. More specifically, the respondent pointed to the fourth paragraph of the tentative agenda decision, which states (in part, with emphasis added):

> The Interpretations Committee noted that if the issuer has the contractual right to choose to settle a non-derivative financial instrument <u>in cash</u> or a fixed number of its own equity instruments, that financial instrument would meet the definition of an equity instrument in IAS 32 <u>as long as</u> the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions…

13. The respondent expressed the view that the sentence reproduced in the paragraph above seems necessarily and wholly true only if the amount of cash is fixed. The respondent stated that if the instrument is viewed as an equity instrument on the basis

that there is only an obligation to deliver a fixed number of shares and not an obligation to deliver cash, then the issuer's right to choose to settle in cash is in effect a purchased call option embedded in that equity instrument. Therefore, it is necessary to consider whether that call option:

(a) should be treated as a separate component of a compound instrument in accordance with paragraphs 15 and 28 of IAS 32, and/or

(b) should be separately accounted for as a non-equity derivative in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

14. The respondent stated that paragraph AG30(b) in IAS 39 suggests that a call option with a specified exercise price that is embedded in an equity instrument is separately accounted for as a derivative under IAS 39 unless that call option meets the conditions for classification as an equity instrument under IAS 32. The respondent expressed the view that paragraph AG30(b) presumably means that, from the issuer's perspective, the call option would be excluded from the scope of IAS 39 only if it will be settled by exchanging a fixed amount of cash (or another financial asset) for a fixed number of the issuer's own equity instruments, in accordance with the requirements in paragraphs 11 and 16 of IAS 32.[1]

15. The respondent stated that it is possible that Interpretations Committee members have differing views on whether an issuer's option to redeem what is otherwise an equity instrument for an amount of cash that is not fixed would be required to be accounted for separately as a financial asset (ie a purchased non-equity derivative). The respondent expressed the view that such a scenario was neither contemplated in the

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

submission to the Interpretations Committee nor discussed by the Interpretations Committee—and therefore, the respondent believes that the agenda decision should be explicitly limited to a right to settle by delivering a fixed amount of cash.

Staff analysis and recommendation

16. We believe that a non-derivative financial instrument meets the definition of an equity instrument in its entirety if the issuer has the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments, irrespective of whether the amount of the cash to be delivered under the cash settlement alternative is fixed or variable.[2] We think this is consistent with the Interpretations Committee's discussion at the May 2013 meeting.

17. Interpretations Committee members asked the staff during the May 2013 meeting for additional information about the cash settlement alternative; in particular, whether the amount of cash to be delivered under that alternative was fixed or variable. The submission itself did not include that information but the staff informally queried the submitter and learned that, under the cash settlement alternative, the issuer would deliver the outstanding principal amount plus any accrued (but unpaid) interest. While that information helped the staff better understand the instruments described in the submission, it did not affect our analysis. At the May 2013 meeting, Interpretations Committee members seemed to agree that the three financial instruments described in the submission meet the definition of an equity instrument, irrespective of whether the amount of cash to be delivered under the cash settlement alternative was fixed or variable. For example, some members discussed a scenario

[2] As noted in paragraph 3(c) of this paper, the submission assumed that a contractual obligation to deliver cash (or another financial asset) is not established indirectly through the instrument's terms and conditions.

in which an issuer could choose to settle a contractual obligation by delivering either a fixed number of its own ordinary shares or the cash value of those shares (ie a variable amount of cash)—and seemed to agree that such an instrument is a non-derivative that would meet the definition of an equity instrument.

18. 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 instruments should be 'sliced and diced' into components due to differing views on the contractual substance of a particular instrument.

19. However, we think the requirements for compound instruments are not relevant to the three financial instruments described in the submission. We think that the three financial instruments meet the definition of an equity instrument in their entirety—that is, consistent with paragraphs 16(a) and 16(b)(i) in IAS 32, they are non-derivative instruments that contain neither an obligation to deliver cash (or another financial assets) nor an obligation to deliver a variable number of the issuer's own equity instruments—and therefore it would be inappropriate to separate those instruments into components that do not faithfully or holistically reflect the issuer's contractual rights and obligations.[3]

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[3] For example, as reproduced in paragraph 13 of this paper, one respondent suggested identifying a component that reflects 'an obligation to deliver a fixed number of shares' — but such a contractual obligation does not exist. Rather the issuer has the contractual right to choose to settle the non-derivative financial instrument by delivering either a fixed number of shares or cash, and we think that IAS 32 requires such a contract to be classified in its entirety as an equity instrument. In other words, we think it would be inappropriate to identify a component that is not contractually specified or establish terms that are not clearly present in the contract.

20. However, we think that financial instruments, in particular those that are more structured or complex and that include liability components, require careful analysis to determine whether they contain equity and non-equity components that must be accounted for separately in accordance with IAS 32. We have added an observation to the proposed agenda decision in Appendix A to respond to the concern set out in paragraph 11 of this paper that the agenda decision could be used inappropriately to support conclusions under other fact patterns that require a more complex analysis.

21. Therefore, after considering the comments received on the tentative agenda decision, we recommend that the Interpretations Committee should finalize its decision not to add this issue to its agenda. The proposed wording of the final agenda decision is included as Appendix A to this paper.

Questions for the Interpretations Committee
(1) Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should finalize its decision not to add this issue to its agenda? (2) Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the final agenda decision?

Appendix A—Proposed wording for the Agenda Decision

A1. The proposed wording for the final agenda decision is presented below. New text is underlined and deleted text is struck through.

IAS 32 *Financial Instruments: Presentation*—Classification of financial instruments that give the issuer the contractual right to choose the form of settlement

The IFRS Interpretations Committee received a request to clarify 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. The holder's redemption right was described differently for each of the three financial instruments; however if the holder exercised its redemption right, in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments. The issuer was not required to pay dividends on the three instruments but could choose to do so at its discretion.

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. Consequently, if the contractual substance of 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 definitions of both 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 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. ~~(For example,~~ ~~p~~ Paragraph 20(b) of IAS 32 ~~states~~ provides the example 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 such that the issuer will settle in cash.~~)~~

However the Committee acknowledged that financial instruments, in particular those that are more structured or complex, require careful analysis to determine whether they contain equity and non-equity components that must be accounted for separately in accordance with IAS 32.

The Interpretations Committee noted that if the issuer has a contractual obligation to deliver cash, that obligation meets the definition of a financial liability.

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—Comment letters received

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Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
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Email: ifric@ifrs.org

29 July 2013

Dear Mr. Upton

Tentative Agenda Decision - IAS 32 *Financial Instruments: Presentation*: Classification of financial instruments that give the issuer the contractual right to choose the form of settlement

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the May IFRIC Update of the tentative decision not to take onto the Committee's agenda a request for clarification of the classification as equity or as a liability of financial instruments giving the issuer a contractual right to settle in cash or in a fixed number of its own equity instruments.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0)20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

Accounting Standards Board
AcSB
CNC
Conseil des normes comptables

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July 29, 2013

(By e-mail to ifric@ifrs.org)

IFRS Interpretations Committee
30 Cannon Street,
London EC4M 6XH
United Kingdom

Dear Sirs,

Re: Tentative agenda decision on IAS 32 *Financial Instruments: Presentation* – Classification of financial instruments that give the issuer the contractual right to choose the form of settlement

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the IFRS Interpretations Committee's tentative agenda decision regarding classifying financial instruments that give the issuer the contractual right to choose the form of settlement. This tentative agenda decision was published in the May 2013 IFRIC Update.

The views expressed in this letter take into account comments from individual members of the AcSB staff but do not necessarily represent a common view of the AcSB or its staff. Views of the AcSB are developed only through due process.

We agree with the Committee's decision not to add this item to its agenda for the reasons provided in the tentative agenda decision. However, we think the incomplete reference to paragraph 20 detracts from the clarity of the tentative agenda decision and recommend the following changes:

> The Interpretations Committee noted that if the issuer has the unconditional 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. ~~(For example, p~~Paragraph 20(b) of IAS 32 ~~states~~provides the example 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 so that "the value of the share settlement alternative is such that the issuer will settle in cash".~~)~~

We would be pleased to provide more detail if you require. If so, please contact me at +1 416 204-3276 (e-mail pmartin@cpacanada.ca), or Kathryn Ingram, Principal, Accounting Standards at +1 416 204-3475 (e-mail kingram@cpacanada.ca).

Yours truly,

Peter Martin, CPA, CA
Director, Accounting Standards

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Mr Wayne Upton
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Our ref MV/288
Contact Mark Vaessen

26 July 2013

Dear Mr Upton

Tentative agenda decision: *IAS 32 Financial Instruments: Presentation—Classification of financial instruments that give the issuer the contractual right to choose the form of settlement*

We appreciate the opportunity to comment on the IFRS Interpretations Committee's (Committee) tentative agenda decision, *IAS 32 Financial Instruments: Presentation—Classification of financial instruments that give the issuer the contractual right to choose the form of settlement*. We have consulted with, and this letter represents the views of, the KPMG network.

We believe that the description of the fact pattern and the response in the tentative agenda decision should be revised to clarify that the cash settlement alternative considered by the Committee represents settlement in a fixed amount of cash.

The first paragraph describes the fact pattern considered by the Committee. The last sentence states: "however if the holder exercised its redemption right, in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments" (emphasis added). While that sentence is consistent with the fact pattern submitted to the Committee, we believe that the sentence is ambiguous as to whether the amount of cash to be paid under the cash settlement alternative is fixed or variable.

We believe it is important to reflect in the agenda decision the assumption that the cash settlement alternative represents a fixed amount of cash, to prevent the agenda decision from being used to support conclusions under other fact patterns that require a more complex analysis.

To illustrate, the fourth paragraph of the tentative agenda decision states: "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" (emphasis added). That sentence only seems necessarily and wholly true if the amount of cash is fixed. If the instrument is otherwise viewed as an equity instrument on the basis that there is only an obligation to deliver a fixed number of shares and not an obligation to deliver cash, then the right to settle in cash is in effect a call option embedded in that equity instrument and it is necessary to consider additionally whether:

(a) the option should be treated as a separate component under IAS 32.15 and .28, and/or

(b) separately accounted for as a derivative in accordance with IAS 39.

IAS 39.AG30(b) suggests that a call option with a specified exercise price that is embedded in an equity instrument is separately accounted for as a derivative under IAS 39 unless the option meets the conditions for classification as an equity instrument under IAS 32 – presumably meaning that the option will only be exempt from IAS 39 if it will be settled only by exchanging a fixed amount of cash (or another financial asset) for a fixed amount of equity instruments in accordance with the definitions and guidance in IAS 32.11 and .16.

It is possible that Committee members would have differing views on whether an issuer's option to redeem what is otherwise an equity instrument for an amount of cash that is not fixed would be required to be accounted for separately as a financial asset. We do not believe that such a scenario was either contemplated in the submission to the Committee or discussed by the Committee. Therefore, we believe the agenda decision should be explicitly limited to a right to redeem for a fixed amount of cash.

Please contact Mark Vaessen or Chris Spall on +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited