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 subject to a cap and a floor

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Background

1. At its meeting in July 2013, the IFRS Interpretations Committee (the Interpretations Committee) discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument. The financial instrument had a stated maturity date and at maturity the issuer was obliged to deliver a variable number of its own equity shares to equal a fixed cash amount, subject to a cap and a floor on the number of shares to be delivered. However the issuer had the contractual right to choose to settle the instrument at any point before maturity by delivering the maximum number of equity shares (fixed and capped).

2. At the July 2013 meeting, the Interpretations Committee primarily focused on the issuer's early settlement option—specifically, its effect on the classification of the financial instrument in accordance with IAS 32 *Financial Instruments: Presentation*.[1] In the light of its analysis of the existing IFRS requirements, the Interpretations Committee tentatively decided not to add the issue to its agenda. The relevant portion of the IFRIC Update is reproduced in Appendix C of this agenda paper—and Agenda paper 8 for this meeting asks the Interpretations Committee how it wishes to proceed with the issue.

[1] For more information on this issue, please refer to Agenda paper 17 for the July 2013 Interpretations Committee meeting.

3. In addition to reaching that tentative agenda decision, the Interpretations Committee asked the staff to analyze the accounting for a 'simplified' version of the financial instrument described in paragraph 1. That simplified financial instrument obliges the issuer to deliver a variable number of its own equity shares to equal a fixed cash amount, subject to a cap and a floor on the number of shares to be delivered —in other words, the simplified instrument is the same as the instrument discussed in July 2013 **excluding** the issuer's option to settle early by delivering a fixed number of equity shares. We note that the simplified instrument was previously submitted to the Interpretations Committee (at the time called the IFRIC) in June 2009.[2] At that time, the IFRIC decided not to add the issue to its agenda because the IASB's project on financial instruments with characteristics of equity ('the FICE project') was expected to address the issue. The relevant portion of the IFRIC Update from January 2010 is reproduced in Appendix D of this agenda paper. However, since the IFRIC's discussion in 2009 and 2010, the FICE project has been moved to the IASB's research agenda.

Description of the instrument

4. The simplified instrument that is discussed in this paper has the following features:

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

   (b) When the instrument was issued, the issuer's share price was CU10. Therefore, when the instrument was issued, the share price would

[2] The submission was discussed in Agenda paper 5 for the July 2009 IFRIC meeting, Agenda paper 14 for the November 2009 IFRIC meeting and Agenda paper 4G for the January 2010 IFRIC meeting.

equate to the delivery of a number of shares that is within the range between the cap and the floor.

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

Alternative accounting treatments

5. We are aware of four alternative views—and note that they are the same as the views submitted to the IFRIC in 2009.

6. Under all of the alternative views, the issuer's obligation to pay interest meets the definition of —and therefore would be classified as—a financial liability. Therefore, for simplicity, those interest payments are ignored in the analysis below.

View 1

7. Proponents of View 1 believe that the instrument is a non-derivative for which the issuer is obliged to deliver a variable number of equity shares between 80 and 130. Therefore, the instrument would be classified as a financial liability in its entirety. Under View 1, the conversion feature is viewed as a single obligation and, in accordance with IAS 32, cannot be subdivided into further components for the purpose of identifying any equity sub-component(s).

8. However, under IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*, the instrument is a hybrid financial instrument that contains a host financial liability to deliver as many equity shares as are worth CU1000 together with a cap and a floor on the number of shares deliverable on conversion. The cap and floor are separable embedded (non-equity) derivative features and thus the issuer would separate them from the host contract and account for them at fair value through profit or loss. Since the embedded features relate to the same risk exposure (that is, the price of the issuer's equity share) and are not separately exercisable, they are treated as a single compound embedded derivative in accordance with paragraph AG29 of IAS 39 or paragraph B4.3.4 of

IFRS 9.[3] Proponents of View 1 note that the embedded features may be analyzed in two different ways with the same accounting outcome:

- **View 1A**: The cap and the floor are net settled derivatives (ie the effect of the cap and the floor is that the number of equity shares delivered on conversion when the share price is above CU12.50 or below CU7.70 is increased or decreased respectively by the difference between (i) the number of shares that would have a total value of CU1000 as required by the *host* instrument and (ii) the minimum or maximum number of shares deliverable under the hybrid instrument of 80 and 130 respectively).
- **View 1B**: The cap and the floor are identified as a derivative to exchange the stated principal amount of the host instrument of CU1000 (or, alternatively, the cash that would theoretically be payable if the instrument were redeemable at this amount) for either 80 or 130 equity shares – which is not a single fixed number of equity shares.[4]

View 2

10. Proponents of View 2 express the view that the instrument has two components:

(a) a non-derivative obligation to deliver a <u>fixed</u> minimum number of 80 equity shares in all circumstances, which is an equity instrument; and

(b) an obligation to deliver an additional <u>variabl</u>e number of equity shares (between zero and 50) depending on the issuer's ultimate share price, which is a derivative liability.

View 3

11. Proponents of View 3 believe that the instrument has three components:

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[3] We are aware that some may argue that there is a discussion to be had as to whether the share-price link is an embedded derivative that requires separation under IAS 39 and IFRS 9. However, the submission received in 2009—as well as Agenda paper 5 for the July 2009 IFRIC meeting—was clear that there would be an embedded derivative that would require separation under View 1.

[4] Paragraph 16 of IAS 32 states that a derivative meets the definition of equity only if it will be settled by the issuer exchanging a <u>fixed</u> amount of cash (or another financial asset) for a <u>fixed</u> number of its own equity instruments. This is often called 'the fixed-for-fixed' requirement in IAS 32.

(a) an obligation to deliver as many shares as are worth CU1000 if the share price is between CU7.70 and CU12.50, which is a non-derivative financial liability;

(b) a derivative (a written call option) to exchange the stated principal amount of CU1000 for 80 shares when the share price is above CU12.50, which is an equity instrument; and

(c) a derivative (a purchased put option) to exchange the stated principal amount of CU1000 for 130 shares when the share price is below CU7.70, which is an equity instrument.

12. Proponents of View 3 believe that the two derivatives described above in bullets (b) and (c) are both equity components because each individually satisfies the 'fixed-for-fixed' requirement in IAS 32 (as discussed in footnote 4).

View 4

13. View 4 is a hybrid of Views 1A and 3 that has the same result as View 1. Proponents of View 4 believe that the instrument has three components:

(a) an obligation to deliver as many shares as are worth CU1000, which is a non-derivative financial liability;

(b) a derivative (a written call option) to exchange as many shares as are worth CU1000 for 80 shares when the share price is above CU12.50, which is a non-equity derivative;

(c) a derivative (a purchased put option) to exchange as many shares as are worth CU1000 for 130 shares when the share price is below CU7.70, which is a non-equity derivative.

14. Proponents of View 4 believe that the two derivatives described above in bullets (b) and (c) are both accounted for as non-equity derivatives because neither satisfies the 'fixed-for-fixed' requirement in IAS 32 (as discussed in footnote 4).

Outreach request

15. We sent a request for information to the International Forum of Accounting Standard Setters (IFASS) 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. We asked for further explanation if there is diversity in practice in the respondent's jurisdiction. We also asked Interpretations Committee members if they had experience with this instrument in practice.

16. We received 23 responses, which represented informal feedback and did not necessarily represent the formal views of any organization. There were three broad views expressed in that feedback:

    (a) Some respondents did not provide a view on the accounting because the instrument is not common in their jurisdictions.

    (b) Some respondents said that there is diversity in practice. These respondents had differing views on which of the four views are acceptable but each of the views were found to be acceptable by at least one respondent.

    (c) Some respondents said that instrument is a financial liability in its entirety. Some of the respondents who expressed this view preferred either View 1 or View 4 while others did not specifically discuss the accounting for the financial liability (other than to confirm that there is not an equity component). In general, these respondents expressed the view that IAS 32 does not permit an issuer to divide a single obligation to deliver a variable number of equity shares into sub-components (or settlement outcomes) for the purpose of identifying 'something' that meets the definition of equity.

Staff analysis

17. We think the instrument described in this paper is a financial liability in its entirety. It is a non-derivative that obliges the issuer to deliver a variable number (ie between 80 and 130) of its own equity instruments—and such an obligation meets the definition of a financial liability in accordance with paragraph 11(b)(i) in IAS 32. While the variability is limited by the cap and the floor, the number of equity shares that the issuer is obliged to deliver is not fixed.

18. Consistent with the view described in paragraphs 7 and 16(c) of this paper, we believe that IAS 32 requires an entity to assess the conversion feature as a whole. We think it is inappropriate to consider that the instrument contains a separate conversion feature for each scenario where the issuer will deliver a different number of equity shares. In other words, we think IAS 32 does not permit an issuer to divide a single conversion feature into multiple settlement outcomes—and treat each settlement outcome as a separate sub-component—for the purposes of evaluating the classification requirements in that Standard. Indeed, we think that almost any obligation to deliver a variable number of equity shares could be 'sliced and diced' into sub-components with the objective of identifying a sub-component that would satisfy the fixed-for-fixed requirement and thus achieve equity classification—but we think such treatment is inconsistent with the requirements in IAS 32.

19. Furthermore, we think the cap and floor are embedded derivative features in accordance with paragraph 11 of IAS 39 and paragraph 4.3.3 IFRS 9, whose values change in response to the price of the issuer's equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those embedded derivative features from the host liability contract and account for them at fair value through profit or loss in accordance with IAS 39 or IFRS 9.

Staff recommendation

20. We think the appropriate accounting can be derived from IAS 32 and IAS 39 or IFRS 9 without need for further guidance. Consequently we do not think that any changes to or formal interpretation of IAS 32, IAS 39 or IFRS 9 are required.

21. 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 accounting for a financial instrument that that is mandatorily convertible into a variable number of shares, subject to a cap and floor? 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:

> **Accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and floor**
>
> The IFRS Interpretations Committee discussed how an issuer would account for a particular mandatorily convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*. The financial instrument has a stated maturity date and at maturity the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount—subject to a cap and a floor, which limit and guarantee, respectively, the number of equity instruments to be delivered.
>
> The Interpretations Committee noted that that the instrument meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 because the issuer has a contractual obligation to deliver a variable number of its own equity instruments. The Interpretations Committee noted that it is inappropriate to consider that the instrument contains separate conversion features for each scenario where the issuer will deliver a different number of its own equity instruments. That is, IAS 32 does not permit an issuer to divide a single conversion feature into multiple settlement outcomes for the purposes of evaluating the classification requirements in IAS 32.

Furthermore, the Interpretations Committee noted that the cap and the floor are embedded derivative features whose values change in response to the price of the issuer's equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those embedded derivative features from the host liability contract and account for them at fair value through profit or loss in accordance with IAS 39 or IFRS 9.

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, IAS 39 and IFRS 9 relevant to this issue 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—Tentative agenda decision (July 2013)

IAS 32 *Financial Instruments: Presentation*—Classification of a financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares

The Interpretations Committee discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument in accordance with IAS 32 *Financial Instruments: Presentation*. The instrument has a stated maturity date and at maturity the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount, subject to a cap and a floor. The cap and floor limit and guarantee, respectively, the number of equity instruments to be delivered. The issuer is required to pay interest at a fixed rate. The issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, it must:

a. deliver the maximum number of equity instruments specified in the contract; and

b. pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

The Interpretations Committee noted that paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. Consequently the Interpretations Committee noted that if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument.

The Interpretations Committee noted that the issuer cannot assume that a financial instrument (or its components) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of its own equity instruments. The Interpretations Committee noted that judgement will be required to determine whether the issuer’s early settlement option is substantive and thus should be considered in determining how to classify the instrument. If the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument. To determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or business reasons that the issuer would exercise the option. For example, among other factors, the issuer could consider whether the instrument would have been priced differently if the issuer’s early settlement option had not been included in the contractual terms.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, neither an interpretation nor an amendment to a Standard was necessary and consequently [decided] not to add the issue to its agenda.

However, the Interpretations Committee asked the staff to analyse the accounting for a mandatorily convertible instrument that obliges the issuer to settle the instrument by delivering a variable number of its own equity instruments, subject to a cap and a floor; ie the instrument described above excluding the issuer's option to settle early by delivering a fixed number of equity instruments. The staff will bring that analysis to a future meeting.

Appendix D—Agenda decision (January 2010)

IAS 32 *Financial Instruments: Presentation* - Application of the 'fixed for fixed' condition

The IFRIC received requests for guidance on the application of paragraph 22 of IAS 32 which states that 'except as stated in paragraph 22A, a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument' (often referred to as the 'fixed-for-fixed' condition).

The IFRIC identified that diversity may exist in practice in the application of the fixed-for-fixed condition to other situations in addition to the specific situations identified in the requests.

The IFRIC noted that the Board is currently undertaking a project to improve and simplify the financial reporting requirements for financial instruments with characteristics of equity. A key objective of this project is to develop a better distinction between equity and non-equity instruments. This includes consideration of the current fixed-for-fixed condition in IAS 32.

Consequently, the IFRIC concluded that the Board's current project on Financial Instruments with Characteristics of Equity is expected to address issues relating to the fixed-for-fixed condition on a timely basis. Consequently, the IFRIC decided not to add this issue to its agenda.