STAFF PAPER

January 2014

IFRS Interpretations Committee Meeting

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

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Background

1. In 2013 the IFRS Interpretations Committee (the Interpretations Committee) received two requests to address the accounting for a financial instrument that is mandatorily convertible into a variable number of the issuer's own equity shares (subject to a cap and a floor on the number of shares to be delivered) but gives the issuer the contractual right to settle the instrument at any point before maturity by delivering the maximum number of equity shares (fixed and capped).

2. In July 2013, the Interpretations Committee discussed how the issuer would assess the substance of its early settlement option for the purposes of applying the definitions of a *financial liability* and an *equity instrument* in IAS 32 *Financial Instruments: Presentation*.

Description of the instrument

3. Each of the submissions provided an example to illustrate the issue and Agenda paper 17 for the July 2013 meeting sets out both examples. The key features were the same in all important respects; therefore, for simplicity, we have reproduced only one of the examples below:

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

(b) When the instrument was issued, the fair value of the issuer's equity share was CU10. Therefore, when the instrument was issued, the share price would equate to the delivery of a number of shares that is within the range between the cap and the floor.

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

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

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

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

4. Neither submission specified the term of the instrument, but we understand that these types of instruments generally have short lives; for example, one such instrument issued in 2012 had a term of three years. We also understand that in some cases the make-whole provision is computed as the present value of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

Accounting treatment described in the submissions

5. Both submissions raised questions and discussed alternative views on how IAS 32 should be applied to the issuer's early settlement option. Those questions and

alternative views are discussed in detail in Agenda paper 17 for the July 2013 meeting. But, expressed simply, the fundamental issue is how to determine whether the issuer's early settlement option—described in paragraph 3(d) of this paper—has substance. In particular, given that the issuer will always have to deliver its own equity shares, must pay the same amount of interest irrespective of when the shares are delivered and may be able to deliver fewer shares depending on the share price at maturity, the question arises about how to assess whether the right to deliver fixed (maximum) shares before maturity has substance. If that settlement option does **not** have substance, it must be disregarded for the purposes of classifying the financial instrument in accordance with paragraph 15 of IAS 32.

Summary of the Interpretations Committee's discussion in July 2013

6. At its July 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 and the definitions of a financial liability, a financial asset and an equity instrument.

   (b) Consequently, if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument.

   (c) 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.

   (d) 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.

(e) 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.

7. 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 tentatively decided not to add the issue to its agenda.

8. 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 3 of this agenda paper. 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; ie the issuer does **not** have the early settlement option described in paragraph 3(d) of this paper. Agenda paper 15 for this meeting discusses that 'simplified' instrument.

Comments received

9. We received six comment letters on the Interpretations Committee's tentative agenda decision, which are set out in Agenda paper 8A for this meeting.

10. Most of the respondents agreed with the Interpretations Committee's tentative decision not to add this issue to its agenda. These respondents generally agreed with the principle articulated in the tentative agenda decision that if the issuer's early settlement option is **not** substantive, then it should be disregarded for the purposes of classifying the instrument in accordance with IAS 32. However,

some respondents requested that the Interpretations Committee reconsider and/or clarify particular wording in the agenda decision; specifically:

(a) the threshold for determining whether a contractual feature has substance, including whether that threshold is the same as determining whether a feature is ‘genuine’;

(b) the meaning of ‘actual economic or business reasons that the issuer would exercise the option’ as that phrase is used in the draft agenda decision (refer to paragraph 6(e) above); and

(c) the effect of the instrument’s pricing in the assessment of whether a contractual feature has substance (refer to paragraph 6(e) above).

11. However, one respondent suggested that the Interpretations Committee add this issue to its agenda—or ask the IASB to consider amending IAS 32 if the guidance in IFRSs is not sufficiently clear to issue an Interpretation. This respondent expressed concern that while the tentative agenda decision may address the specific instrument described in the submission, other instruments will be issued in the future and the analysis will be less clear—and therefore additional debates will arise in practice about what constitutes a substantive early settlement feature.

The threshold for determining whether a contractual feature has substance

12. While they agreed in principle that the issuer’s early settlement option should be disregarded for the purposes of classifying the instrument if that feature is not substantive, some respondents asked the Interpretations Committee to clarify the criteria for making that determination. Specifically, some respondents asked whether, and if so how, the following guidance in IAS 32 should be applied to the early settlement feature described in the submission—and generally implied that these paragraphs would be helpful (or perhaps are necessary) to determine whether that contractual feature has substance:

(a) **Paragraph 20(b) of IAS 32—**This paragraph states that a financial instrument that does not explicitly establish a contractual obligation to deliver cash (or another financial asset) may establish such an obligation indirectly through its terms and conditions. As an example, this paragraph states that 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. This paragraph also notes that although the entity does not have an explicit contractual obligation to deliver cash (or another financial asset), the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

Some respondents noted that this paragraph discusses a comparison between a cash settlement alternative and a share settlement alternative—and asked whether (and if so how) the paragraph also applies to two share settlement alternatives (ie one variable and one fixed). One respondent asked whether the financial instrument described in the submission would meet the definition of a financial liability simply because the holder has been guaranteed receipt of an amount that is at least equal to the variable share settlement option.

(b) **Paragraphs 25 and AG28 of IAS 32**—These paragraphs discuss contingent settlement provisions that require the entity to deliver cash (or another financial asset)—or otherwise to 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 holder of the instrument. An issuer must disregard a contingent settlement provision if it is 'not genuine' —ie the occurrence of the uncertain future event is extremely rare, highly abnormal and very unlikely to occur.

At least one respondent noted that this notion is well understood in practice and suggested that the Interpretations Committee clarify whether it intends for 'not substantive' to be analogous to (ie to be the same threshold as) 'not genuine'.

13. One respondent expressed a general concern that the wording in the tentative agenda decision would introduce a threshold that is 'too low'; ie it would seemingly require an issuer to disregard too many contractual features for the purposes of classifying a financial instrument. This respondent noted that such a low threshold appears in contrast to other requirements in IAS 32, which seemingly would set a higher hurdle. According to the respondent, this high threshold assures that preparers do not have to 'prove' the benefit of each contractual feature in order to consider that feature when classifying a financial instrument. Additionally, this respondent noted that in Agenda paper 17 for the July 2013 meeting the staff discussed factors that may be considered when an issuer assesses whether its early settlement option has substance (for example, the width between the cap and floor, the share price at issuance and the volatility of the share price) and stated that including these factors in the agenda decision would be helpful.

The meaning of 'actual economic or business reasons that the issuer would exercise the option'

14. As noted above in paragraph 6(e), the tentative agenda decision noted that in order 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 its option. Some respondents expressed concern about that language and provided the following comments:

    (a) The word 'actual' should be replaced by the words 'reasonably possible' or 'possible' because there only needs to be a reasonable possibility that the issuer might exercise the option for that feature to have substance.

    (b) The meaning of 'economic reasons' and 'business reasons' should be clarified (for example, whether economic reasons relate only to the instrument itself or to the reporting entity more generally), including how those terms relate to each other (for example, whether economic reasons are a subset of business reasons). In addition, business reasons likely would be based on entity-specific preferences or priorities—and therefore would be difficult to rebut in practice.

(c) It was unclear how 'actual economic or business reasons' are different from economic compulsion—and the Board has stated in the past that economic compulsion by itself would not result in a financial instrument being classified as a liability in accordance with IAS 32.

Effect of the instrument's pricing in the assessment of whether a feature has substance

15. As noted above in paragraph 6(e), the tentative agenda decision noted that, 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. A few respondents expressed concern that this reference to pricing may inappropriately limit the assessment of whether the early settlement option has substance. One respondent suggested that that the Interpretations Committee should acknowledge that an issuer must consider other factors.

Other comments raised related to the tentative agenda decision

16. One respondent said that the tentative agenda decision uses the word 'substance' in a different context from paragraph 15 of IAS 32. Specifically, the former is discussing whether a specific contractual feature must be considered for classification purposes, whereas the latter is discussing the instrument's overall classification.

17. The tentative agenda decision focused on how an issuer would assess the substance of its early settlement option—however, two respondents asked specifically about two possible views on the accounting for the instrument described in the submission:

(a) One respondent said that although the instrument is not a derivative in its entirety, the issuer's early settlement option is a derivative and therefore is subject to the 'fixed for fixed' condition in paragraph 11(b)(ii) of IAS 32. The issuer's settlement option would not meet the fixed-for-fixed condition because the issuer has the option to deliver a **fixed** number of shares before maturity (ie the cap) in exchange for giving up its obligation to deliver a **variable** number of shares at maturity (ie the range between the cap and the floor). Under this view, the instrument would not meet the definition of an equity instrument **even if** the issuer's settlement option is deemed to be substantive.

(b) Another respondent noted that, if the issuer exercises its early settlement option, it must pay (in cash) all of the interest that would have been payable if the instrument had remained outstanding until its maturity date (refer to paragraph 3(d)(ii) above). This respondent said the effect of this **variable** cash obligation on the classification of the instrument in its entirety is unclear.[1]

Staff analysis

18. The definitions in IAS 32 of *financial asset*, *financial liability* and *equity instrument* are based on the financial instrument's contractual rights and contractual obligations. Therefore, we agree with the respondents who point out that an instrument's contractual terms are the starting point for the issuer's classification assessment.

19. However, paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the **substance of the contractual**

[1] As noted in Agenda paper 17 for the July 2013 meeting, we think the interest payments meet the definition of a financial liability because those amounts are payable (in cash) in all cases. The focus of this analysis is on the substance (and classification) of the *other* components of the instrument. If the issuer's early settlement option **is substantive**, we think that component meets the definition of an equity instrument in paragraph 16(b)(i) because it is a non-derivative that will be settled in the issuer's own equity instruments and includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments. If the issuer's early settlement option **is not substantive**, it would be excluded from the classification assessment. Agenda paper 15 for this meeting discusses the accounting for that 'simplified' instrument.

arrangement. In order to do so, we believe the issuer must assess the substance of its early settlement option to determine whether that contractual feature should be considered in the classification of the instrument. Consistent with the tentative agenda decision published in July 2013, we think 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. In other words, we do not think that IAS 32 permits an issuer's fixed-share settlement alternative to always—or automatically—take precedence over ('trump') the other contractual terms of the instrument. Rather, **judgment is required** to determine whether the issuer's early settlement option is substantive and thus should be considered in determining how to classify the instrument.

20. We note that most respondents generally agreed with that principle; ie if the issuer's early settlement option is **not** substantive, then it should be disregarded for the purposes of classifying the instrument in accordance with IAS 32. The remaining question is how the issuer should assess whether that feature has substance.

Assessing the substance of the early settlement option

21. While IAS 32 does not explicitly address the specific fact pattern described in the submission, some paragraphs indeed discuss circumstances in which a contractual term is excluded from the classification assessment of a financial instrument:

    (a) Paragraphs 25 and AG28 of IAS 32 discuss contingent settlement provisions that require the entity to deliver cash (or another financial asset)—or otherwise to 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 holder of the instrument. In accordance with those paragraphs in IAS 32, an issuer must disregard a contingent settlement provision if it is 'not genuine' —ie the occurrence of the uncertain future event is extremely rare, highly abnormal, and very unlikely to occur.

(b) Paragraph 20 of IAS 32 states that a financial instrument that does not explicitly establish a contractual obligation to deliver cash (or another financial asset) may establish such an obligation indirectly through its terms and conditions. As an example, this paragraph states that 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.

22. We think those paragraphs are helpful in that they acknowledge circumstances in which a contractual feature does not affect the classification assessment of the instrument. However, we believe that neither of those paragraphs is entirely—or exactly—on-point to the fact pattern submitted and therefore we think it would be inappropriate to simply apply paragraphs 25 (and AG28) or paragraph 20 in IAS 32 by analogy. Rather, the issuer must consider—and take into account— how the fact patterns described in those paragraphs are different from the fact pattern described in submission.

A feature that is 'not genuine'

23. Some respondents suggested that the notion of 'not genuine' (as described above in paragraph 21(a) of this paper) should be applied to determine whether the issuer's early settlement option has substance. However, we think that notion specifically addresses the accounting for contingent settlement provisions. **That is, we think that 'not genuine' is used in IAS 32 to assess the probability that an uncertain future event—ie an event that is beyond the control of both the issuer and the holder— will occur.** In other words, 'not genuine' focuses on the likelihood that a particular event will occur and, as a result, a particular contractual obligation that meets the definition of a financial liability will 'kick in'.

24. However, we think the circumstances described in the submission are different and thus the discussion of 'not genuine' in IAS 32 is not entirely relevant. That is because the issuer's early settlement option is **not** a contingent settlement provision—but rather, at all times, the issuer has a contractual right to settle the

instrument by delivering a fixed number of its own shares. The question is whether the issuer's existing contractual right to do so has substance—ie whether there is an actual economic or other business reason that the issuer would exercise its early settlement option. [2]

25. Said another way, we think the discussion of 'not genuine' in IAS 32 focuses on ***when*** **an entity would be required to do something that meets the definition of a liability** (eg settle in cash) and how likely it is that that (uncontrollable) event would arise. The question is—will the obligation actually arise? If the entity would have to settle in cash (for example) only upon the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur, then the issuer effectively ignores that obligation in classifying the financial instrument. That guidance primarily focuses on assessing the probability that the uncertain future event will occur, which in turn will trigger an obligation.

26. In contrast, the discussion of substance in the submission focuses on ***why*** **an issuer would chose to do something that it already has the contractual right to do** (eg settle the contract before maturity by delivering a maximum (fixed) number of its own shares) and whether in fact it could be envisaged that the issuer would make that decision. The question is whether that right would be exercised. We think the discussion of substance is focused on whether there are reasons—that are not purely theoretical—for why the issuer would choose to exercise its early settlement option.[3]

27. Furthermore, we note that 'not genuine' is **not** used in IAS 32 as a broader (or general) test for assessing substance—and we think it would be inappropriate to use it as such. Indeed, the notion of 'not genuine' is not used in paragraph 20(b) of IAS 32 to determine whether a particular share settlement alternative should be

[2] We note that assessing the substance of a contractual term is different from so-called economic compulsion. The former focuses on assessing whether a **contractual feature** should be excluded from the classification assessment because the feature does not reflect the substance of the contractual arrangement. In contrast, the latter focuses on including a **non-contractual feature** in the classification assessment. As discussed in more detail in Agenda paper 17 for the July 2013 Interpretations Committee meeting, the IASB confirmed in June 2006 that IAS 32 does not require or permit factors not within the contractual arrangement to be taken into consideration in classifying the financial instrument.

[3] We note that some respondents did not like the word 'actual' as it was used in the tentative agenda decision to describe the economic or other business reasons that an issuer would exercise its early settlement option. However we think that word serves a purpose to distinguish 'real' reasons from those that are purely theoretical.

considered in the classification assessment. Rather, as discussed in the paragraphs below, that paragraph requires the issuer to compare the relative value of each of the two settlement alternatives, presumably with the objective of assessing whether it is conceivable that the issuer would choose the share settlement alternative.

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

28. We agree with respondents that paragraph 20(b) of IAS 32 is helpful in that it describes an instrument that has two settlement alternatives—ie the issuer can choose to deliver either cash or its own shares—and discusses whether the share settlement alternative should be excluded from the classification assessment. Similarly, in the instrument described in the submission, the issuer has two settlement alternatives—but those alternatives **are different** from the alternatives set out in paragraph 20(b) in IAS 32. Specifically, in the submission, both alternatives are share-settled, ie the issuer can choose to deliver either a variable number of its own shares or a fixed number of its own shares. As discussed in Agenda paper 17 for the July 2013 meeting, we think having a choice between delivering cash or a fixed number of shares **is different than** having a choice between delivering a variable number of shares and a fixed number of shares. And, indeed, paragraph 20(b) only discusses the former. That is because the issuer may have valid reasons for choosing to deliver its own shares instead of cash, even if the value of the shares is greater. But those reasons are not applicable if the issuer is choosing between delivering a fixed number of its own shares and a variable number of its own shares.

29. Therefore, we think the discussion in paragraph 20(b) is relevant and useful but we think *further* analysis is needed to determine whether the issuer's early settlement option is substantive. That is, we think it would not be appropriate for the issuer to make that assessment solely by applying paragraph 20(b) in IAS 32 by analogy without considering—and taking into account— how the fact pattern described in that paragraph is different from the fact pattern described in submission. The paragraphs below discuss other factors that we think are relevant to the early settlement option that is described in the submission.

Other factors to consider

30. In order to determine whether the issuer's early settlement option is substantive, we think it is necessary to determine whether there are actual reasons that the issuer would exercise its early settlement option—or whether, for example, the option was included in the contract to achieve a particular accounting outcome. This is consistent with the Interpretations Committee's discussion at its July 2013 meeting. During that meeting, some members noted that there may be various reasons that an issuer may choose to exercise its early settlement option — and not all of those reasons are purely economic (ie the decision is not solely based on the issuer's share price). In other words, even if it seems uneconomical to exercise the early settlement option (ie because it would not be financially advantageous for the issuer to settle before maturity because the issuer may be able to deliver fewer shares if it waits until maturity, plus all of the interest has to be paid (in cash) in either case), there may be other business reasons that the entity would choose to do so. And those reasons would be weighed against the pure cost of exercising the early settlement option; for example, there may be considerations related to the issuer's credit rating, regulatory capital, or tax status. Therefore, the tentative agenda decision acknowledged that there may be economic **or business reasons** that the issuer may exercise its contractual early settlement option. (We note that some interested parties may argue that achieving a desired accounting result is an 'actual business reason' for including the early settlement option in the contract. We do not think that was the Interpretation Committee's intention and therefore have proposed that the agenda decision is clear on that point. We also acknowledge the feedback that an 'economic reason' is a particular type of 'business reason' and have updated the agenda decision accordingly.)

31. As an example of how the issuer could make that determination, the tentative agenda decision noted that an issuer could consider (among other factors) whether the instrument would be priced differently if the issuer's early settlement option had not been included in the contractual terms. As noted in paragraph 15 of this paper, a few respondents expressed concern that this reference to pricing may inappropriately limit the assessment of whether the early settlement option

has substance. However, we note that the tentative agenda decision discussed pricing as an example that should be considered among other factors. Therefore we do not think that the Interpretations Committee intended to restrict the assessment to an analysis of the instrument's pricing.

32. As noted in paragraph 13 of this paper, at least one respondent noted that Agenda paper 17 for the July 2013 meeting set out other factors that an issuer could consider to determine whether its early settlement feature is substantive—and that respondent expressed the view that it would be helpful if the agenda decision included those other factors. Specifically, in that agenda paper, we noted that the issuer's assessment of the early settlement feature may depend on factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share price. For example, the early settlement option may be less likely to have substance— especially if the instrument is short-lived—if the range between the cap and the floor is wide and the issuer expects (for example, based on the current share price) that it would deliver a number of shares that is close to the floor (ie the minimum) if it waited until maturity to settle the instrument. That is because the issuer may have to deliver significantly more shares to settle early than it would otherwise be obliged to deliver at maturity. In response to the feedback received, we have proposed to include additional language in the agenda decision that addresses these factors.

33. We acknowledge that determining whether there are actual economic or other business reasons that the issuer would exercise its early settlement option—and thus whether that option has substance—will require judgement and will take into account all relevant facts and circumstances. However, we note that judgements related to substance are required elsewhere in IFRS. For example, IFRS 10 *Consolidated Financial Statements* requires an investor to consider its **substantive rights** relating to the investee when it assesses whether it has power (ie to determine which rights are relevant to assessing whether the investor indeed has power) and in the IASB's discussions in the Revenue Recognition project, the Board discussed the fact that nonsubtantive terms in a revenue contract should be ignored in the assessment of whether and when the customer obtains control of a good or services.

Staff recommendation

34. After considering the comments received on the tentative agenda decision, we recommend that the Interpretations Committee should finalise its decision not to add this issue to its agenda. As noted in paragraphs 10 and 20 of this agenda paper, most respondents generally agreed with the principle set out in the tentative agenda decision—ie if the issuer's early settlement option is **not** substantive, then it should be excluded from the classification assessment of the instrument— but requested that the Interpretations Committee reconsider and/or clarify particular wording.

35. The proposed wording of the final agenda decision, which takes into account the feedback received, 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 finalise 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 s struck through.

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 the definitions of *financial asset*, *financial liability* and *equity instrument* in IAS 32 are based on the financial instrument's contractual rights and contractual obligations. However, 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.

The Interpretations Committee noted that the guidance in paragraph 20(b) IAS 32 is relevant to assessing the substance of the issuer's early settlement option because that paragraph describes an instrument that has two settlement alternatives—ie in that paragraph, the issuer can choose to deliver either cash or its own shares—and discusses whether the share settlement alternative should be excluded from the classification assessment. However, the Interpretations Committee noted that having a choice between delivering cash or shares is different than having a choice between delivering a variable number of shares and a fixed number of shares. Therefore, the Interpretations Committee noted that it would not be appropriate for the issuer to assess the substance of the issuer's early settlement option solely by applying paragraph 20(b) in IAS 32 by analogy without taking into account how the fact pattern described in that paragraph is different from the fact pattern described in submission.

Specifically, the Interpretations Committee noted that to ~~To~~ determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. For example, ~~among~~ along with 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 also noted that factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share price could be relevant to the assessment of whether the issuer's early settlement option is substantive. For example, the early settlement option may be less likely to have substance—especially if the instrument is short-lived—if the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor (ie the minimum). That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity.

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.~~