

## STAFF PAPER

January 2014

## IFRS Interpretations Committee Meeting

<b>Project</b>	<b>IAS 32 <i>Financial Instruments: Presentation</i></b>		
<b>Paper topic</b>	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—Comment letters received		
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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*.

1. We received six comment letters on the IFRS Interpretations Committee's tentative agenda decision and those letters are set out below.

September 17, 2013

(Via email to [ifric@ifrs.org](mailto: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 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**

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 are mandatorily convertible into a variable number of shares (subject to a cap and a floor) but give the issuer the option to settle by delivering the maximum (fixed) number of shares. This tentative agenda decision was published in the July 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. We think that the substance of the features embodied in a financial instrument should always be considered in determining its classification. However, we do not understand the final paragraph of the decision. Unless the Committee thinks that IAS 32 is possibly unclear on the treatment of a more basic instrument or intends to undertake a comprehensive examination of IAS 32, we do not think that committing to a potentially open-ended analysis is helpful.

*AcSB response to tentative agenda decision:*

*September 17, 2013*

*Classification of financial instrument convertible to variable number of shares,  
subject to a cap and a floor, with an option to convert early to a fixed number  
of shares*

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](mailto:PMartin@cpacanada.ca)) or Kate Ward, Principal, Accounting Standards at +1 416 204-3437 (e-mail [KWard@cpacanada.ca](mailto:KWard@cpacanada.ca)).

Yours truly,

A handwritten signature in black ink that reads "Peter Martin". The signature is written in a cursive, slightly slanted style.

Peter Martin, CPA CA  
Director, Accounting Standards



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IFRS Interpretations Committee  
30 Cannon Street  
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20 September 2013

Dear Sirs

**Tentative Agenda Decision - 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**

We are writing in response to the IFRS Interpretations Committee's tentative agenda decision not to take the above item onto its agenda.

As part of its discussion, the Interpretations Committee noted that:

'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.'

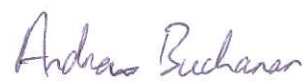
This implies that the Interpretations Committee considered that, if the early settlement option had no effect on the pricing of an instrument, the early settlement feature should be regarded as not being substantive. However, for at least some instruments that have been issued to date for which the early settlement option does not appear to have had any effect on the pricing, the instruments have been classified largely as equity.

We also remain concerned that, even if instruments with features that we described in our agenda request are accounted for in future as giving rise substantially to financial liabilities, other structures will soon be issued where the analysis is less clear cut, with associated debates arising around what might or might not constitute a substantive early settlement feature (whether in the context of regulatory capital requirements, potential future debt covenant requirements or otherwise).

We believe that it would be appropriate for the Interpretations Committee to reconsider its tentative agenda decision. If it is considered that the guidance in IFRS is not sufficiently clear to enable an interpretation to be issued, we suggest that the issue is referred to the

IASB for consideration of whether it would be appropriate to make changes to IAS 32 *Financial Instruments: Presentation*.

Yours faithfully

A handwritten signature in dark ink that reads "Andrew Buchanan". The signature is written in a cursive style with a large initial 'A'.

Andrew Buchanan

*Global Head of IFRS*

Wayne Upton  
Chairman  
IFRS Interpretations Committee  
30 Cannon Street  
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EC4M 6XH

Email: [ifric@ifrs.org](mailto:ifric@ifrs.org)

25 September 2013

Dear Mr Upton

**Tentative Agenda Decision - 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**

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the July 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 a financial instrument that bears interest in cash, is mandatorily convertible into a variable number of shares (subject to a cap and floor) on a stated maturity date and gives the issuer an option to settle at any time before maturity for cash equal to all interest that would have been payable until maturity and the maximum number of shares that would have been delivered on maturity.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda and that the Committee's tentative conclusion that, subject to a judgement on whether the issuer's early settlement option is substantive, the instrument may be considered a 'non-derivative' that can be classified as equity is a valid application of IAS 32.

However, we note that an alternative view exists that was not considered by the Committee in developing the tentative agenda decision. Under this view, although the instrument as a whole is not a derivative, the right for the issuer to redeem the instrument is, and therefore it is subject to the 'fixed-for-fixed' criterion in paragraph 11(b)(ii). Applying this analysis to the instrument that the Committee considered results in a conclusion that this criterion is not met because the issuer has the option to deliver a *fixed* number of equity instruments to the holder in exchange for the issuer giving up its obligation to deliver a *variable* number of equity instruments. Under this view the instrument is not an equity instrument.

We believe the Committee should consider this alternative school of thought before finalising its decision.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'V. Poole', with a stylized flourish at the end.

Veronica Poole  
Global IFRS Leader

International Financial Reporting Standards  
Interpretations Committee  
30 Cannon Street  
London  
EC4M 6XH

25 September 2013

Dear IFRS Interpretations Committee members,

**Tentative Agenda Decision – 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**

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, is pleased to submit its comments on the above Tentative Agenda Decision, as published in the July 2013 IFRIC Update.

The IFRS Interpretations Committee (the 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 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 shares (fixed and capped).”

We request that before finalising the Tentative Agenda Decision, the Committee provides clarifications on the following aspects:

- ▶ whether and, if so, how the guidance in IAS 32.20(b) applies to this issue;
- ▶ how the terms “economic reasons” and “business reasons” used in the Tentative Agenda Decision relate to each other; and
- ▶ on which grounds some of the alternative views mentioned in Agenda Paper 17 of the July 2013 meeting were dismissed.

Appendix A provides more detail on the clarifications requested.

Should you wish to discuss the contents of this letter with us, please contact Tony Clifford at the above address or on +44 (0)20 7951 2250.

Yours faithfully

*Ernst + Young Global Limited*



## Appendix A

This appendix provides more detail on the clarifications that we request on the Tentative Agenda Decision.

### *Whether and, if so, how the guidance in IAS 32.20(b) applies to this issue*

Both submissions to the Committee include different views that all involve an assessment of the question of whether IAS 32.20(b) is relevant to this issue. Staff Paper 17 acknowledges that that paragraph is relevant to this issue but this is not mentioned in the Tentative Agenda Decision, even though the Committee's discussion did not indicate any disagreement.

We think it would be helpful to clarify whether, for the purpose of classifying a financial instrument as equity or a financial liability, settlement in an entity's own equity instruments in a way that fails the equity definition is equivalent to delivering cash or other financial assets. We think this is a matter of principle that determines whether the guidance in IAS 32 that elaborates on how to apply paragraph 16(a) (i.e. IAS 32.17-20) is also relevant for how to apply paragraph 16(b). In our response to the Committee's other tentative agenda decision on convertible instruments at the July 2013 meeting (in relation to Staff Paper 18) we suggest this clarification as one of several principle-level clarifications that could be achieved by changes to authoritative guidance in order to reduce diversity in views and improve the clarity of the requirements of IAS 32.

We also think that the Committee should clarify how the reference in IAS 32.20(b) to the holder having "in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21)" relates to the fact pattern that it discussed. In particular, the reference to paragraph 21, which addresses ways of settling obligations by delivering an entity's own equity instruments that result in classifying the obligation as a liability, contradicts the view in the Staff Paper in paragraph 58 (which the Committee did not challenge) that such a settlement was 'notably different' from a settlement in cash for the purpose of applying IAS 32.20. We note that in the fact pattern that the Committee discussed, the holder was guaranteed in any event that the settlement would not be for less than what it was entitled to under the settlement alternative that constitutes the settlement of a liability (i.e. the variable number of shares). This raises the question why the rationale in IAS 32.20(b) would not apply.

### *How do "economic reasons" and "business reasons" relate to each other?*

The Tentative Agenda Decision states "the issuer will need to understand whether there are actual economic or business reasons that the issuer would exercise the option". We think the drafting of the Tentative Agenda Decision should be clarified regarding how the two notions of "economic reasons" and "business reasons" relate to each other:

- ▶ In a narrower sense, "economic reasons" could be regarded as only related to the economics of the instrument itself. This is what the example in the Tentative Agenda Decision regarding the pricing of the instrument illustrates. This notion of "economic reasons" appears to be instrument-specific rather than entity-specific. In the fact pattern discussed by the Committee this means the option would be assessed against whether it

is substantive as a *financial option*. This would be the case if it could have substantial intrinsic value and thus also time value but not if the benefit of the option represented entity specific factors instead of the option's financial value. So in the fact pattern discussed by the Committee, the option would not be substantive because it would never have any more favourable settlement (conversion) than the mandatory conversion at maturity. In addition, the obligation to pay the interest that would have been payable without early conversion makes early conversion even less financially advantageous. If this narrow interpretation of "substantive" is the intended meaning, then only "economic reasons" should be referred to. The additional reference to "business reasons" should not be included as it would only be confusing.

- ▶ In a wider sense, referring to "business reasons" would introduce additional aspects that would apply even if there were no "economic reasons" for the entity to exercise the conversion feature. Then, even if an entity could not claim "economic reasons" in the narrower sense, it could still claim that it nonetheless had a "business reason" for including the conversion feature, which would make that feature 'substantive'. Such a "business reason" could be more entity specific than an "economic reason", for example having the opportunity to issue shares early (i.e. before mandatory conversion on maturity) when an entity experiences difficulties in maintaining its required regulatory capital. even if from an economic perspective the conversion option was out-of-the-money at that time. Other more entity specific "business reasons" that would make a feature substantive could for example be tax consequences for the entity. If this wider sense is the intended meaning, then "business reasons" should be referred to with a clarification that they also *include* "economic reasons". We also consider that when "business reasons" is used in this meaning, whether a conversion feature has or lacks 'substance' would be difficult to assess because the notion of a "business reason" would be often based on an entity's specific preferences and priorities and difficult to rebut.

#### *The grounds on which some of the alternative views were dismissed*

Staff Paper 17 set out two alternative views that were not in the original submissions but obtained in response to the Committee's outreach request (see paragraphs 49 and 50 of Staff Paper 17). Neither the staff analysis nor the Committee's discussion addressed those views so it remains unclear on which grounds they were dismissed.

In particular, it remains unclear why the variable amount of cash that is paid in case of an early conversion - in consideration of the interest that would have been payable without early conversion and thus varies depending on when the early conversion option is exercised - could still result in the entire instrument being classified as equity. This gives rise to the following questions:

- ▶ Does conversion into a fixed number of shares under the early conversion feature constitute the settlement of a derivative? If so, the question then is why the exchange of a fixed number of shares for an amount that varies depending on the remaining interest that would have been payable from the time of conversion to maturity would still meet the requirement that it is a fixed amount of cash (or another financial asset).

- ▶ Does conversion into a fixed number of shares under the early conversion feature constitute the settlement of a non-derivative? If so, there would be no obligation to deliver a variable number of the issuer's own equity instruments so aspect (b)(i) of the definition of a financial liability in IAS 32.11 would not be met. However, it is unclear why the early redemption option would meet the criteria for prepayment options to be closely related to the host contract under paragraph AG30(g) of IAS 39 *Financial Instruments: Recognition and Measurement* because the assessment from the issuer's perspective must be made before separating the equity element of a convertible debt instrument. On that basis, the obligation to pay the interest that would have been payable without early conversion means that the lender is reimbursed for more than lost interest based on the interest rate *differential* (between the effective interest rate and the market rate) and the total consideration given (i.e. the exercise price) also does not approximate amortised cost on each exercise date. Consequently, the embedded prepayment option would have to be separated and accounted for at fair value through profit or loss. This separated prepayment option then constitutes – for accounting purposes – a financial asset of the issuer of the convertible instrument. The implication for an early conversion is that it represents an exchange of that prepayment option, which for accounting purposes is extinguished when it is 'traded in' on early conversion (like a free-standing option), together with a fixed number of shares for a non-derivative. The question then is why such a conversion would still meet the definition of an equity instrument given that the entity needs to deliver more than just a fixed number of its own equity instruments to settle the contract (i.e. a mix of own equity instruments *and a financial asset*).



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Berlin, 13 September 2013

Dear Wayne,

**IAS 32 - classification of a financial instrument that is mandatorily convertible into a variable number of shares but with an option to deliver a fixed number of shares**

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the IFRS IC's tentative agenda decision, published in the July 2013 *IFRIC Update* on the above captioned issue.

We support the IFRS IC's view taken in its agenda decision that neither an interpretation nor an amendment to IAS 32 is necessary. However, we do not fully agree with the rationale or arguments the IFRS IC has developed in concluding on the issue. Therefore, we ask the IFRS IC to reconsider the wording of its decision. We hereby provide our thoughts on which points we would not fully agree.

Interpretation of the term "substance"

We are concerned that the agenda decision wording introduces a too low threshold by requiring proving that there should be at least as many economic benefits in exercising the option as there might be costs to the issuer. As mentioned by a number of IFRS IC members during the discussion, the standard - for objectivity reasons - appears to set a quite high hurdle to overcome the assumption that the option to early exercise has substance. In this respect, we refer to the following guidance from the standard.

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Präsidium:

Dr. h.c. Liesel Knorr (Präsidentin), Dr. Christoph Hütten (Vizepräsident)



Para. 55 of Agenda Paper 17 (AP) for the IFRS IC July Meeting states that it is reasonable to consider the guidance in IAS 32.25, AG28 on the term “genuine” when assessing the issuer’s option. IAS 32.25 and AG28 explain the term “genuine” in the context of contingent settlement provisions. A financial instrument is a financial liability unless “*the part of the contingent settlement provision that could require settlement in cash ... is not genuine*”. Hence, the term “genuine” is applied to the occurrence of a contingent event in which the issuer e.g. would be required to settle in a variable number of own equity instruments. AG28 explains that such an event is not genuine, if its occurrence is “*extremely rare, highly abnormal and very unlikely*”.

We also think that the guidance in IAS 32.20(b), i.e. the option has no substance unless the value of the maximum number of shares is “*determined to exceed substantially*” the value of the other options, underlines the basic principle in the standard in which the Board has set a quite high hurdle to overcome the assumption that an option to early exercise has substance.

Also, as stated explicitly in IAS 32.AG26, the assessment based on the substance of the contractual arrangements should neither be affected by history nor by the intention of the issuer to act in a certain way (i.e. to exercise the option). Furthermore, it is stated that possible negative impacts on third parties should not be taken into account. It is our understanding that, in general, the probability that an option is exercised is not taken into account when classifying a financial instrument. This is explicitly expressed in IAS 32.30, which states that changes in the likelihood that a conversion option will be exercised will not result in a revision of an initial classification. The last sentence in IAS 32.30 explains that this is the case because there is still a contractual obligation to pay cash no matter how small the probability is that this payment will occur. The same is true for the assessment at initial classification.

This guidance underlines that there is an assumption of a contractual arrangement having substance, and that only in situations where this arrangement is obviously so unfavourable (“*substantially exceeds*”) that its exercise would be extremely rare, highly abnormal and very unlikely, it would be considered to be without substance. This principle assures that preparers do not have to prove the benefit of each contractual arrangement in order for it to be considered when classifying a financial instrument.

Hence, this guidance should be mentioned in the agenda decision to help constituents in exercising judgement and to reduce diversity.



If the IFRS IC, however, decides that applying these notions does not result in an economically meaningful accounting, one would need to think about amending/clarifying the standard.

For the specific fact pattern, para. 62 of AP17 mentions the width between cap and floor, the share price at issuance and the volatility of the share price as criteria that should be considered in making the judgement for the specific instrument presented. Including this guidance in the wording would also help to exercise judgement and reduce diversity.

#### Clarification of the term “economic or business reasons”

As this is one of the central arguments in the discussion as well as in the agenda decision wording, we fail to understand what distinguishes these “economic or business reasons” from economic compulsion, which should not be taken into consideration when classifying a financial instrument as either equity or liability. As an example we refer to para. 59 of AP17, where the staff itself mentions cash management and liquidity as reasons to be considered in classifying an instrument. Though, para. 67 et seq. note that non-contractual features should not be taken into consideration.

As pointed out in para. 67, “IAS 32 does not require or permit factors not within the contractual arrangement to be taken into consideration in classifying the financial instrument.” There is no distinction between factors that may force the issuer to act in a way which is detrimental (economic compulsion) or factors that may outweigh disadvantages (economic reasons). Accordingly, if economic factors outside the contractual arrangement should not be considered at all, it is consistent to apply a high hurdle to overcome the assumption that the option to early exercise has substance. Including this notion in the agenda wording without clarifying it would result in confusion.

If the IFRS IC decides to retain the term, we would like to propose that the term “actual” should be exchanged for the term “possible”. When assessing a financial instrument at inception, those reasons do not have to be present at that date. But there only needs to be a reasonable possibility that they might occur during the term of the instrument.

#### Application of the principle stated in IAS 32.20(b)

In addition to being considered in interpreting the term “substantive” (see above), the guidance IAS 32.20(b) should have more weight in the assessment for itself. It states that in or-



der to establish an indirect obligation (here: not to exercise the option), the value of the maximum number of shares must be determined to substantially exceed the other alternative(s). Hence, the standard acknowledges that even if there are situations where the value of the maximum number of shares exceeds the other alternative, an indirect obligation would not be established.

We question the staff's view presented in para. 59 of AP17 that the difference in the alternative(s) to the settlement in a fixed number of own equity instruments in IAS 32.20(b) (i.e. cash) and the submission (i.e. variable number of own equity instruments) is relevant, as there may be reasons for the issuer preferring to deliver a fixed number of shares instead of cash, such as cash management. As said above, however, economic factors outside the contractual arrangement should not play a role.

To summarise, we consider all the guidance in IAS 32 (i.e. IAS 32.20(b), IAS 32.25) supporting the IFRS IC decision. Thus, we suggest it is fully taken into account and included in the agenda decision wording. If, however, the IFRS IC does not consider this guidance being relevant, we feel that there is potential for misinterpretation or diversity in practice when applying IAS 32. As a consequence, this would require an interpretation or a narrow-scope amendment to the standard.

If you would like to discuss our views in more detail, please do not hesitate to contact me.

With kind regards,

*Liesel Knorr*

President



IFRS Interpretations Committee  
1<sup>st</sup> Floor  
30 Cannon Street  
London  
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24 September 2013

Dear Committee Members,

**Tentative agenda decision: 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**

We are responding on behalf of PricewaterhouseCoopers to your invitation to comment on the above tentative agenda decision, published in the July 2013 edition of the IFRS Interpretations Committee Update. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms that commented on the tentative agenda decision. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We agree with the principle articulated in the tentative agenda decision regarding the classification of an instrument that is mandatorily convertible into a variable number of shares subject to a cap and floor but gives the issuer the option to settle by delivering the maximum fixed number of shares ('MCB instrument'). We agree that an issuer option that is not substantive should not be considered in determining the classification of a financial instrument. However, we have several concerns with the agenda decision as currently drafted and how it might be applied in practice as set out below.

**Assessing whether a contractual term lacks substance**

The draft agenda decision indicates that a contractual feature would not be considered in determining the classification of the instrument if that feature is not substantive. We agree with this principle, but we believe the criteria used in the draft agenda decision to evaluate whether a feature is substantive or not should be clarified.

Agenda paper 17 references 'substance' in paragraph 15 of IAS 32. Substance is used in this paragraph to assess the overall classification of the instruments. For the MCB instrument, the tentative agenda decision uses the word 'substance' in the same paragraph to determine whether specific contractual features need to be considered for classification purposes. We believe the draft agenda decision and paragraph 15 of IAS 32 use the word 'substance' in different contexts.

We further note that paragraph AG28 of IAS 32 includes the term 'not genuine' to assess whether contingent settlement events that trigger a contractual obligation should be disregarded in the classification. This term is already defined in IAS 32 and well understood in practice.

We recommend the Committee clarify whether they intend for substance to be analogous to 'not genuine' as defined in IAS 32. If the Committee does not believe this is an appropriate threshold, we encourage the committee to clearly explain how the term 'substance' relates to 'not genuine' when

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applied to contractual features, for example by giving guidance on whether it is a lower threshold than 'not genuine'.

**Impact the feature has on the instrument's pricing as an example of substance**

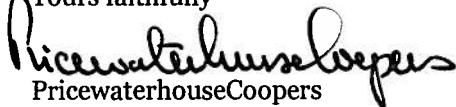
The draft agenda decision refers to whether an instrument would have been priced differently had the term not been included in the contractual terms in the analysis of whether the term has substance. We believe the reference to pricing may inappropriately limit the assessment of whether the option has substance to just considering its effect on pricing. We believe other factors may be taken into account in assessing whether an option has substance, for example whether an issuer might convert for regulatory purposes. We suggest that the requirement to consider other factors is acknowledged in the agenda decision.

**Actual economic or business reasons an issuer might exercise an option**

The draft agenda decision indicates that the issuer will need to understand whether there are **actual** economic or business reasons that the issuer would exercise the option to determine if the issuer option is substantive. We propose that the word 'actual' should be replaced by the words 'reasonably possible'. We believe there only needs to be a reasonable possibility that the issuer might exercise the option during the term of the instrument for it to have substance.

If you have any questions in relation to this letter please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 207 804 2497) or Gail Tucker (+44 117 923 4230).

Yours faithfully

  
PricewaterhouseCoopers