# STAFF PAPER

March 2014

## IFRS Interpretations Committee Meeting

| Project | New items for initial consideration |
|---|---|
| Paper topic | IAS 39 *Financial Instruments: Recognition and Measurement* Classification of a hybrid financial instrument by the holder |

CONTACT(S) Irina Makarova imakarova@ifrs.org +44 (0) 20 7246 6453



## Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the classification of a hybrid financial instrument with a revolving maturity option, an early settlement option and a suspension of interest payments option (all at the option of the issuer) by the holder. Specifically, the submitter raises a question if the host of such financial instrument should be classified by the holder as an equity or as a debt instrument under IAS 39 *Financial Instruments: Recognition and Measurement*.

2. We performed outreach with the International Forum of Accounting Standard-Setters (IFASS) and securities regulators on this topic in order to find out whether the issue raised by the submitter is widespread and whether significant diversity in practice exists. The results of this outreach are presented in this Agenda Paper.

3. The submission is reproduced in Appendix C of this paper.

## Purpose of this Agenda Paper

4. The purpose of this Agenda Paper is to:
   (a) provide a summary of the submission received;
   (b) provide a summary of the outreach conducted;
   (c) present an assessment of the issue against the Interpretations Committee's agenda criteria; and
   (d) make a staff recommendation not to take the issue onto the Interpretations Committee agenda.

## Summary of the submission received

5. The submitter describes the following main terms of the instrument under issue:
   (a) maturity: 30 years;
   (b) interest features:
      (i) rate is fixed (government bond plus spread);
      (ii) spread is stepped-up after the start date of early settlement option; and
      (iii) benchmark interest rate is reset every 10 years.
   (c) options (all at the option of the issuer):
      (i) revolving maturity option every 30 years;
      (ii) early settlement option: after 10 years, no contractual obligation for early settlement; and
      (iii) suspension of interest payment option, which can be exercised if dividends on common stock are not distributed.
6. The submitter asks to clarify whether the host contract of such an instrument would be considered as an equity or as a debt instrument from the holder's perspective.
7. The submitter is aware of the two views described in paragraphs 8 to 11 below.

*View 1: The host contract is an equity instrument*

8. The host instrument would be classified as an equity instrument because:

   (a) the instrument represents the residual interest in the net assets of the issuer, as it meets the definition of equity instrument in IAS 32 *Financial Instruments: Presentation*; and

   (b) the instrument has no stated maturity in substance.

9. Under this view the whole instrument is classified first (before identifying embedded derivatives) as follows:

   (a) if the host contract is determined after identifying embedded derivatives first, the holder would account for the residual as a debt instrument for which the payment of principal is fixed. However, the hybrid instrument at issue does not have such a feature in substance. In addition, it would not be consistent with the guidance in paragraph C.1 of IAS 39.

   (b) the revolving maturity option cannot be separated as it constitutes an essential characteristic of this instrument.

   (c) the early settlement option should be separated as a call option for an equity instrument.

*View 2: The host contract is a debt instrument*

10. The host instrument would be classified as a debt instrument because:

    (a) the host contract can be regarded as an equity instrument only under the assumption that the issuer will not exercise the early settlement option but will certainly exercise the revolving maturity option. However, this assumption may be inconsistent with expectations of market participants or investors.

    (b) in November 2006, the IFRIC noted that the issuer is required to classify an instrument in accordance with IAS 32, whereas the holder is required to account for it in accordance with IAS 39.

11. Under this view the host contract is classified after identifying embedded derivatives based on the discussion of a similar issue held by the IFRIC in 2006. The Agenda

Paper of the November 2006 IFRIC meeting noted that the holder should determine the residual, ie the host contract, after identifying all embedded derivatives.

## Summary of the outreach conducted

12. We have performed an outreach with the IFASS and securities regulators. Specifically, we asked:

    (a) whether financial instruments described in the submission are typical in their jurisdictions;

    (b) whether the respondents were aware of any difficulties or challenges in their jurisdictions in accounting for such financial instruments;

    (c) what the prevalent interpretation or approach to classification of such hybrid financial instruments would be (we also asked to describe the rationale for that prevalent interpretation or treatment); and

    (d) to what extent the respondents observed diversity in practice in respect of the issue.

13. We received 14 responses from national standard-setters. The geographical breakdown of the responses received is as follows:

| Geographical region: | Number of respondents |
|---|---|
| Asia | 4 |
| Americas | 4 |
| Europe | 3 |
| Australia and Oceania | 2 |
| Africa | 1 |
| Total respondents | 14 |

14. All the respondents noted that instruments with the particular terms and conditions described in the submission are not typical in their jurisdictions.

15. Five of the respondents mentioned that they noted financial instruments with some terms that are similar to those of the described instrument. One respondent provided a particular example of such similar instrument—an instrument with no maturity option (other than on liquidation) and no obligatory interest payments option (other than on liquidation) in which the issuer can decide to pay interest or redeem it.

16. The views of the respondents, who noted financial instruments with some terms that are similar to the ones described, are mixed:

    (a) three respondents stated that classification very much depends on the individual features of a particular instrument.

    (b) two respondents noted that classification as an equity instrument is a prevalent view. They also observed that the instrument could be classified as a debt instrument in particular circumstances.

17. Two of those respondents noted some diversity in practice.

18. Five of the respondents expressed the view that there is no significant need to provide further guidance on this issue. They noted that:

    (a) the terms and conditions of the financial instrument are narrow and specific. Moreover, a simplified fact pattern described in the submission could be complemented with a package of different features that may alter the conclusion.

    (b) introducing detailed guidance for each specific instrument could result in a rule-based approach. Some respondents also noted that issuing guidance on such a narrow issue could provide a case for a specific hybrid instrument, which is engineered to be close to the dividing line between equity and liabilities.

    (c) accounting for such complex financial instruments requires use of judgement and consideration of facts and circumstances and is dealt in practice through normal consultation processes.

    (d) another respondent noted that a new concept of distinguishing equity from liabilities is considered to be the only "sustainable solution".

19. One respondent noted that it will be helpful if the IASB clarifies this issue.

20. Consequently, we think that the instrument with the particular terms and conditions described in the submission is not common and the issue is not widespread.

## Assessment against agenda criteria

21. Our assessment against the Interpretations Committee agenda criteria[1] is as follows:

| Agenda criteria | |
|---|---|
| We should address issues (see paragraph 5.16 of the *IFRS Foundation Due Process Handbook*): | |
| that have widespread effect and have, or are expected to have, a material effect on those affected. | **No**, all respondents noted that the instrument is not typical in their jurisdiction. |
| where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods. | Not applicable. |
| that can be resolved efficiently within the confines of existing IFRS and the *Conceptual Framework for Financial Reporting*. | Not applicable. |
| In addition: | |
| Is the issue sufficiently narrow in scope so 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 IFRS (see paragraph 5.17 of the *IFRS Foundation Due Process Handbook*)? | **No**, the terms of the financial instrument under issue are very specific. We think that it is not cost-effective for the Interpretations Committee to undertake the due process. |
| Will the solution that was developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21 of the *IFRS Foundation Due Process Handbook*)? (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.) | **No**, IFRS 9 *Financial Instruments* would not require bifurcation for hybrid contracts with financial asset hosts. Thus it will resolve the issue whether an instrument should be classified before or after identifying embedded derivatives. |

## Staff recommendation

22. Based on the responses to the outreach request, we observed that the fact pattern submitted is not typical and the issue is not widespread.

23. We believe that specifying accounting for a particular financial instrument would not be efficient and could result in a rule-based guidance, taking into account that:

[1] These criteria can be found in the *IFRS Foundation Due Process Handbook* .

(a) the financial instrument described in the submission is very specific; and

(b) the terms of the particular instrument could be complemented with different features that may alter the conclusion.

Thus, we think that the issue is too narrow and cannot be addressed by the Interpretations Committee in an efficient manner. Instead, an entity should determine the classification based on terms of a particular instrument and the existing guidance in IFRS.

24. We also note that IFRS 9 would resolve the issue whether hybrid contracts with financial asset hosts are classified before or after identifying embedded derivatives. IFRS 9 would not require bifurcation for such contracts, and the holder would need to assess the classification of the instrument as a whole. Thus, we do not believe that developing accounting requirements on this issue will be effective for a reasonable time period.

25. The IFRIC discussed a similar issue in November 2006 (the decision taken and staff's analysis is presented in Appendix B of this paper) and noted that existing guidance in IAS 39 is sufficient. On this basis the IFRIC decided not to add the issue onto its agenda.

26. Therefore, we think that the Interpretations Committee's agenda criteria 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 in Appendix A of this paper.

| Questions for the Interpretations Committee |
| --- |
| 1. Does the Interpretations Committee agree with the staff's recommendation not to add the issue to its agenda?<br><br>2. If the Interpretations Committee agrees with the staff recommendation, does it agree with the proposed wording of the tentative agenda decision as set out in the Appendix A? |

## Appendix A
## Proposed wording for tentative agenda decision

A1 The proposed wording for the tentative agenda decision is presented below.

**IAS 39 *Financial Instruments: Recognition and Measurement*—Classification of a hybrid financial instrument by the holder**

The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the classification of a hybrid financial instrument with a revolving maturity option, an early settlement option and a suspension of interest payments option (all at the option of the issuer) by the holder. Specifically, the submitter raises a question if the host of such financial instrument should be classified by the holder as an equity or as a debt instrument under IAS 39 *Financial Instruments: Recognition and Measurement*.

Based on the responses to the outreach request the Interpretations Committee observed that the issue is not widespread.

The Interpretations Committee also noted that the financial instrument under issue is too specific and the issue cannot be addressed by the Interpretations Committee in an efficient manner.

Regarding the question whether the instrument should be classified before or after identifying embedded derivatives, the Interpretations Committee noted that IFRS 9 *Financial Instruments* would not require bifurcation for hybrid contracts with financial asset hosts and a holder would be required to classify the instrument as a whole. As a result, the Interpretations Committee considered that developing accounting guidance on this issue would not be effective for a reasonable time period.

The Interpretations Committee considered that its agenda criteria are not met. Consequently the Interpretations Committee [decided] not to add this issue to its agenda.

## Appendix B—Decision previously taken by IFRIC on classification of a hybrid financial instrument by the holder (November 2006 and January 2007)

B1 In November 2006 the IFRIC discussed an issue on classification of a hybrid financial instrument by the holder[2], in particular the following questions were analysed:

(a) whether the accounting for financial instruments in the financial statements of the holders should be symmetrical with that in the financial statements of the issuer; and

(b) whether the holder should assess the classification of the instrument as a whole or after identifying all embedded derivatives.

B2 With respect of the first question the IFRIC noted that:

> IAS 32 and IAS 39 do not directly address whether the accounting for financial instruments in the financial statements of the holders should be symmetrical with that in the financial statements of the issuer. However, the IFRIC noted that the issuer of a financial instrument is required to classify it in accordance with IAS 32, whereas the holder is required to classify and account for it in accordance with IAS 39.
>
> The IFRIC noted that IAS 39 requires the holder to identify embedded derivatives of hybrid financial instruments. IAS 39 also requires the holder to account for the embedded derivatives separately if all the conditions in IAS 39 paragraph 11 are met. These requirements apply to the holder regardless of whether any embedded derivatives are accounted for separately in the financial statements of the issuer. In the light of the existing guidance in IAS 39, the IFRIC decided that the first issue should not be taken onto the agenda.

[2] The full text of the observes notes: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2006/November/3rd/0611-AP12ii-IAS-27-obs.pdf

IFRIC update for November 2006 (tentative agenda decision on page 11): http://www.ifrs.org/Updates/IFRIC-Updates/2006/Documents/IFRIC0611.pdf

IFRIC update for January 2007 (agenda decision on page 5): http://www.ifrs.org/Updates/IFRIC-Updates/2007/Documents/IFRIC07013.pdf

B3 With respect of the second question, the agenda paper stated that the holder should determine the residual (the host contract) after identifying all embedded derivatives.

B4 In January 2007 the IFRIC finalised its decision not to take the issue onto its agenda in the light of the existing guidance in IAS 39.

B5 The staff analysis of this issue is reproduced below[3]:

**STAFF ANALYSIS**

***1st issue***

23. IAS 32 requires the recognition of a financial liability when the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. A financial instrument is classified as equity in IAS 32 if it is not a financial liability. IAS 32.11 defines an equity instrument as a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

24. Similarly, for a compound financial instrument that contains both a financial liability and an equity component, IAS 32 requires that the financial liability component be identified and measured first on initial recognition of the financial instrument.

25. Holders of financial instruments are required to classify and account for the financial instruments in accordance with IAS 39 (not IAS 32).

26. IAS 39 first requires the identification of an embedded derivative. IAS 39.10 requires the identification of the effect of those cash flows of a hybrid instrument that vary in a way similar to a stand-alone derivative (also see BC 77(a) of IAS 39). After an embedded derivative is identified, the remaining non-derivative component is the host contract.

27. IAS 39 also requires the measurement of embedded derivatives first. AG 28 of IAS 39 states that the initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

28. The staff notes that AG 33A of IAS 39 states that:

[3] The full test of the observes notes: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2006/November/3rd/0611-AP12ii-IAS-27-obs.pdf

'When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently.''

29. Therefore, in determining how to account for a hybrid instrument in the financial statements of the holders, the staff believes that holders of the financial instrument need to:

- Step 1: identify embedded derivatives;
- Step 2: determine whether the remaining (i.e. the host) is a debt or an equity instrument; and
- Step 3: determine whether the characteristics and risks of any identified embedded derivatives are closely related to those of its host contract.

*Identifying embedded derivatives*

30. Under IAS 39.10, an embedded derivative is a component of a hybrid (combined) instrument that includes a non-derivative host contract- with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

31. In the process of identifying embedded derivatives, the holders should bear in mind the following:

- any identified embedded derivatives should meet the definition of a derivative (see IAS 39.10 and IAS 39.11[4]);
- in the absence of implied or stated terms, judgement is required. However, a cash flow that does not exist in the terms of the hybrid instrument cannot be created (see C.1 of the Guidance on Implementing IAS 39);
- for any non-option embedded derivatives, the fair value on initial recognition of the hybrid instrument should have a fair value of zero. Otherwise, there will be an infinite number of embedded derivatives (see C.1 and C.2 of the Guidance on

[4] A derivative is a financial instrument that contains the following three characteristics: (i) its value changes in response to an underlying; (ii) it requires no initial net investment; and (iii) it is settled at a future date.

Implementing IAS 39); and

- for any option-based embedded derivatives, the fair value does not need to be equal to zero on initial recognition of the hybrid financial instrument.

32. In addition, AG 29 of IAS 39 states: 'Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. If an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.'

33. Based on the information available in the illustrative example, an option-style derivative (representing the holders' right to exchange equity interest in the issuer of the puttable instruments for a variable amount of cash) is embedded in the puttable instruments.

*Determining whether the host is a debt or an equity instrument*

34. After identifying embedded derivatives, the next step is to determine whether the remainder (i.e. the host) is a debt or an equity instrument. The host of a hybrid financial instrument should be of non-derivative nature (see IAS 39.10).

35. The classification of whether the host is a debt or an equity instrument is important because the accounting for a debt and an equity instrument may be different under IAS 39. For example, the accounting treatments for an available-for-sale debt investment and for an available-for-sale equity investment are different in terms of (i) whether previously recognised impairment losses can be reversed[5]; and (ii) how transaction costs are accounted for[6].

36. IAS 39 provides some guidance on how to determine whether a host contract is a debt or an equity instrument, as follows:

- AG 27 of IAS 39 states: 'If a host contract has no stated or predetermined maturity

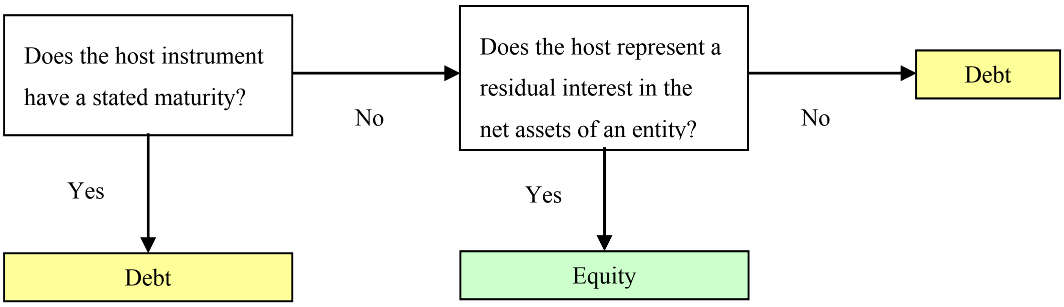
[5] IAS 39.66 requires that, for unquoted equity instruments that are measured at cost less any impairment losses because their fair values cannot be measured reliably, previously recognised impairment losses cannot be reversed in subsequent periods.

[6] AG 67 of IAS 39 states that: 'If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.'

and represents residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.'

- C.5 of the Guidance on Implementing IAS 39 states: 'The host contract is a debt instrument because the hybrid instrument has a stated maturity.'

37. Taken together, the guidance in AG 27 of IAS 39 and C.5 of the Guidance on Implementing IAS 39 can be shown as a decision-tree in determining whether the host contract is a debt or an equity instrument for the purposes of the preparation of the financial statements of a holder of a financial instrument, as follows:




38. An embedded option is identified in the illustrative example (see paragraph 33 of this agenda paper). The remaining contract, which represents a residual interest in the net assets of the issuer, is an equity instrument.

*<u>Determining whether any identified embedded derivatives are closely related to the host contract</u>*

39. IAS 39.11 states: 'An embedded derivative shall be separated from the host contract and accounted for as a derivative under IAS 39, if and only if: (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).'

40. Whether or not the host contract and an embedded derivative are closely related depends

on the nature of the host contract and the embedded derivative.

41. IAS 39 provides two lists of examples describing circumstances where embedded derivatives are closely related to the host contract and circumstances where embedded derivatives are not closely related to the host contract (see AG 30 and AG 33 of IAS 39).

## Appendix C—Submission received

C1 We received the request below. All information was copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

**IFRS IC Potential Agenda Item – Holders' classification of a hybrid financial instrument with a revolving maturity option**

**<u>The issue</u>**

In terms of holders, IAS 39 seems to lead to different accounting treatments for financial instruments in which an issuer has options of revolving maturity, early settlement and suspension of interest payments.

**<u>Background</u>**

An issuer would classify a 'hybrid instrument as a whole' that is issued under the following main terms and conditions as equity according to IAS 32.

**<Main terms and conditions of the hybrid instrument at issue>**

| | Main terms and conditions |
|---|---|
| Principal payment | ▪ Maturity: 30 years |
| Interest payment | ▪ Fixed interest rate: Government bond interest rate + spread<br>▪ Step-up of coupon: Spread to be stepped up after 10 years<br>▪ Reset of benchmark interest rate: The benchmark interest rate to be reset every 10 years after the issuance |
| Early settlement option | ▪ The issuer may choose to repay before maturity after 10 years from the date of issuance<br>▪ No contractual obligation for early settlement |
| Revolving maturity option | ▪ Revolving every 30 years (at the option of the issuer) |
| Interest payment stop option | ▪ Skipping interest payment (at the option of the issuer)*<br>▪ The issuer cannot skip interest if it pays dividends on common stock<br>▪ Also, the issuer cannot pay dividends on common stock if it skips interest |

* For some cases of similar hybrid instruments, an issuer can defer interest payment (compound

interest is applied to accumulated interests at the time of interest payment) instead of skipping interest payment.

However, there are different views among the holders of this instrument on how to identify its host contract and embedded derivatives.

Some argue that the holder should identify the host contract as an equity instrument at first and then identify the residual component of the hybrid instrument as embedded derivatives such as the early settlement option (View 1).

Alternatively, others suggest that the holder should identify the host contract as a debt instrument with the stated maturity of 30 years, after identifying embedded derivatives such as the early settlement option, the revolving maturity option and the interest payment stop option (View 2).

**Discussion**

The rationales for each view are as follows:

***View 1: The host contract is an equity instrument***

The hybrid instrument at issue represents the residual interest in the net assets of the issuer, as it meets the definition of equity instrument in IAS 32. In addition, it has no stated maturity in substance, as the issuer is able to defer the payment of principal at the issuer's discretion. Therefore, the holder of the hybrid instrument should identify its host contract as an equity instrument.

The holder, first of all, should determine the host contract and then identify embedded derivatives based on the host contract. As the next step, the holder should determine whether to separate them from the host contract or not.

If the host contract is determined after identifying embedded derivatives first, the holder would account for the residual, i.e., the host contract, as a debt instrument for which the payment of principal is fixed. However, the hybrid instrument at issue does not have such a feature in substance. In addition, the determination of the host contract after identifying embedded derivatives is not consistent with Guidance C.1 in IAS 39 which states as follows;

*An entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist.*

The hybrid instrument includes a revolving maturity option, and the issuer's contractual right to avoid the repayment of principal for an indefinite period of time constitutes an essential characteristic of an equity instrument. As such, the holder should not separate the hybrid instrument into a debt instrument and a revolving maturity option.

In addition, the holder should separate the early settlement option from the host contract in accordance with IAS 39. The early settlement option is a call option for an equity instrument, as the hybrid instrument is basically a combination of a host equity contract and an embedded call option.

***View 2: The host contract is a debt instrument***

In November, 2006, the IFRIC noted that IAS 32 and IAS 39 do not directly address whether the accounting for hybrid instruments in the financial statements of the holder should be symmetrical with that in the financial statements of the issuer. However, the IFRIC decided that the issuer of a hybrid instrument is required to classify it in accordance with IAS 32, whereas the holder is required to account for it in accordance with IAS 39.

According to the decision of the IFRIC, a hybrid instrument classified as an equity instrument by the issuer should not be always classified as an equity instrument by the holder. The agenda paper 12(ii) of the IFRIC meeting in November, 2006 states that the holder should determine the residual, i.e., host contract, after identifying all embedded derivatives.

The options such as early settlement option, revolving maturity option and interest payment stop option should be identified as embedded derivatives in accordance with IAS 39, as these options may cause the cash flows (from a 30-year debt instrument without those options) to be modified according to some variables such as the issuer's credit spread. After all embedded derivatives are identified from the hybrid instrument, only a debt instrument with a stated maturity of 30 years will be left. Therefore, this debt instrument should be identified as the host contract.

The host contract can be regarded as an equity instrument only under an assumption that the issuer will not exercise the early settlement option but certainly exercise the revolving maturity option. But this assumption may not be consistent with expectations of market participants or investors for this type of hybrid instrument. In addition, if the host contract is identified as an equity instrument under this unreasonable assumption, the host contract and embedded derivatives are identified in a manner that would result in creating cash flows of undated equity instrument which does not exist in the stated or implied substantive terms of the hybrid instrument.

**Investors' comments on subsequent measurement and accounting issues against view 1**

(1) If the host contract is an equity instrument, expected future cash flows from the host contract will

be substantially zero.

Only when revolving maturity option and interest payment stop option are all exercised and the issuer has no obligation to pay principal and interest, the host contract can be an equity instrument. However, if revolving maturity option and interest payment stop option are all exercised, the value of the host contract is zero because there are no expected future cash flows. The fact that revolving maturity option and interest payment stop option may be or may not be exercised indicates that those options would be embedded derivatives.

(2) Separation of the early settlement option from the host equity contract will increase the holder's P&L volatility.

If the host contract is identified as an equity instrument and classified as available for sale,[7] the holder has to separate the host contract and the early settlement option, although the fair values of the host contract and the option change depending on the market interest rate with a close relationship.[8] If the hybrid instrument is classified as available for sale and the host contract is identified as an equity instrument, there will be an accounting mismatch because while a gain or loss arising from a change in the fair value of the host equity contract should be recognised in other comprehensive income, a gain or loss arising from a change in the fair value of the early settlement option should be recognised in profit or loss.

The accounting mismatch will increase the volatility of the holder's P&L and then may cause a misunderstanding of the holder's performance.

(3) Impairment recognition for the host equity contract will increase holder's P&L volatility.

According to paragraph 61 of IAS 39, a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is objective evidence of impairment.

In the case of this type of hybrid instrument, if the host contract is identified as an equity instrument and the increase in risk-free interest rate is significant or prolonged, impairment would be recognised without any deterioration in the issuer's creditworthiness and any increase in the issuer's credit spread, as a decline in the fair value of the host equity contract below its cost is significant or

[7] This type of hybrid instrument is mostly classified as 'available for sale,' not 'held for trading,' because the main purpose of investors such as insurance companies and national pension fund is to hold the hybrid instrument until it is called as a long-term investment.

[8] An increase in market interest rate will result in a decrease in the fair values of the host equity contract (asset) and the early settlement option (liability). Meanwhile, a decrease in market interest rate will result in an increase in the fair values of the host equity contract (asset) and the early settlement option (liability).

prolonged.

According to paragraph 69 of IAS 39, impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale should not be reversed through profit or loss. Therefore, if risk-free interest rate is increasing, the holder may recognise the decrease in the fair value of the host equity contract as impairment losses. On the other hand, if risk-free interest rate is decreasing, the holder may recognise the increase in the fair value of the host equity contract as other comprehensive income.

This kind of accounting mismatch will also increase the volatility of the holder’s P&L and then may cause a misunderstanding of the holder’s performance.

**Question**

**Which view is appropriate for the holder’s classification of the financial instrument at issue?**