STAFF PAPER

13–14 May 2014

IFRS Interpretations Committee Meeting

Project	**IAS 32 *Financial Instruments: Presentation***
Paper topic	Accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

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Introduction

1. In January 2014, the IFRS Interpretations Committee (the Interpretations Committee) discussed how to account for a particular mandatorily convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*. The financial instrument has a stated maturity date and at maturity the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount—subject to a cap and a floor, which limit and guarantee, respectively, the number of equity instruments to be delivered.

2. This instrument was previously submitted to the Interpretations Committee (at the time called the IFRIC) and was discussed at meetings in July 2009, November 2009 and January 2010. At that time, the IFRIC decided not to add the issue to its agenda because the IASB's project on financial instruments with characteristics of equity ('the FICE project') was expected to address the issue. However, since the IFRIC's discussion in 2009 and 2010, the FICE project has been moved to the IASB's research agenda.

Description of the instrument

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

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

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

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

Alternative views

4. Agenda Paper 15 for the January 2014 Interpretations Committee meeting presented four alternative views regarding the accounting for this instrument. For simplicity, the accounting for the interest payments are ignored in the analysis below.

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

6. However, under IAS 39 and IFRS 9, the instrument is a hybrid financial instrument that contains a host financial liability to deliver as many equity shares as are worth CU1000 together with a cap and a floor on the number of shares

deliverable on conversion. The cap and floor are separable embedded (non-equity) derivative features and thus the issuer would separate them from the host contract and account for them at fair value through profit or loss. Since the embedded features relate to the same risk exposure (that is, the price of the issuer's equity share) and are not separately exercisable, they are treated as a single compound embedded derivative in accordance with paragraph AG29 of IAS 39 or paragraph B4.3.4 of IFRS 9[1].

7. Proponents of View 1 note that the embedded features may be analysed in two different ways with the same accounting outcome:

   (a) **View 1A**—The cap and the floor are net settled derivatives (ie the effect of the cap and the floor is that the number of equity shares delivered on conversion when the share price is above CU12.50 or below CU7.70 is increased or decreased respectively by the difference between (i) the number of shares that would have a total value of CU1000 as required by the host instrument and (ii) the minimum or maximum number of shares deliverable under the hybrid instrument of 80 and 130 respectively).

   (b) **View 1B**—The cap and the floor are identified as a derivative to exchange the stated principal amount of the host instrument of CU1000 (or, alternatively, the cash that would theoretically be payable if the instrument were redeemable at this amount) for either 80 or 130 equity shares–which is not a single fixed number of equity shares.[2]

8. **View 2**—The instrument has two components:

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

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

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

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

9. **View 3**—The instrument has three components:

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

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

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

10. The two derivatives described above in bullets (b) and (c) are both equity components because each individually satisfies the 'fixed-for-fixed' requirement in IAS 32.

11. **View 4**—The instrument has three components:

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

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

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

12. View 4 is a hybrid of Views 1A and 3 that has the same result as View 1.

Summary of the Interpretation Committee's discussion in January 2014

13. At its January 2014 meeting, the Interpretations Committee tentatively decided to not to add this issue to its agenda and noted the following:

    (a) The instrument is a non-derivative instrument that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 because the issuer has a contractual obligation to deliver a variable number of its own equity instruments. Although the variability is limited by the cap and the floor, the number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the instrument does not meet the definition of equity.

    (b) It is inappropriate to consider that there are separate conversion features for each of the scenarios in which the issuer will deliver a different number of its own equity instruments because the conversion outcomes are mutually exclusive. That is, IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity in that Standard.

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

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

Comments received

6. We received 8 comment letters on the Interpretations Committee's tentative agenda decision, which are attached to this paper as Appendix B. We have analysed the comments in the following paragraphs.

Comments on IAS 32 in general

7. In addition to commenting specifically on the tentative agenda decision, respondents raised some general concerns about the Interpretations Committee's approach to addressing IAS 32 issues. EY noted that the piecemeal consideration of individual complex financial instruments and the publication of associated agenda decisions increase the risk of unintended accounting consequences for other instruments for which the classification is well understood and accepted in practice. Some respondents expressed a preference for an approach that would address the classification of instruments as liabilities or equity in a more principles-based and comprehensive manner. EY noted that such an approach may be too broad for the Interpretations Committee; however it might be the best way to ensure that the Interpretation Committee is not asked to consider the accounting for many more complex financial instruments on a piecemeal basis. The AcSB suggested that the IASB address the instrument described in this paper as part of its comprehensive project on financial instruments with characteristics of equity. They noted that the IASB has already commenced work on that project and has also been discussing the distinction between liabilities and equity in its Conceptual Framework project.

Comments on the tentative agenda decision

8. Comment letters from ESMA, PWC and DTTL agreed with the Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision. However, DTTL are concerned that the third paragraph of the tentative agenda decision could be interpreted as suggesting that a separate embedded derivative would be recognised for each of the cap and the floor. Since the cap and the floor both relate to price risk and are not independent of each other, DTTL would expect the issuer to recognise a single compound

embedded derivative in accordance with paragraph AG29 of IAS 39 or paragraph B4.3.4 of IFRS 9.

9. Comment letters from AASB, AcSB and KPMG agreed with the Interpretations Committee's decision not to add this item onto its agenda, however they would like the rationale for its conclusions to be more robust and more clearly expressed.

10. The AcSB thinks that insufficient support is provided in the tentative agenda decision for identifying only one approach for accounting for this financial instrument to the exclusion of the alternatives identified in the staff paper. They also note that the staff paper did not explain how the alternative approaches were inconsistent with IAS 32. The AcSB questions whether IAS 32 provides sufficiently clear guidance. For these reasons, they disagree with the wording in the tentative agenda decision that states what is "inappropriate" in accordance with IAS 32, what IAS 32 "does not permit" or other similar descriptions. Similarly, the AASB suggested that if a clear rationale cannot be readily found in IAS 32 (which the AASB considers to be the case) then the agenda decision should instead indicate that the distinction between financial liabilities and equity is a broad issue that the Interpretations Committee cannot efficiently address on a timely basis.

11. KPMG suggested that the following changes to the proposed wording would better portray the technical rationale for the agenda decision:

    (a) Paragraph 4(c) of Agenda Paper 15 stated that the instrument includes a contractual obligation to pay interest but this is not mentioned in the draft tentative agenda decision. The statement in the draft agenda decision that the "instrument" meets the definition of a liability because the issuer has a contractual obligation to deliver a variable number of own equity instruments is not complete and accurate unless this contractual obligation is the only feature of the instrument. They recommend that this is addressed by changing the relevant sentence to: "The Interpretations Committee noted that the issuer's obligation to deliver a variable number of the entity's own equity instruments meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32."

(b) The last two sentences in the second paragraph of the tentative agenda decision are unnecessary and should be deleted. KPMG think that the preceding two sentences in the tentative agenda decision adequately express the Interpretations Committee's rationale. This respondent expressed the view that the agenda decision could instead be supplemented by noting that the contractual substance of the conversion feature is a single obligation to deliver a number of equity instruments at maturity that varies based on the value of those equity instruments and that such a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purposes of evaluating whether the instrument contains a component that meets the definition of equity. KPMG also said that if the Interpretations Committee wanted to substantiate its view further, it also could explain that ***any*** obligation to deliver a variable number of equity instruments could be divided into a multiplicity of fixed and variable sub-components with the objective of identifying an equity component. If this were permitted, it would be contradictory to the plain meaning and intention of the definitions in IAS 32.11.

12. Comment letters from EY and a preparer, Québecor, included a number of concerns about the tentative agenda decision. These respondents think that the technical analysis underlying the agenda decision should be reconsidered by the Interpretations Committee and published again as tentative before it is finalised.

13. Québecor believes that the Interpretations Committee's conclusion that an instrument meets the definition of a financial liability if it is mandatorily convertible into a variable number of the issuer's own shares (subject to a cap and a floor) will be misleading to investors and users of financial statements. Specifically, this respondent expressed the view that such classification does not necessarily reflect the economic substance of these instruments on the market.

They believe that these instruments have equity and non-equity components and should therefore be recorded accordingly as compound instruments. They disagree that the conversion feature should be viewed as a whole when the issuer assesses whether the financial instrument is comprised of one or more components. In their view, the fact that the conversion outcomes are mutually exclusive does not release the issuer from having to evaluate the substance of the terms of the mandatorily convertible instrument in accordance with IAS 32 to determine whether the instrument contains both equity and non-equity components. In addition, this respondent stated that the conversion feature is not a "conversion ***option***" because there are no settlement alternatives; the investor will definitely receive the issuer's shares at maturity. In their comment letter, Québecor offers an alternative analysis of the economics and rationale for classifying part of the instrument as equity.

14. EY agree that treating the instrument as a liability in its entirety is an acceptable interpretation of IAS 32. They also agree that it would follow from that analysis that the cap and the floor are embedded derivative features that should, under IAS 39 or IFRS 9, be accounted for separately from the host financial liability. However, EY do not think that this is the only interpretation of the requirements of IAS 32, which have inherent limitations. Therefore this respondent expressed the view that the alternative views in practice are legitimate interpretations of IAS 32.

15. EY also suggested that the rationale for the Interpretations Committee's conclusions should be better expressed. In their view, the basis for the Interpretations Committee's conclusions is unclear from the tentative agenda decision and the associated staff paper.

Staff analysis and recommendation

16. In the staff's view, the primary concern of some respondents regarding the tentative agenda decision focuses on whether IAS 32 permits the issuer to divide the obligation to deliver a variable number of shares into sub-components. We have reflected other comments on the drafting in Appendix A.

17. In particular, respondents were concerned by the statement that:

> …it is inappropriate to consider that there are separate conversion features for each of the scenarios in which the issuer will deliver a different number of its own equity instruments because the conversion outcomes are mutually exclusive. That is, IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity in that Standard.

18. In our view, the fact that financial instruments can be structured in different ways while resulting in the same economic outcome is the reason why IAS 32 prioritises the classification of liabilities. The analysis of any given instrument into a multitude of combinations of options and forwards is arbitrary and would reduce comparability. To counteract this, IAS 32 first defines a financial liability and then defines equity as any contract that evidences a residual interest in the assets of the entity after deducting all of its liabilities. So, instruments and components of instruments meet the definition of equity only if they do not meet the definition of a financial liability, either in isolation or in combination with other contractual features.

19. Even if an instrument has equity-like characteristics (for example, if changes in the value of the instrument reflects changes in the value of the issuer's own equity), that fact does not preclude classification as a liability if the instrument meets that definition. In our view, this is consistent with the IASB's conclusions regarding puttable instruments as noted in paragraph BC7 of the Basis for Conclusions on IAS 32. As noted in that paragraph, a share with an embedded put option meets the definition of a liability in its entirety.

20. Thus, the obligation to deliver a variable number of the entity's own equity instruments meets the definition in paragraph 11(b)(i) of IAS 32 in its entirety. Even though the number of shares to be delivered is limited and guaranteed by a cap and a floor, the overall number of shares to be delivered is ***not*** fixed. That is, the obligation is a non-derivative for which the entity is obliged to deliver a variable number of the entity's own equity instruments. That definition does not

have limits or a threshold regarding the amount or degree of variability that is required. In our view, this is consistent with the IASB's stated intention when it issued IAS 32, as described in paragraph BC4, to preclude equity classification for non-derivative contracts that are not for the receipt or delivery of a ***fixed*** number of shares. Put simply, if the number of equity instruments that the issuer is obliged to deliver is not fixed, then the instrument does not meet the definition of equity.

21. In addition, this conclusion would also be consistent with paragraph AG27(d) of IAS 32 which also states that:

> A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. **Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold.** Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability. [emphasis added]

22. In our view, paragraph 28 of IAS 32 does not apply to the instrument described in this paper because the whole instrument meets the definition of a liability. We disagree with the views that there is no guidance for paragraph 28, therefore the instrument could be separated into components. In our view, paragraph 28 applies when only part of an instrument meets the definition of a financial liability.

23. For example, consider the case of a simple convertible bond that is issued for CU1000 and includes an obligation either to deliver cash of CU1000 or to deliver 100 shares at the option of the holder. The obligation to deliver cash of CU1000

meets the definition of a financial liability in paragraph 11(a)(i) of IAS 32. However, this only captures part of the instrument (ie the component that meets the definition in paragraph 11(a)(i)). The obligation to deliver a fixed number of 100 shares does not meet any of the conditions in the definition of a financial liability in paragraph 11 of IAS 32, however it does meet the definition of equity in paragraphs 11 and 16. Thus the entity would apply paragraph 28 to separately classify that residual component as equity.

24. However, if the **only** outcome will be that the obligation will be settled with the delivery of a variable number of shares between 80 and 130, then the whole obligation meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32. There are no remaining contractual terms or features to analyse. The delivery of the number of shares set out in the floor is not, in the context of IAS 32, a separate component, because it is part of an obligation that meets a condition in the definition of a liability in its entirety.

25. In contrast, some of the views noted in paragraph 5–12 would require the entity to identify an equity component in isolation, and then classify the remaining terms as financial liabilities. In our view, this is not consistent with the definitions in IAS 32.

26. In our view, the above analysis is sufficient to conclude that the obligation to deliver a variable number of shares must be classified as a financial liability in its entirety in accordance with IAS 32.

27. We agree with the views that the last two sentences of the second paragraph in the Interpretations Committee's tentative agenda decision are not relevant and should be deleted.

28. Therefore, 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. The proposed wording of the final agenda decision is included as Appendix A to this paper.

Questions for the Interpretations Committee

(1) Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should finalize its decision not to add this issue to its agenda?

(2) Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the final agenda decision?

Appendix A—Proposed wording for the Agenda Decision

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

IAS 32 Financial Instruments: Presentation—accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

The Interpretations Committee discussed how an issuer would account for a particular mandatorily convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*. The financial instrument has a stated maturity date and at maturity the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount—subject to a cap and a floor, which limit and guarantee, respectively, the number of equity instruments to be delivered.

The Interpretations Committee noted <u>that the issuer's obligation to deliver a variable number of the entity's own equity instruments is a non-derivative that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 in its entirety.</u> ~~that the instrument is a non-derivative instrument that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 because the issuer has a contractual obligation to deliver a variable number of its own equity instruments.~~ Although the variability is limited by the cap and the floor, the number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the contractual obligation <u>meets the definition of a financial liability and</u> does not meet the definition of equity. ~~The Interpretations Committee noted that it is inappropriate to consider that there are separate conversion features for each of the scenarios in which the issuer will deliver a different number of its own equity instruments because the conversion outcomes are mutually exclusive. That is, IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity in that Standard.~~

Furthermore, the Interpretations Committee noted that the cap and the floor are embedded derivative features whose values change in response to the price of the issuer's equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those <u>features and</u> <u>account</u>

for the embedded derivative features separately from the host liability contract ~~and account for them~~ at fair value through profit or loss in accordance with IAS 39 or IFRS 9.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, an Interpretation was not necessary and consequently ~~[~~decided~~]~~ not to add the issue to its agenda.

Appendix B—Comment letters received

Accounting Standards Board
AcSB
CNC
Conseil des normes comptables

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April 14, 2014

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

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

Dear Sirs,

Re: Tentative agenda decision on IAS 32 *Financial Instruments: Presentation* — Accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the IFRS Interpretations Committee's tentative agenda decision on how an issuer would account for a particular mandatorily convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*. This tentative agenda decision was published in the January 2014 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. We think insufficient support is provided in the tentative agenda decision for identifying one approach as the appropriate basis of accounting for this financial instrument to the exclusion of the alternatives identified in the staff paper. We also note that the staff paper did not explain how the alternative approaches were inconsistent with IAS 32. We question whether IAS 32 provides guidance that is clear enough for the Committee to take a view. For these reasons, we disagree with the tentative agenda decision identifying what is "inappropriate", what IAS 32 "does not permit" or other similar descriptions.

We recommend instead that the IASB address this issue as part of its comprehensive project on financial instruments with characteristics of equity. We note that the IASB has already commenced work on that project and has also been discussing the distinction between liabilities and equity in its conceptual framework project.

We would be pleased to provide more detail if you require. If so, please contact me at +1 416 204-3276 (e-mail pmartin@cpacanada.ca), or Rebecca Villmann, Principal, Accounting Standards at +1 416 204-3464 (email rvillmann@cpacanada.ca).

Yours truly

Peter Martin

Peter Martin, CPA, CA
Director, Accounting Standards

European Securities and Markets Authority

The Chair

23 April 2014
ESMA/2014/429

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

Re: The IFRS Interpretations Committee's tentative agenda decision on IAS 32 – *Financial Instruments: Presentation* - accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

Dear Mr. Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

ESMA has considered the IFRS Interpretations Committee's (IFRS IC) tentative decision not to add to its agenda the request for clarification it received on the accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor, as in the light of its analysis of the existing IFRS requirements, no interpretation or amendment to the Standard was required. ESMA fully supports the conclusion expressed by the IFRS IC that it is inappropriate to consider that there are separate conversion features for each of the scenarios in which the issuer will deliver a different number of its own equity instruments because the conversion outcomes are mutually exclusive.

ESMA strongly believes that IAS 32 – *Financial Instruments: Presentation* does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of an equity instrument. ESMA is of the view that the analysis provided in the tentative agenda decision is useful for preparers and could contribute to a more consistent application of the IFRS requirements for the classification of this kind of instruments.

Furthermore, ESMA noted that during the January 2014 meeting, the IFRS IC decided not to finalise the agenda decision analysing the accounting requirements related to the classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non viability' event. The IFRS IC indicated that the scope of the issue raised is too broad and cannot be addressed in an efficient manner through an agenda decision.

ESMA understands that the IFRS IC concluded that IAS 32 is not sufficiently clear to finalise the tentative agenda decision published in July 2013 and that the tentative decision stating that the equity component is nil could have had unintended consequences (for instance in the case of a convertible bond with reimbursement if there is a change of control). However, in light of the economic environment and the expected issuance of contingent convertible instruments to meet the regulatory capital requirements, ESMA is concerned that the failure to finalise the agenda decision or to provide any additional guidance in this regard could lead to further diversity in practice.

As ESMA understands that the IFRS IC considers the issue to be too broad to be addressed, we believe that in light of its importance it would be appropriate for the IFRS IC to refer it to the International Accounting Standard Board (IASB). Considering the elements mentioned above, ESMA urges the IASB to deal with this matter as soon as possible.

We would be happy to discuss these issues further with you.

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

Cc: Hans Hoogervorst, Chairman, International Accounting Standards Board

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Wayne Upton
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7 April 2014

Dear Mr Upton

Tentative agenda decision - IAS 32 *Financial Instruments: Presentation*: Accounting for a financial instrument mandatorily convertible into a variable number of shares subject to a cap and a floor

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the January IFRIC Update of the tentative decision not to take onto the Committee's agenda the accounting for a financial instrument that is mandatorily convertible at a stated maturity date into a variable number of its own equity instruments to equal a fixed cash amount (subject to a cap and a floor).

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision. However, we are concerned that the third paragraph of the tentative agenda decision could be interpreted as suggesting that a separate embedded derivative be recognised for each of the cap and the floor. As the cap and the floor both relate to price risk and are not independent of each other then, in accordance with paragraph AG29 of the Application Guidance to IAS 39 *Financial Instruments: Recognition and Measurement*, we would expect a single compound embedded derivative to be recognised.

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

Yours sincerely

Veronica Poole
Global IFRS Leader

Building a better
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International Financial Reporting Standards Interpretations Committee
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7 April 2014

Dear IFRS Interpretations Committee members,

Tentative agenda decision – IAS 32 *Financial Instruments*: Presentation—Accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above tentative agenda decision of the IFRS Interpretations Committee ('Committee') published in the January 2014 *IFRIC Update*.

We have a number of reservations about the tentative agenda decision and have expanded on these in the appendix to this letter. However, in summary, our concerns are, as follows:

- The requirements in IAS 32 for determining whether and how 'financial asset', 'financial liability' and/or 'equity components' should be identified when classifying complex financial instruments contain inherent limitations, some of which have been evidenced by the Committee's recent work. Without additional guidance, it is inevitable that divergent, but legitimate, interpretations are likely to emerge.
- We are concerned that the piecemeal consideration of individual complex instruments and the publication of associated agenda decisions containing interpretative guidance increase the risk of unintended accounting consequences for other instruments, the classification of which is well understood and accepted.
- Whilst the technical analysis may be appropriate in this case, as we note in the appendix, it is unclear to us, from the tentative agenda decision and the associated staff paper, precisely what the basis is for the Committee's detailed conclusions in this case. It is important that a clear analysis is provided for the agenda decision for the following reasons: it will have an interpretative effect; it could have a profound impact on some entities' financial statements (given the diversity of interpretation noted by the staff); and, in particular, to guide preparers on interpreting IAS 32 in analogous circumstances.

Consequently, we consider that the agenda decision should not be finalised in its current form.

At a minimum, we believe the technical analysis underlying the agenda decision should be reconsidered by the Committee. Even if the Committee were to confirm the accounting conclusion in the tentative agenda decision, the underlying analysis should be explained to constituents and the decision re-exposed before finalisation.

Our preferred approach, however, would involve the development of principles-based guidance to help entities determine whether, and if so how, an instrument should be split into financial asset, financial liability and equity components and how those components should be identified. Such a project may be too broad for the Committee to address by itself. Nevertheless, in the absence of a comprehensive project to address the classification of financial instruments as equity and/or financial liabilities, this appears to be the best way to avoid the Committee being asked to consider the analysis of many more complex financial instruments.

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 – Detailed Comments

The main principles of IAS 32 were developed approximately 20 years ago, when the majority of financial instruments commonly used for raising finance tended to have simpler features than a number of instruments do now. It has long been clear that the classification requirements of IAS 32 can be difficult to apply consistently to more complex financial instruments, particularly those that appear to have both equity- and liability-like features.

It is evident from the number of recent requests to the Committee to provide guidance on the classification of complex financial instruments that the use of such instruments has increased. The scope of IAS 32 has also been extended in recent years to address the classification of contingent consideration in a business combination, including obligations that may be settled in equity instruments. This has led to the limitations of IAS 32 becoming more apparent.

One of the underlying reasons that IAS 32 can be so difficult to apply consistently is that virtually no guidance is provided on the constraints or principles to be applied when an entity is determining whether, and precisely how, to split a non-derivative financial instrument into financial asset, financial liability and equity components, in accordance with paragraph 28. Rather, the standard contains just two examples setting out how IAS 32 applies to those particular instruments[1] and a constraint which we discuss below. This is in contrast to IAS 39 (IFRS 9) which, whilst still requiring the application of judgement, contains more detailed guidance on when, and how, to separately account for derivative features embedded within a host contract.

It is therefore quite likely that diverse, but legitimate, conclusions will be drawn when dealing with instruments that are significantly different from those set out in the standard, as borne out in this case by the evidence obtained by the staff. In fact, the Committee itself has faced similar difficulties in coming to a consensus on the classification of a number of complex financial instruments. For example, it is our understanding that, when considering the classification of financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event, the Committee believed that it was unclear how IAS 32 ought to be read, and in what order the classification analysis would be performed. The instrument currently under consideration seems to give rise to similar issues.

We also struggle to reconcile the statement in the tentative agenda decision that 'IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity in that Standard' with the standard itself, at least, not in this context. The term 'conversion feature' is something of a misnomer here because it infers an exchange of equity instruments for something else such as cash or forgone repayment of principal. Such a feature would normally be considered a *derivative* involving the delivery of a reporting

[1] These are: (a) a simplified version of a relatively conventional convertible bond [particularly paragraphs 29, 32, AG31 to AG33 and IE34 to IE36]: and (b) a non-cumulative preference share requiring a mandatory repayment of principal or repayment at the option of the holder with discretionary coupons [paragraph AG37].

entity's equity instruments and we agree that IAS 32 contains no provisions for separating such instruments into components.

However, as stated in paragraph 17 of the Staff Paper, this instrument represents simply a *non-derivative* obligation to deliver between 80 and 130 equity instruments. Further, paragraph 28 requires a non-derivative financial instrument to be split into components when it contains both a liability and an equity component. Unfortunately, as noted above, virtually no guidance is provided in the standard on the constraints or principles to be applied when applying this paragraph. Consequently, for example, we don't understand the basis for saying the separation of such an obligation into an obligation to deliver 80 equity instruments (an equity component) and an obligation to deliver between 0 and 50 equity instruments (a liability component) would not comply with the requirements of IAS 32.

Whilst we share some of the concerns of the staff that almost any obligation to deliver a variable number of equity instruments could be 'sliced and diced' into sub-components that are classified as equity, this concern appears overplayed to some extent. For example, paragraph 21 of IAS 32 is absolutely clear that an instrument containing an obligation to deliver a variable number of equity instruments equal to a fixed or determinable value would be classified as a liability, rather than being split into a large number of components each of which would be classified as equity. This paragraph therefore acts as an important constraint in applying paragraph 28, ensuring that when equity instruments are being used as currency the related obligation is classified as a financial liability.

In recent months, the Committee has addressed the classification of a number of financial instruments in accordance with IAS 32, largely in isolation of each other. The standard is difficult to apply to some instruments, partly because there are so many different aspects to the classification requirements. We are concerned that this approach gives rise to a genuine risk that sensible and appropriate conclusions in the context of one specific instrument could give rise to unintended consequences for other instruments that are not apparent at the time of the decision. The streamlined due process associated with agenda decisions increases this risk.

For example, it is now becoming clear that some of the considerations applicable to financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event could have implications for the classification of partnerships' ownership interests. For example, whether discretionary non-cumulative payments should be associated with an equity component (possibly one ascribed a nil value on initial recognition) or a liability component is particularly relevant.

For the avoidance of doubt, we agree that treating the instrument as a liability in its entirety is an acceptable interpretation of IAS 32. We also agree that it would follow from this analysis that the cap and the floor are embedded derivative features that should, under IAS 39 or IFRS 9, be accounted for separately from the host financial liability. However, we remain unconvinced by the Committee's conclusion that this is the only interpretation.

pwc

IFRS Interpretations Committee
1st Floor
30 Cannon Street
London
EC4M 6XH

19 March 2014

Dear Committee Members,

Tentative agenda decision: IAS 32 Financial Instruments: Presentation – Accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

We are responding on behalf of PricewaterhouseCoopers to your invitation to comment on the above tentative agenda decision, published in the January 2014 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 conclusions 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 ('MCB instrument'). We believe IAS 32 is clear and hence agree with the tentative decision not to add this issue to the agenda. In particular we agree that the MCB instrument should be viewed as an obligation to deliver a variable number shares which is a non-derivative liability as defined in IAS 32 paragraph 11(b)(i). We also agree the instrument also contains embedded derivatives that should be separated from the host liability contract and accounted for at fair value through profit or loss (unless the entire instrument is measured at fair value through profit or loss using the fair value option).

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 International Ltd

PricewaterhouseCoopers

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14 March 2014

Mr Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Wayne

Tentative agenda decision - IAS 32 *Financial Instruments: Presentation* – accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

The AASB is pleased to respond to the IFRS Interpretations Committee's tentative decision (published in the January 2014 IFRIC Update) not to add to its agenda a request to clarify the accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor.

In the tentative decision, the following views are expressed:

- the instrument is a non-derivative instrument that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 because the issuer has a contractual obligation to deliver a variable number of its own equity instruments;

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

- it is inappropriate to consider that there are separate conversion features for each of the scenarios in which the issuer will deliver a different number of its own equity instruments because the conversion outcomes are mutually exclusive. That is, IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity in that Standard.

Whilst the AASB agrees with the IFRS Interpretations Committee's tentative decision not to add the issue to the Committee's agenda, the AASB has concerns that a strong rationale for the conclusion is not expressed in the tentative agenda decision. In particular, the AASB notes that the views expressed in the second and third bullet points above have not been articulated by reference to the relevant paragraphs in IAS 32.

The AASB recommends that the tentative agenda decision be redrafted to provide a more robust discussion of the reasons why the conclusion reached is the most appropriate accounting treatment for the instrument. However, if a clear rationale cannot be readily found in IAS 32 (which the AASB considers to be the case) the agenda decision should instead indicate that the classification of debt and equity is a broad issue that may not be efficiently addressed by the Committee on a timely basis.

If you have any questions on the comments above, please contact me or Sue Lightfoot (slightfoot@aasb.gov.au).

Yours sincerely

K.M. Stevenson

Kevin M. Stevenson
Chairman and CEO

April 11,2014,

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

Dear Members of the IFRS Interpretations Committee,

Re: IAS 32 Financial Instruments: Presentation - accounting for a financial instrument that is mandatorilv convertible into a variable number of shares subject to a cap and a floor

Quebecor appreciates this opportunity to comment on IFRS Interpretations Committee tentative agenda decisions related to accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor.

Quebecor is one of Canada's largest media companies. As an issuer of mandatorily convertible debentures with a cap and a floor feature, we are sensitive to this issue.

Analysis of the economic substance of the instrument

We believe that the accounting treatment for a financial instrument that is mandatorily convertible into a variable number of shares, subject to a cap or a floor, should reflect the economic substance of the instrument.

For the purposes of this analysis, we suggest analyzing a simplified instrument (even simpler than the one discussed in the staff paper), similar to the one that we have issued and the economic substance of which is well documented in the financial literature. This instrument has the following characteristics:

(a) An entity issues a financial instrument for CU1000. The instrument has a stated maturity date. At maturity, the issuer must deliver a variable number of its own equity shares to equal CU1000 - subject to a maximum of 100 shares and a minimum of 80 shares.

(b) When the instrument was issued, the issuer’s share price was CU10. Therefore, the number of shares to be delivered, based on the share price at issuance, was equal to the 100-share cap. That means the holder of the instrument will not benefit from an equity price increase if the share price is between CU10.00 (minimum conversion price) and CU12.50 (maximum conversion price) per share at maturity. Therefore the holder will receive a fixed number of 100 shares if the share price is equal to or lower than the minimum conversion price and he will receive a fixed number of 80 shares if the share price is equal to or higher than the maximum conversion price.

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

According to concepts generally accepted worldwide by the financial community for economic analysis of this kind of instrument, the structure of the instrument allows an equity investor to trade a portion of the future upside on the stock price for fixed income on its investment. The economic value of the potential upside sacrificed to the benefit of the issuer by the investor (conversion premium) equals the present value of coupons on the debenture. Therefore, we would note that the interest payments are the main economic justification for the number of share cap and floor features on the instrument, and accordingly should not be excluded from the analysis for reasons of simplicity. As per the financial literature, the fair value of this instrument should be calculated on the following factors:

1) At issuance, the value of a fixed number of shares based on the maximum number of shares, which from the holder's point of view is equal to investing in the issuer's equity.
2) The value of an obligation to pay interest over the term of the convertible debenture, based on the present value of the future coupon payments.
3) The value of a call option written by the holder whereby the issuer can require the holder to sell the maximum number of shares at the minimum conversion price. This holder call option is an asset for the issuer.
4) The value of a call option written by the issuer whereby the holder can require the issuer to sell the minimum number of shares at the maximum conversion price. This issuer call option is a liability for the issuer.

Call options written by the holder and the issuer in 3) and 4) have a net asset value for the issuer that equals the present value of the coupon liability at issuance. The conversion premium or the difference in value between the maximum and the minimum number of shares represents the potential upside sacrificed to the benefit of the issuer by the investor, in exchange of coupons in 2).

These economic characteristics are analysed in Morgan Stanley Dean Witter's white paper entitled "Guide to PEPS: Premium Exchangeable Participating Securities" presented in the Appendix. This white paper also describes the different valuation methods used above. Because of its economic characteristics, this instrument trades on the market as an equity instrument. That is the case with the instrument issued by Quebecor. As well, the conversion premium is negotiated with investors as a concession for the payment of coupons (usually representing between 15% and 25% of the face value of the instrument for similar instruments issued in past years in North America and in Europe).

Strictly from an economic standpoint, as for most financial instruments, this instrument required an initial capital investment by the holder, who expects to generate a yield on its investment in the future. It is then very important to note that, according to the above simplified financial instrument characteristics, the cap and the floor limits on the number of shares affect exclusively future upside on the instrument (the expected yield), and that these limits have no impact on the initial investment by the holder. As such, any downside in the value of the shares affecting the initial investment is entirely assumed by the holder as any equity investor.

As for the instrument analysed in the staff notice, the main difference from the simplified instrument analysed previously is the additional downside protection to the benefit of the holder, up to the issuance of a maximum of 130 shares when the price of the stock decreases to CU7.70. From an economic standpoint, the value of this additional feature should be offset at the issuance date by a reduction in the coupon or an additional concession by the holder on the minimum number of share. At the end, the economic value of each feature should equal zero when added together, as the overall value of the instrument cannot be different from the face value at the issuance date.

Our comments on the staff paper

We believe the Committee conclusion that all instruments that are mandatorily convertible into a variable number of shares subject to a cap and a floor feature are financial liabilities will be misleading to investors and users of financial statements, as it does not necessarily reflect the economic substance of these instruments on the market. Moreover, we are of the opinion that these instruments are compound financial instruments and should therefore be recorded accordingly.

We disagree that the conversion feature should only be viewed as a whole to assess whether this financial instrument is comprised of one or more components or is a compound instrument. As demonstrated above, for a simplified instrument, these instruments incorporate a certain number of features in addition to conversion rights. IAS 32 clearly states in paragraph 28 that the issuer of a non-derivative financial instrument *“shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component.* This requirement has always been in line with the objective stated in paragraph 15 of IAS 32 of classifying a financial instrument, or its component parts, in accordance with the substance of the contractual arrangements within the definitions of a liability or an equity instrument. We are unable to find any technical guidance that would indicate that IAS 32 requires conversion features to be assessed as a whole.

In our view, the fact that the conversion outcomes are mutually exclusive does not release the issuer from having to evaluate the terms of the mandatorily convertible instrument to properly determine whether its components should be classified as a financial liability or asset or an equity instrument, based on the substance of this instrument as required by IAS 32. In addition, the conversion feature available to the investor is not a “conversion option” because there are no settlement alternatives; the investor is entitled to shares only at maturity.

More specifically, as for the simplified instrument analysed above, we believe that it is a misinterpretation of the instrument characteristics to view the whole instrument as a liability, based only on the variability in the number of shares to be issued on maturity, for the following reasons:

- In this case, the variability in the number of shares relates only to an upside in stock price (between the maximum and the minimum number of shares) that would have otherwise generated value on the instrument in excess of its initial value (at the issuance date), converting this upside into fixed income.
- The characteristics of the instrument do not provide the holder with any guarantee of the recoverability of its initial investment, as it is assuming 100% of the downside risk on its investment.
- Preventing the holder from participating in the upside in the underlying stock price (between the maximum and the minimum number of shares) generates a net asset for the issuer, offsetting its coupon liability. The net asset value represents the difference between the value of a call option that provides the issuer with all upside in price in excess of the conversion price at the maximum number of shares, and a call option that provides the holder with all upside in price in excess of the conversion price at the minimum number of shares.

The initial investment of CU1000 in the simplified instrument analyzed above has the same characteristics as an equity instrument, except for the conversion premium. It should be noted that this upside sacrifice in exchange for a coupon generally covers only a small portion of the potential future upside on the entity’s shares. Upside and downside in the value of a capital investment (non-derivative instrument) generated by the fluctuation in the price of an entity’s shares on the market are generally not recorded in income according to accounting standards (as for all equity investments). This won’t be the case should the initial investment in this instrument be recorded as a liability. When this investment is recorded in equity, only the fluctuation in the value of the conversion premium (in the form of the net asset value of 2 derivatives, as discussed above) and the present value of coupons are recorded in income, which from the perspective of the entity’s shareholders reflects the economic substance of the instrument, meaning the trade-off between the credit premium and the coupons. Regardless of this trade-off, the instrument holder incurs the same financial risk on its initial investment as the entity’s shareholders. The staff position fails to recognize the investor’s real economic position as a holder of common stock.

We believe instruments that provide for downside protection, in addition to an exchange feature that provides for an exchange of the upside in value for coupons, are less common on the market. However, we think that an economic approach similar to the one presented above should be considered to identify components for this kind of instrument. Accordingly, we believe that a more exhaustive analysis should be conducted before reaching a conclusion on the instrument analysed in the staff notice and on all similar instruments, and that an economic overview of each component should also be produced. Furthermore, we believe the staff conclusion represents fundamental changes to current standards on the accounting and classification of financial instruments, with significant impacts on the application of IAS 32.

From our perspective, each mandatorily convertible instrument should be separated into its components based on its specific parameters and economic characteristics as required by IAS 32. We believe that the identification of components should be based on the economic characteristics generally used worldwide by the financial community for valuation.

The approach based on economic substance should reduce diversity in reporting methods, resulting in an accounting treatment more in line with the way these instruments are viewed on the financial markets.

We thank you for considering our comments.

Sincerely,

Jean-Frangois Pruneau
Senior Vice President and Chief Financial Officer

Denis Sabourin
Vice President and Corporate Controller

Eric Denis
Senior Director, Financial Reporting

Appendix

Morgan Stanley Dean Witters white paper

Guide to PEPS: Premium Exchangeable Participating Securities

http://www.math.ust.hk/~maykwok/courses/FINA556/Sp2010/PEPS%20paper.pdf

KPMG

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Mr Wayne Upton
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Our ref MV/288
Contact Mark Vaessen

3 April 2014

Dear Mr Upton

Tentative agenda decision: *IAS 32 Financial Instruments: Presentation - accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor*

We appreciate the opportunity to comment on the IFRS Interpretations Committee's (Committee) tentative agenda decision, *IAS 32 Financial Instruments: Presentation - accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor*. We have consulted with, and this letter represents the views of, the KPMG network.

We agree with the conclusion in the tentative agenda decision and support the view that the instrument described in the Agenda Paper 15 *Classification of a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor* (January 2014 meeting) is a financial liability, and the cap and floor are embedded derivative features that should be separated.

However, we are concerned that the tentative agenda decision may be seen as containing incomplete and broad general statements that may obscure the technical rationale behind the decision reached by the Committee and have unintended consequences. We believe that the following changes should be made to the proposed wording in the draft agenda decision to portray better the technical rationale for the tentative agenda decision:

1) Paragraph 4(c) of Agenda Paper 15 stated that the instrument includes a contractual obligation to pay interest but this is not mentioned in the draft tentative agenda decision. The statement in the draft agenda decision that the "instrument" meets the definition of a liability because the issuer has a contractual obligation to deliver a variable number of own equity instruments is not complete and accurate unless this contractual obligation is the only feature of the instrument. We recommend that this is addressed by changing the relevant sentence to: "The Interpretations Committee noted that the issuer's obligation to deliver a

variable number of the entity's own equity instruments meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32."

2) The second paragraph of the tentative agenda decision states that "*The Interpretations Committee noted that it is inappropriate to consider that there are separate conversion features for each of the scenarios in which the issuer will deliver a different number of its own equity instruments because the conversion outcomes are mutually exclusive. That is, IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity.*" These are broad general propositions that do not seem necessary to deal with the particular issue and may cause confusion because:

- it is not clear why or how the fact that the "conversion outcomes are mutually exclusive" supports the notion that it is inappropriate to consider that there are separate conversion features;

- no other basis is provided for distinguishing a "conversion feature" that cannot be divided into multiple settlement outcomes from a case where there are "separate conversion features" although the wording may be read as implying that the result may be different in the latter case;

- the text refers generally to the treatment of "conversion feature[s]" which could encompass a wide variety of derivative features whereas the case considered by the Committee relates specifically to a mandatory conversion feature that is a non-derivative obligation.

Also, these sentences do not seem to counteract the view discussed in the agenda paper and apparently rejected by the Committee that there is an equity component equal to the obligation to deliver the floor number of equity instruments on the grounds that at least the floor number is deliverable in all scenarios because this view does not appear to involve separating based on mutually exclusive settlement outcomes.

Furthermore, the current proposed wording may be read as contradicting the view that a contract may meet the fixed-for-fixed requirement in paragraph 11(b)(ii) of IAS 32 if the number of shares to be delivered or the amount of cash to be received changes over the life of the contract but the change is predetermined at the inception of the contract - ie. for each of multiple exercise dates, the amount of cash and the amount of shares are both fixed. An example of this type of instrument may be the conversion feature in a convertible bond with a 2-year maturity that would convert into 100 shares at the end of year 1 or 120 shares at the end of year 2. We support this view and believe it is generally accepted among practising accountants even though the different settlement outcomes under the contract are mutually exclusive. Conversely, in the instrument discussed in the tentative agenda decision, the number of shares to be delivered under the contract on a specified maturity date is not determined at inception and this forms a more appropriate basis for the rationale for the tentative agenda decision.

The current proposed wording also does not appear to be consistent with the Committee's recent agenda decisions on:

- *IAS 32 Financial Instruments: Presentation—Classification of financial instruments that give the issuer the contractual right to choose the form of settlement* (September 2013) , and
- *IAS 32 Financial Instruments: Presentation—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* (January 2014) .

These decisions allowed for the possibility of equity classification, depending on the circumstances, based on mutually exclusive conversion outcomes.

We believe that the two sentences in the second paragraph of the tentative agenda decision quoted above are unnecessary and should be deleted, both for the reasons stated above and because the preceding two sentences in the tentative agenda decision would express the Committee's rationale adequately. The agenda decision could instead be supplemented by noting that the contractual substance of the conversion feature is a single obligation to deliver a number of equity instruments at maturity which varies based on the value of those equity instruments and that such a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purposes of evaluating whether the instrument contains a component that meets the definition of equity. If the Committee wanted to substantiate further the view taken, it also could explain that any obligation to deliver a variable number of equity instruments could be divided into a multiplicity of fixed and variable sub-components with the objective of identifying an equity component and allowing this would be contradictory to the plain meaning of IAS 32.11 and the apparent intention of the definitions therein.

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

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited