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Accounting Standards Committee of Germany
® IFRS-Fachausschuss

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IFRS Interpretations Committee
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Berlin, 13 September 2013

Dear Wayne,

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

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

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

Interpretation of the term "substance"

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

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

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

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

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

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

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

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

Clarification of the term "economic or business reasons"

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

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

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

Application of the principle stated in IAS 32.20(b)

In addition to being considered in interpreting the term "substantive" (see above), the guidance IAS 32.20(b) should have more weight in the assessment for itself. It states that in order to establish an indirect obligation (here: not to exercise the option), the value of the maximum number of shares must be determined to substantially exceed the other alternative(s). Hence, the standard acknowledges that even if there are situations where the value of the maximum number of shares exceeds the other alternative, an indirect obligation would not be established.

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

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

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

With kind regards,

Liesel Knorr
President