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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board meeting: 22 June 2006, London

Project: IFRIC Update

Subject: Classification of a financial instrument as a liability or equity (Agenda Paper 5C)

Background

1. At its March 2006 meeting the IFRIC discussed the role of contractual and economic obligations in the classification of a financial instrument under IAS 32 *Financial Instruments: Presentation*. For background, the staff include the IFRIC paper discussed at the meeting as appendix one.
2. At that meeting, the IFRIC agreed that IAS 32 is clear that a contractual obligation was necessary in order that a financial instrument be classified as a liability (ignoring the classification of financial instruments that may or will be settled in the issuer's own equity instruments). Such a contractual obligation could be explicitly established or could be indirectly established. However, the obligation must be established through the terms and conditions of the instrument. The IFRIC agreed that IAS 32 is clear that economic compulsion, by itself, would not result in a financial instrument being classified as a liability.
3. The IFRIC decided that, since the Standard is clear, it would not expect diversity in practice and would not take this item onto its agenda. The IFRIC

requested the staff to draft reasons for not adding this submission to its agenda.

4. All of the above decisions were duly reported in the IFRIC Update of March 2006, and also reported to the Board as part of the update on IFRIC activities.
5. At the May 2006 meeting, the IFRIC, while not disputing the effect of the standard it had accepted in March, failed to reach agreement on the reasons proposed by the staff. The Chairman withdrew the item.

Staff request to the Board

6. The staff believes that it would be helpful to the Board's constituents if the Board confirmed the position set out in paragraph 2 of this paper.

Appendix One - Observer Notes of paper discussed at the March 2006 IFRIC meeting

INFORMATION FOR OBSERVERS

IFRIC Meeting: 2 March 2006, London
Project: Classification of a financial instrument as liability or equity
– Agenda Paper 5 (REF NO IAS 32-02/4)

INTRODUCTION

1. The IFRIC has been asked to consider the classification under IAS 32 *Financial Instruments: Disclosure and Presentation* of two financial instruments - namely:
 - (a) **‘Step-up’ instrument** – an irredeemable callable financial instrument with dividends (fixed or variable) payable only if dividends are paid on ordinary shares (which themselves are payable at the discretion of the issuer). This instrument also includes a ‘step-up’ dividend clause that would increase the dividend at a pre-determined date in the future unless the instrument had previously been called by the issuer¹. On liquidation of the issuer, principal could either be paid out ahead of ordinary shares (but subordinated to other claims) or paid out ahead of ordinary shares and some other subordinated debt instruments (that themselves are classified as a liability under IAS 32).
 - (b) **Financial instrument (‘base’ instrument) linked to a debt instrument** – an irredeemable callable financial instrument with dividends (fixed or variable) that must be paid if interest is paid on another (or ‘linked’) instrument. The issuer must pay the interest on the

¹ The linkage to dividends on the ordinary shares and the ‘step-up’ clause creates an economic incentive for the issuer to pay dividends on the instrument and call the instrument - so the instrument is priced, and behaves, similarly to a debt instrument.

‘linked’ instrument² and hence the ‘linked’ instrument is classified as a liability. The submission specifically identified the issues of:

- i. The impact on the classification of the ‘base’ instrument of the relative size of the linked instrument to the ‘base’ instrument³
 - ii. The impact on classification of the ‘base’ instrument if the linked instrument is callable by the issuer at any time
2. This paper considers only those liabilities within the scope of IAS 32 and the (often contentious) dividing line that results in a financial instrument being classified as either a financial liability or equity.
3. Specifically, this paper considers:
 - (a) The definition of a liability and equity under *The Framework*
 - (b) The definition of a financial liability under IAS 32, including the role of statutory and contractual obligations
 - (c) The role of ‘substance’ in the classification of financial instruments
 - (d) The relationship between contractual obligations and the notion of ‘economic compulsion’
 - (e) The impact on classification under IAS 32 of obligations and ranking of those obligations arising on liquidation

SUMMARY OF STAFF ANALYSIS AND RECOMMENDATIONS

Summary of staff analysis

4. The staff believes that it is clear from *The Framework* definition that there must be a present obligation for a liability to exist. Liabilities within the scope of IAS 32 are those that arise from contractual present obligations. Conversely, IAS 32 identifies a critical feature of an equity instrument as

² It is hence very likely that the dividends will be paid (except maybe in extreme circumstances) on the ‘base’ instrument and so, economically, the ‘base’ instrument would be priced, and behave, like a debt instrument.

³ [Footnote omitted]

including no present contractual obligation to pay cash or transfer another financial asset.

5. Under IAS 32, such a financial contractual obligation may be explicitly established or may be indirectly established (as illustrated in paragraph 20 of IAS 32). However, the staff believes that IAS 32 is clear that any such obligation must be established through the terms and conditions of the financial instrument for that financial instrument to meet the definition of a financial liability under IAS 32.
6. The two examples of indirect contractual obligations found in paragraph 20 of IAS 32 both extend the definition of a financial liability found in paragraph 11 of IAS 32. This results in some liabilities (which otherwise would not be within the scope of IAS 32) being included within the scope of IAS 32.
7. The example in paragraph 20(a) of IAS 32 clearly illustrates, in the view of the staff, that any indirect obligation must arise through the terms and conditions of the financial instrument. The financial instrument in this example contains a non-financial obligation. However, a transfer of cash or another financial asset can only be avoided by settling the non-financial obligation and hence, under IAS 32, an indirect financial obligation is created. However, in order for this instrument to be classified as a financial liability, this indirect financial obligation must arise through the terms and conditions of the instrument⁴.
8. The staff believes that ‘economic compulsion’ does not play a role in the classification decision under IAS 32. However, once a financial obligation has been established through the terms and conditions, economic compulsion may then result in a particular form of settlement being more likely to occur. Hence, in the previous example, an indirect financial obligation is established through the terms and conditions of the instrument. If the value of the non-financial obligation was significantly greater than the indirect contractual financial obligation, economic compulsion would result in the instrument being settled in cash or by delivery of another financial asset.

⁴ IAS 32 contains further guidance to situations where there is no contractual obligation to deliver cash or another financial asset. For example, it is clearly stated in paragraph AG 26 that if payments are at the discretion of the issuer of a financial instrument, then the instrument should be classified as equity.

9. The staff believes that the original example included in paragraph 22 of IAS 32 (1998)⁵ of an undated preference share with contractually accelerating dividends was (as stated in that paragraph) intended to illustrate the notion of an indirect contractual obligation rather than to suggest that ‘economic compulsion’ (rather than a contractual obligation) could result in the classification of a financial instrument as a liability. As the Board noted in the Basis, this example was confusing (as clearly in that example, there was no contractual obligation!) and hence was replaced with the examples now found in paragraph 20 of IAS 32 (as revised in 2003).
10. In classifying a financial instrument, IAS 32 (and *The Framework*) requires the underlying substance to be considered. IAS 32 characterises ‘substance’ in terms of the contractual arrangements. However, in assessing the substance of the terms and conditions of a financial instrument, the impact of relevant local laws, regulations and the entity’s governing charter in effect at the date of classification should also be considered. This point was clearly articulated in IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments*. Also please refer to further comments in footnote 6 below.
11. Under IAS 32 an instrument is not prohibited from being classified as equity simply because the issuer has an obligation, conditional solely on liquidation, to settle the instrument. Furthermore, the staff believes that the seniority of a financial instrument does not play a part in classification under IAS 32 – otherwise, for example, all preference shares would be classified as liabilities (which is clearly not the case for irredeemable preference shares with discretionary dividends).
12. With respect to the ‘step-up’ instrument, the staff have the following summary comments:
- (a) There is no contractual obligation either to redeem the instrument or to ever pay a dividend. Even if the ‘step-up’ clause is activated, the entity still has no present contractual obligation to pay that dividend or to redeem the instrument.

⁵ See footnote 18 for the text of paragraph 22 of IAS 32 (1998).

- (b) The economic (and non-contractual) effect of either not redeeming the instrument or paying the increased dividends should, in the view of the staff, not be considered in the classification under the current wording of IAS 32.
 - (c) Furthermore, the staff believes that, under the going concern assumption of *The Framework*, obligations, and the seniority of payment of those obligations, which arise only on liquidation of an entity, should not be considered in the classification of a financial instrument required by IAS 32.
 - (d) The staff believes that this instrument, as described, should be classified as an equity instrument. However, the staff notes that such classification would not necessarily reflect the likely economic behaviour of this instrument, which would be priced, and behave, like a debt instrument.
13. With respect to a ‘base’ instrument linked to a debt instrument, the staff has the following summary comments:
- (a) The linkage to the debt instrument, on which interest is contractually obliged to be paid, results in a contractual obligation to pay dividends on the base instrument. This means that the base instrument is classified as a liability under IAS 32.
 - (b) The staff notes that this classification also reflects the expected economic behaviour of the base instrument as it is very likely that the dividends will be paid on the ‘base’ instrument (except maybe in extreme circumstances) and so economically the ‘base’ instrument would be priced, and behave, like a debt instrument
 - (c) With regard to the relative sizes of the ‘base’ instrument and ‘linked’ instrument, the staff believes that the key criterion in IAS 32 for an instrument to be classified as a financial liability is the existence of a contractual financial obligation. The mere existence of the linked instrument creates a contractual obligation with regard to the base instrument⁶.

⁶ [Footnote omitted].

- (d) If the linked instrument is callable by the issuer at any time, the issuer could avoid paying the dividends on the base instrument. However, until the linked instrument is called, a contractual obligation to pay dividends on the base instrument exists. [Remainder of paragraph omitted]⁷.

Staff recommendations

14. The staff believes that IAS 32 is clear with regard to the dividing line between a financial liability and equity – that a financial obligation must be established through the terms and conditions of the financial instrument⁸.
15. The staff is unsure whether there is widespread divergent interpretation in practice on these issues. If the IFRIC believes that there is widespread divergent interpretation in practice, then the IFRIC may wish to address this submission. However, should the IFRIC decide to follow this route, the staff believes that the IFRIC needs to provide clarity as to the reasons for (and contents of) an Interpretation.
16. If the IFRIC does not consider there to be widespread divergent interpretation in practice the staff recommends that the IFRIC does not address this submission, and the staff will suggest wording for the published reasons for rejection.

DEFINITION OF A LIABILITY AND EQUITY UNDER *THE FRAMEWORK*

17. A liability is defined in paragraph 49(b) of *The Framework* as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits”.
18. Paragraphs 60 – 64 provide further guidance to the definition of a liability. The key points include:
- (a) There must be a present obligation for a liability to exist
 - (b) An obligation is a duty or responsibility to act or perform in a certain way

⁷ [Footnote omitted].

⁸ Ignoring contracts that will or may be settled in the entity’s own equity instruments.

- (c) Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement
 - (d) Obligations can also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner
 - (e) A distinction must be drawn between a present obligation and future commitment (i.e. a liability cannot be recognised solely on the basis of a management decision)
19. Equity is 'defined' in *The Framework* as "the residual interest in the assets of the entity after deducting all of its liabilities". Hence, under *The Framework*, whether an item is equity depends upon whether an item does not meet the definition of a liability (i.e. it is a 'residual').

DEFINITION OF A FINANCIAL LIABILITY UNDER IAS 32

20. Paragraph 11 of IAS 32 defines a financial liability as any liability that is "a contractual obligation (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity..."⁹
21. Hence IAS 32 defines a financial liability in terms of:
- (a) *The Framework* definition of a liability (i.e. a financial liability is a subset of all liabilities under *The Framework*); and
 - (b) An obligation arising under a contract¹⁰.
22. Therefore, for a financial liability to exist there must be a contractual present obligation, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits¹¹. Paragraph BC7 of IFRIC 2 also states that "...under IAS 32, the terms of the contractual agreement govern the classification of a financial instrument as a financial liability or equity".

⁹ The rest of the definition deals with contracts that will or may be settled in the entity's own equity instruments.

¹⁰ Paragraph 13 of IAS 32 defines a contract as being an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid.

¹¹ IAS 32 defines the outflow of resources embodying economic benefits as the contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

23. The requirement for a contractual present obligation is also emphasized in AG25 and AG26, which make it clear that the fundamental characteristic of a financial liability is a contractual present obligation to transfer assets to the holder of an instrument - over which the issuer has no discretion.
24. Paragraph 16 of IAS 32 states that a financial instrument is an equity instrument only if the instrument contains no contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer¹² [emphasis added]. This is reinforced in paragraph 17, which states that “a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation...”

THE ROLE OF SUBSTANCE IN CLASSIFICATION

25. Paragraph 51 of *The Framework* states that in classifying an item as an asset, liability or equity attention should be paid to the underlying substance and economic reality and not merely its legal form.
26. Paragraph 15 of IAS 32 applies this principle when it states that “the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument” [emphasis added].
27. This paragraph (and the related guidance in AG26) is not in conflict with *The Framework*, but does narrow *The Framework* reference to ‘substance’ to the ‘substance of the contractual arrangements’ for financial instruments [emphasis added].
28. This is of course consistent with the fact that IAS 32 defines financial liabilities in terms of contractual obligations, and hence for the purposes of IAS 32 it is the substance of the contractual rights rather than, for example, the legal form, that should be considered; just because a financial instrument has the legal title of ‘shares’ does not mean that the instrument should be classified as equity under IAS 32.

¹² Ignoring instruments that will, or may, be settled in the issuer’s own equity instruments.

29. Hence, assets and liabilities that derive from statutory requirements imposed by government are not financial liabilities or financial assets (for example, income taxes). There must be a contractual arrangement. This is set out in paragraph AG 12 of IAS 32¹³.
30. ‘Statutory’ assets and liabilities, as described in the previous paragraph, should be distinguished from the effects of statutory requirements on contractual arrangements. As discussed in paragraph 5 of IFRIC 2, the terms and conditions of a financial instrument include relevant local laws, regulations and the entity’s governing charter in effect at the date of classification. However, any obligation under IAS 32 must still result from the contractual arrangements, and it must be a present obligation of the entity.

¹³ “Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 21 *Income Taxes*. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.”

CONTRACTUAL OBLIGATIONS AND ECONOMIC COMPULSION

Introduction

31. This section considers whether economic compulsion, rather than a contractual obligation, can result in a financial instrument being classified as a liability.
32. Paragraph 61 of *The Framework* states that “...the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party” [emphasis added].
33. This is echoed in paragraph 13 of IAS 32 which states that “...‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law.” [emphasis added]
34. However, the guidance in paragraph AG 12 of IAS 32 is clear that “Liabilities or assets that are not contractual...are not financial liabilities or financial assets”.
35. Paragraph 20 of IAS 32 states that a contractual obligation can be established either explicitly, or indirectly. However, any obligation must be established through the terms and conditions of the financial instrument¹⁴
36. Paragraph 20 provides two examples of indirect obligations arising from the terms and conditions of a financial instrument.

Paragraph 20(a) of IAS 32 – an indirect contractual financial obligation that can only be avoided by settlement of a non-financial obligation

37. Paragraph 20(a) states that if, under the terms of a financial instrument, an entity can avoid a transfer of cash or other financial asset only by settling a non-financial obligation, the financial instrument should be classified as a financial liability.

¹⁴ “A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions...” [emphasis added]

38. The definition of a financial liability in paragraph 11 refers only to a contractual obligation to deliver cash or another financial asset to another entity (or to exchange financial assets or financial liabilities with another entity under potentially unfavourable conditions). Paragraph 11 does not refer to the settlement of a non-financial obligation.
39. Paragraph 20(a) effectively extends the definition of a financial liability to circumstances in which, although there is no contractual obligation to deliver cash, a contractual obligation to deliver cash or another financial asset can be avoided only by settlement of a non-financial obligation. Hence, IAS 32 states that there is an implicit contractual obligation to deliver cash or another financial asset¹⁵.
40. Paragraph 20(a) therefore results in some liabilities (which otherwise would not be within the scope of IAS 32) being included within the scope of IAS 32.
41. Paragraph AG26 of IAS 32 discusses (amongst other things) the economic consequences of an entity either fulfilling or not fulfilling a non-contractual obligation. The guidance in AG26 states that the classification of a financial instrument should not be affected by factors other than the substance of the contractual arrangements (i.e. the economic consequences of a non-contractual obligation should not be considered in the classification of a financial instrument). For example, a history (and presumably an expectation by holders of that instrument) of the issuer making distributions, or an intention to make distributions in the future, should not affect the classification of a preference share as an equity instrument or a financial liability.
42. AG26 also clearly states that if payments are at the discretion of the issuer the instrument should be classified as equity¹⁶.
43. This is also consistent with paragraph A2 in Example 1 in the appendix of IFRIC 2, which states that “a history of, or intention to make, discretionary payments does not trigger liability classification” [emphasis added]

¹⁵ It is, however, not clear whether the non-financial obligation must be contractual.

¹⁶ “...When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments...”

44. Whilst the staff believes that IAS 32 is clear that only contractual obligations to deliver cash or another financial asset result in classification of a financial instrument as a financial liability, it is sometimes argued that the expectation of an entity making future dividend payments (an “economic” obligation) could fall within paragraph 20(a) of IAS 32 as a ‘non-financial’ obligation.
45. However, paragraph 20(a) applies only to financial instruments in which a contractual obligation to deliver cash or another financial asset can be avoided only by settlement of a non-financial obligation.
46. The only way for an entity to avoid an economic obligation to pay dividends is to redeem the financial instrument. However, if the redemption of the financial instrument is an ‘economic’ obligation (or ‘right’), not a contractual obligation then paragraph 20(a) is not applicable.
47. When taken together with the other guidance in IAS 32 (and notably that found in paragraphs AG25 and AG26), the staff believes that such non-contractual economic obligations should not be considered when classifying a financial instrument under IAS 32.
48. [Paragraph omitted]
49. However, once a financial obligation has been established through the terms and conditions, economic compulsion may then result in a *particular form of settlement being more likely to occur*. Hence, in the example set out in paragraph 20(a) of IAS 32, an indirect financial obligation is established though the terms and conditions of the instrument. If the value of the non-financial obligation was significantly greater than the indirect contractual financial obligation, economic compulsion would result in the instrument being settled in cash or by delivery of another financial asset. Also refer to comments in paragraphs 60 – 63.

Paragraph 20(b) of IAS 32 – an indirect contractual financial obligation arising from a cash settlement option in a contract on an entity's own equity

50. Paragraph 20(b) offers another example of an indirect contractual obligation and further extends the definition of a financial liability.
51. Paragraph 20(b) considers a situation in which an entity has the option to settle a financial instrument with either cash or another financial asset, or its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.
52. The entity has no contractual obligation to deliver cash or another financial asset, and no contractual obligation to deliver a variable number of its own shares - both of which circumstances would result in classification of the financial instrument as a financial liability.
53. However, the entity does have a contractual obligation to settle the financial instrument.
54. In example 20(b), the entity has effectively guaranteed the holder an amount that is at least equal to the cash settlement option¹⁷.
55. The example in paragraph 20(b) is consistent with the principles found in paragraph 21 of IAS 32. In paragraph 21, if the number of an entity's equity instruments that might be delivered under the terms of a financial instrument varies so that the fair value equals the amount of the contractual right or obligation (which itself may vary or be fixed in amount), that financial instrument cannot be classified as equity.
56. In the example of 20(b), whilst the number of shares may not vary (because, if they did, such a contract could never be classified as equity under IAS 32 in any case), the principle that the contractual terms of the financial instrument are *at least* guaranteeing the holder repayment of a fixed amount is applicable.
57. In substance, such a contract represents an obligation of a fixed specified amount, rather than a specified equity interest. As explained in BC13 of

¹⁷ Although, if of course the share price of the entity collapsed, such a guaranteed minimum amount might never be paid; in such a situation, it is likely the entity would be in significant financial difficulties, in which case it is unlikely the entity would be able to deliver the fixed amount of cash or another financial asset. Clearly, in such a situation, the underlying assumption of the entity being a going concern would be brought into question (see also the comments in paragraphs 64-68 regarding the impact of an obligation on liquidation on classification).

IAS 32, a contract to pay a specified amount (which in substance, the example in 20(b) is) is not an equity instrument.

58. Furthermore, as set out in BC14, the Board noted the possible structuring opportunities. The Board noted that “an entity should not be able to obtain equity treatment for a transaction simply by including a share settlement clause” when (in substance) the contract is for a specified value.
59. The example in paragraph 20(b) is also consistent with paragraph 26 of IAS 32, in which a derivative contract which gives one party a choice over how it is settled results in the contract being classified as a financial asset or a financial liability, unless all of the alternatives would result in it being classified as an equity instrument.

Paragraph 22 of IAS 32 (1998) – undated preference shares with a contractually accelerating dividend

60. Paragraph 22 of IAS 32 (1998) included an example of an undated preferred share with a contractually accelerating dividend, whereby in the foreseeable future the dividend yield would become so large that the issuer would be economically compelled to redeem the instrument¹⁸. The example was clear that the instrument should be classified as a liability.
61. This example illustrates that the notion of an indirect contractual obligation existed before IAS 32 was revised in 2003. Indeed, the staff believes (and the paragraph itself stated) that the purpose of this example was to illustrate the notion of an indirect contractual obligation. The example was deleted because (as stated in paragraph BC9), the Board “decided that the example ...was insufficiently clear”. In fact, the example of the undated preferred share contained no contractual obligation for the issuer to do anything! The example was replaced by the examples in paragraph 20 of IAS 32.
62. Paragraph BC9 makes it clear that the Board did not reconsider whether an obligation can be established implicitly rather than explicitly. As stated in

¹⁸ “...A preferred share that does not establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions. For example, a preferred share that does not provide for mandatory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer will be economically compelled to redeem the instrument. In these circumstances, classification as a financial liability is appropriate because the issuer has little, if any, discretion to avoid redeeming the instrument”.

paragraph BC9 “...the Board retained the existing notion that an instrument may establish an obligation indirectly through its terms and conditions” [emphasis added].

63. The staff believes that the example in paragraph 22 of IAS 32 (1998) was intended to illustrate how an indirect contractual obligation could be established – rather than to suggest that, even if no contractual obligation existed, a financial liability could be created.

IMPACT ON CLASSIFICATION OF RANKING ON LIQUIDATION

64. Under IAS 32 an instrument is not prohibited from being classified as equity on the basis that the entity has an obligation, conditional solely on liquidation, to settle the instrument. This is consistent with the underlying assumption in *The Framework* that financial statements are normally prepared on the basis that an entity is a going concern and will continue in operation for the foreseeable future.
65. Hence, ranking on liquidation does not affect the classification of a financial instrument. If it did, then all preference shares would be classified as liabilities under IAS 32 – and this is clearly not the case.
66. Under IAS 32 if there is no contractual obligation to redeem a financial instrument before liquidation or to pay dividends, then the financial instrument is classified as equity. Take, for example, an undated preference share; *if* an entity was liquidated such an instrument would be paid out before the ordinary shares. However, this does not prevent such a preference share being classified as equity (for example, see paragraph AG26 of IAS 32).
67. Obligations arising on liquidation of an entity are explicitly discussed in paragraph 25 of IAS 32, which covers the situation in which a financial instrument may require the issuer to deliver cash or another financial asset, or otherwise settle it in such a way that it would be a financial liability, in the event of the occurrence (or non-occurrence) of uncertain future events that are beyond the control of both the issuer and the holder of the instrument (i.e. contingent settlement provisions).
68. Paragraph 25 of IAS 32 explicitly excludes from consideration an entity’s obligations in the event of liquidation. The paragraph explains that an

instrument with contingent settlement provisions should be classified as a financial liability, unless the obligation arises only in the event of liquidation of the entity.