# STAFF PAPER

February 2016

REG IASB Meeting

| Project | Financial Instruments with Characteristics of Equity | | |
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| Paper topic | Claims with conditional alternative settlement outcomes | | |
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This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction

1. The objective of this paper is to discuss claims with alternative liability or equity settlement outcomes (alternative settlement outcomes) that are:

   (a) conditional on rights within the control of the entity; or

   (b) contingent on the occurrence or non-occurrence of uncertain future events beyond the control of both the entity and holder of the claim.

2. As part of the discussion we consider:

   (a) to what extent the Gamma approach, by the nature of the features it focuses on, reduces the set of claims that are affected by the challenges we identify; and

   (b) whether we should amend some of the existing requirements in IAS 32 to reflect the IASB's current thinking as reflected in the recent Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED).

3. Based on our analysis in this paper, in our preliminary view, for approach Gamma, the requirements for indirect obligations and contingent settlement alternatives should be:

   (a) updated to reflect the features used to identify a liability under approach Gamma. Under approach Gamma a liability settlement outcome would include either:

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

(i) an obligation to transfer economic resources other than at liquidation; or

(ii) an obligation for a specified amount independent of the entity's economic resources; and

(b) aligned with the 'no commercial substance' requirements in the Conceptual Framework ED, in particular:

(i) a claim with alternative settlement outcomes conditional on rights within the control of the entity is a financial liability if the equity settlement outcome has no commercial substance.

(ii) a term may have no commercial substance if it has no discernible effect on the economics of the contracts. Equity settlement outcomes with no commercial substance could include, for example, equity settlement outcomes for which the entity is legally prohibited from exercising, or equity settlement outcomes that are structured in such a way that their value always exceeds the liability settlement outcome.

4. As part of the analysis, we also identify some challenges that we will need to consider further in a future board meeting. These include:

(a) considering to what extent factors and circumstances beyond the contractual arrangement should be taken into consideration in classifying a financial instrument.

(b) considering the recognition and measurement of identified liability and/or equity components of instruments within the scope of this paper.

5. This paper is structured as follows:

(a) Background and scope (paragraphs 6–19)

(b) Issues considered in the past (paragraphs 20–37)

(c) Staff Analysis (paragraphs 38–101)

(d) Consequences for the other approaches we are developing (paragraphs 102–107)

(e) Appendix A—Summary of relevant requirements

## Background and scope

6. In October 2015 (Agenda Paper 5A), as part of our analysis of the challenges for some types of derivatives on own equity, we discussed some types of claims where the counterparty or holder has the right to choose between alternative settlement outcomes. For example, bonds convertible at the option of the holder into a fixed number of shares, or shares redeemable by the holder for a fixed amount of cash. Such claims impose an obligation on the entity, and will have a component that meets the definition of a liability, and in some cases, a component that meets the definition of equity.

7. In this meeting, we continue that discussion with a focus on alternative settlement outcomes that are:

   (a) conditional on rights within the control of the entity; or

   (b) contingent on the occurrence or non-occurrence of uncertain future events beyond the control of both the entity and holder of the claim.

8. Both rights to alternative settlement outcomes granted to the entity and alternative settlement outcomes contingent on future events present a variety of conceptual and application challenges. In simple terms, many of these challenges focus on establishing whether the entity, in fact, has the right to avoid a liability settlement outcome.

9. The Interpretations Committee[1] and the IASB have considered and resolved some of these challenges in the past. However, for other challenges there continues to be disagreement between interested parties regarding the existence of liability and/or equity components, and the requirements for their recognition and measurement.

10. The IASB also recently published proposed guidance on conditional liabilities in the IASB's Exposure Draft *Conceptual Framework for Financial Reporting* (Conceptual Framework ED). We consider as part of our analysis whether that proposed guidance helps the IASB consider some of the challenges identified.

[1] References to the Interpretations Committee include the IFRIC

11. Many of the challenges we identify in this paper will also be relevant for some types of derivatives on own equity, including purchased options of the issuer, or derivatives that are contingent on the occurrence of uncertain future events. However, we have limited the scope of this paper to non-derivatives, because we would like to focus on the critical issue of contingency and conditionality without getting into other complications. A future discussion of derivatives will also need to consider the application of the fixed-for-fixed condition and redemption obligation requirements, in addition to the issues discussed in this paper.

### *Challenges with alternative settlement outcomes conditional on rights within the control of the entity*

12. Some claims against an entity grant *the entity* the right to choose between alternative settlement outcomes, instead of granting that right to the counterparty or holder.

13. Notwithstanding the stated right of the entity to choose between alternative settlement outcomes in such claims, challenges include determining whether the claim, in substance, establishes an obligation that would meet the definition of a liability:

    (a) indirectly through its terms and conditions; or

    (b) as a result of economic compulsion.

14. Depending on the structure of the entity's rights and other facts and circumstances, there may be incentives for the entity to exercise their rights in a particular way. That is, the entity may be 'economically compelled' to exercise a liability settlement outcome. The IASB has made general statements that economic compulsion does not, by itself, create an obligation that is a liability. However, the implications of such a principle have proved controversial.

15. Examples of these instruments include:

    (a) issued preference shares that the entity is allowed to redeem on specific dates. However, if the preference shares are not redeemed, the redemption amount increases at an increasing rate over time (a type of

this instrument was considered by the Interpretations Committee in 2006 (discussed in paragraphs 21–25)).

(b) instruments that can be converted to a fixed number of ordinary shares at the issuer's option (a type of this instrument was considered by the Interpretations Committee in 2013 (discussed in paragraphs 26–29)).

(c) instruments that are mandatorily convertible into a variable number of shares, subject to a cap and floor, and which the entity has a right to settle at any time by transferring the maximum number of shares (a type of this instrument was considered by the Interpretations Committee in 2014 (discussed in paragraphs 30–34)).

### *Challenges with alternative settlement outcomes contingent on events beyond the control of both issuer and holder*

16. Some claims contain alternative settlement outcomes that are triggered by one or more future events that are beyond the control of the entity/issuer and the counterparty/holder.

17. Some of these events are clearly beyond the control of the entity and are not the focus of this paper. However, it is sometimes challenging to determine whether the event specified is within the control of the entity, or beyond its control, and therefore whether the claim establishes a liability. This is particularly the case when the event relates to the entity's future activities, financial performance, or financial position.

18. Examples of these instruments include:

(a) bonds that are convertible into ordinary shares of the entity if the entity's debt/equity ratio falls below a given percentage (a type of this instrument was considered by the Interpretations Committee in 2013 (discussed in paragraphs 35–37)).

(b) instruments that require cash settlement or redemption in the event of a change in control.

(c) instruments that require cash settlement or redemption in the event a future transaction with the entity occurs (such as an initial public offering).

(d) ordinary share conversion 'ratchets' which require the delivery of a variable number of ordinary shares on conversion of a bond or preference share, if the share price is lower than a specified amount.

19. Apart from the challenge of identifying whether some of these claims establish a liability, many of the issues discussed by the Interpretations Committee related to the measurement of the liability and equity components. Those challenges would be equally applicable to all claims with contingent alternative settlement outcomes. We will be considering measurement at a future meeting.

## Issues considered in the past

20. Both the IASB and the Interpretations Committee have considered the application of IAS 32 to some types of claims in the past. In this section we summarise previous discussions regarding the following:

(a) Callable preferred shares with resets (paragraphs 21–25)

(b) Redeemable preferred shares with an issuer's right to deliver a fixed number of shares instead of cash on redemption (paragraphs 26–29)

(c) 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 (paragraphs 30–34)

(d) Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event (paragraphs 35–37)

### *Callable preferred shares with resets*

21. In March 2006 the IFRIC received a request to clarify how an issuer would classify an irredeemable, callable financial instrument with dividends payable only if dividends are paid on the ordinary shares of the issuer (which themselves are payable at the unconditional discretion of the issuer). The instrument 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 issuer, and it has a higher priority on liquidation than subordinated (ie junior) ordinary bonds.

22. The IFRIC discussed the role of contractual obligations and economic compulsion in the classification of such a financial instruments under IAS 32. The IFRIC agreed that this instrument included no contractual obligation ever to pay the dividends or to call the instrument and that therefore it should be classified as equity under IAS 32. It therefore requested the staff to draft reasons for not adding the issue to its agenda. However, 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.

23. In response to a request from the IFRIC, in June 2006[2] The Board discussed whether so-called economic compulsion should affect the classification of a financial instrument (or a component of a financial instrument) under IAS 32. This issue had previously been debated at the IFRIC meetings in March and May 2006. For a financial instrument (or a component of a financial instrument) to be classified as a financial liability under IAS 32, the issuer must have a contractual obligation either[3]:

    (a) to deliver cash or another financial asset to the holder of the instrument, or

    (b) to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

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[2] June 2006 IASB Update

[3] Different requirements apply to financial instruments that may or will be settled in the issuer's own equity instruments.

24. The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

25. The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.

### *Redeemable preferred shares with an issuer's right to deliver a fixed number of shares instead of cash on redemption*

26. In September 2013, the IFRS Interpretations Committee received a request to clarify how an issuer would classify three financial instruments in accordance with IAS 32. None of the financial instruments had a maturity date but each gave the holder the contractual right to redeem at any time. The holder's redemption right was described differently for each of the three financial instruments; however in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments if the holder exercised its redemption right. The issuer was not required to pay dividends on the three instruments but could choose to do so at its discretion.

27. Furthermore, if the issuer decides to settle any of the financial instruments by delivering a fixed number of its own ordinary shares, the value of those shares does not exceed substantially the value of the cash settlement alternative. In other words, none of the financial instruments indirectly establish a contractual obligation to deliver cash, as described in paragraph 20(b) of IAS 32.

28. The Interpretations Committee noted that paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the issuer cannot achieve different classification results for financial instruments with the same contractual substance simply by describing the contractual arrangements differently.

29. The Interpretations Committee noted that a non-derivative financial instrument that gives the issuer the contractual right to choose to settle in cash or a fixed

number of its own equity instruments meets the definition of an equity instrument in IAS 32 as long as the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions. Paragraph 20(b) of IAS 32 provides the example that an indirect contractual obligation would be established if a financial instrument provides that on settlement the entity will deliver either cash or its own equity instruments whose value is determined to exceed substantially the value of the cash.

### *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*

30. In January 2014, The Interpretations Committee discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument in accordance with IAS 32. The 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. The cap and the floor limit and guarantee, respectively, the number of equity instruments to be delivered. The issuer is required to pay interest at a fixed rate. The issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, it must:

    (a) deliver the maximum number of equity instruments specified in the contract; and

    (b) pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

31. The Interpretations Committee noted that if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument.

32. The Interpretations Committee noted that the issuer cannot assume that a financial instrument (or its components) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of its own equity instruments. The Interpretations Committee noted that judgement will be required to determine whether the

issuer's early settlement option is substantive and thus should be considered in determining how to classify the instrument. If the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument.

33. The Interpretations Committee noted that the guidance in paragraph 20(b) of IAS 32 is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment. Specifically, the example in that paragraph describes an instrument that the issuer will settle by delivering either cash or its own shares and states that one of the settlement alternatives should be excluded from the classification assessment in some circumstances.

34. The Interpretations Committee noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. In making that assessment, the issuer could consider, along with other factors, whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms. The Interpretations Committee also noted that factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share price could be relevant to the assessment of whether the issuer's early settlement option is substantive. For example, the early settlement option may be less likely to have substance— especially if the instrument is short-lived—if the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor (ie the minimum). That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity.

### *A financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event*

35. The Interpretations Committee discussed how an issuer would classify a particular mandatorily convertible financial instrument in accordance with IAS 32 Financial

Instruments: Presentation. The financial instrument did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments if the issuer breached the Tier 1 Capital ratio (ie described as a 'contingent non-viability event'). The financial instrument is issued at par and the value of the equity instruments that will be delivered at conversion is equal to that fixed par amount. Interest payments on the instrument are payable at the discretion of the issuer.

36. Specifically the Interpretations Committee discussed the following issues:

    (a) Whether the financial instrument meets the definition of a financial liability in its entirety or must be classified as a compound instrument comprised of a liability component and an equity component (and, in the latter case, what those components reflect); and

    (b) How the financial liability (or liability component) identified above in bullet a. would be measured.

37. The Interpretations Committee decided not to add this issue to its agenda. The Interpretations Committee noted that the scope of the issues raised in the submission is too broad for it to address in an efficient manner.

## Staff analysis

38. As we have been discussing in previous meetings, whether a non-derivative claim meets the definition of a financial liability or of equity will depend on whether it has the relevant features identified. We are exploring different approaches to the distinction between liabilities and equity that focus on different sets of features to meet different information needs.

39. For the reasons stated in Agenda Paper 5, this paper will focus on the Gamma approach, and we will identify the consequences of Alpha and Beta in paragraphs 102–107.

40. The following analysis includes:

(a) to what extent the Gamma approach, by the nature of the features it focuses on, reduces the set of claims that are affected by the challenges we identify (paragraphs 42–47)

(b) the classification of claims that have alternative settlement outcomes under the Gamma approach, assuming those outcomes are within the control of the entity, are substantive and the entity has the practical ability to exercise the options (paragraphs 48–57)

(c) whether we should reconsider some of the existing requirements in IAS 32 in the light of the IASB's proposals in the recent Exposure Draft *Conceptual Framework for Financial Reporting*, including determining:

  (i) whether rights to alternative settlement outcomes are substantive (paragraphs 59–72)

  (ii) whether the entity has the practical ability to exercise a substantive right (paragraphs 73–91)

  (iii) whether the entity has the practical ability to avoid liability settlement outcomes that are contingent on uncertain future events (paragraphs 92–101)

41. As we mentioned in paragraph 19, instruments with alternative settlement outcomes that are clearly beyond the control of the entity are not the focus of this paper. For such instruments, the claim would have a financial liability and possibly an equity component. The next step would be to determine how to account for the components, including their measurement at initial recognition, and subsequent measurement and reclassification. Apart from the challenges of identifying whether some of these claims establish a liability, many of the issues discussed by the Interpretations Committee related to the measurement of those components. We will be considering measurement at a future meeting.

### *Alternative settlement outcomes under the Gamma approach*

42. Approach Gamma focuses the distinction between liabilities and equity on both

    (a) the **timing** of required settlement—which is relevant to assessing the extent to which the entity is expected to have the economic resources required when it is required to transfer them; and

    (b) the **amount** of economic resources required to settle the claim—which is relevant to assessing the extent to which the entity has:

        (i) sufficient economic resources to satisfy the total claims against it if they were all to be settled at a point in time; and

        (ii) produced a sufficient return on its economic resources to satisfy the promised return on claims against it.

43. To provide information to help those assessments, approach Gamma will classify as liabilities obligations:

    (a) to transfer economic resources **other than at liquidation**; or

    (b) for an **amount of economic resources independent** of the entity's economic resources.

44. In the staff's view, the Gamma approach will simplify and clarify the classification of a number of financial instruments that allow the entity to defer transferring economic resources until liquidation, but still require the transfer of a specified amount. This is because liability classification under the Gamma approach:

    (a) is not limited to identifying an obligation to transfer economic resources other than at liquidation.

    (b) includes obligations for a specified amount, even if the entity can defer transferring economic resources until liquidation, or can settle the claim by transferring a variable number of ordinary shares. For these types of instruments, the amount of any transfer is known, but the timing is unknown.

45. Hence, we can conclude that all of the settlement outcomes in the following instruments would be liability settlement outcomes under the Gamma approach (and the Beta approach) because they are obligations of a specified amount:

(a) Preference shares with a cumulative dividend and callable shares with a discretionary dividend that increases over time at a predetermined rate (with the effect that it is in fact cumulative). This is regardless of any unconditional right to defer transferring cash or other financial assets until liquidation.

(b) Claims for a specified amount to be settled either by transferring cash or financial assets, or by transferring a variable number of shares equal to a specified amount of cash or financial assets. This would be regardless of whether the alternative settlement outcome is at the option of the entity, the counterparty, or contingent on some future event.

46. Thus, the Gamma approach would classify as a liability callable preferred shares with resets without the need to consider any other requirements.

47. However, the Gamma Approach does not resolve all of the challenges identified. Some types of non-derivative claims will still contain alternative liability and equity settlement outcomes under the Gamma approach, such as:

(a) A reverse convertible bond—An instrument that includes an unconditional right of the entity to settle a claim either by transferring a fixed number of equity instruments (which would be an equity settlement outcome under the Gamma approach), or a specified amount of cash (which would be a liability settlement outcome under the Gamma approach).

(b) A callable share—An instrument that includes an unconditional right of the entity repurchase a claim that meets the definition of equity under the Gamma approach for a specified amount of cash (which would be a liability settlement outcome under the Gamma approach).

(c) Some types of contingent convertible bonds—Instruments that, contingent on the occurrence of uncertain future events[4], require the entity to settle a claim either by transferring:

(i) a fixed number of equity instruments (which would be an equity settlement outcome under the Gamma approach);

(ii) or a specified amount of cash (which would be a liability settlement outcome under the Gamma approach).

### *Classification of claims which grant the entity the unconditional right to alternative settlement outcomes under the Gamma approach*

48. IAS 32 paragraph 19 states that:

> If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability…

49. Implied in the above requirement is that, if the entity does have an unconditional right to avoid a liability settlement outcome, then the entity does not have a financial liability.

50. We consider whether the entity does have, in fact, an unconditional right to an equity settlement outcome in paragraphs 59–91. However, for the purposes of the following analysis we assume that the entity has a substantive right, and it has the practical ability to exercise it.

51. Under the Gamma approach, a liability settlement outcome would not only include an obligation to transfer economic resources, it would also include an obligation for a specified amount that does not require the entity to transfer economic resources other than at liquidation. As a consequence, if the requirement in paragraph 19 of IAS 32 is carried forward, then it will need to be modified to include the features under the Gamma approach. In other words, a

[4] As we mentioned in paragraph 19, if the uncertain event is clearly beyond the control of the entity, these types of instruments will establish a liability component, and in some cases, an equity component. Our focus in this analysis is on determining whether the uncertain future event is, in fact, within the control of the entity, thus affecting the classification of the instrument.

claim would meet the definition of a financial liability if an entity does not have both:

(a) an unconditional right to avoid transferring cash or other financial assets to settle the claim until liquidation; and

(b) an unconditional right to settle the claim at an amount that is not independent of the entity's economic resources.

52. Such a requirement would result in equity classification of non-derivative claims where the entity has an unconditional right to avoid the liability settlement outcome. Such claims might include the reverse convertible bonds and callable shares in paragraphs 47(a) and 47(b).

53. The classification as equity of the reverse convertible bonds would be consistent with the Interpretations Committee's conclusion that a non-derivative financial instrument that gives the issuer the contractual right[5] to choose to settle in cash or a fixed number of its own equity instruments meets the definition of an equity instrument in IAS 32.

54. Classifying the instruments in paragraphs 47(a) and 47(b) as equity under Gamma will show that, because the claim can be settled with a fixed number of equity instruments

(a) it would not affect a user's assessment of whether the entity's has sufficient economic resources to meet its obligations for a specified amount. Similar to ordinary shares, the amount of the claim will depend on the availability of the entity's economic resources.

(b) Because the claim can be settled with a fixed number of equity instruments it would not affect a user's assessment of whether the entity's will be able to meet its requirements to transfer resources, because the cash settlement transfer can be avoided.

55. However, if classified as equity, the claims in paragraphs paragraphs 47(a) and 47(b) would grant the holders, and impose on the entity, different rights and obligation to other types of claims classified as equity, such as ordinary shares.

[5] To the extent the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions).

For example, the entity's right to settle the claim by paying a specified amount of cash limits the extent of its obligation to that specified amount. This means that the amount of the entity's obligation is limited to the lower of:

(a) the value of the fixed number of shares; and

(b) the specified amount of cash.

56. This is in contrast to a typical convertible bond that is convertible at the holder/counterparty's option, which obliges the entity to deliver an amount that is equal to the *higher* of the value of the fixed number of shares and the specified amount in the bond.

57. Because of the above, the instruments with alternative settlement outcomes that are classified as equity will have differences with other equity instruments, such as ordinary shares.

58. In Agenda Paper 5B (Presentation: Attribution of profit or loss and other comprehensive to sub-classes of equity) we suggest that it would be useful to provide information about the attribution of returns to senior classes of equity claims. If the IASB agrees with that view, we can consider how we might provide useful information about the attribution of returns to instruments with alternative settlement outcomes classified as equity when we discuss derivatives classified as equity at a future meeting. In our view, this will not only provide useful information about these types of claims if the right to the equity settlement outcome is clearly established, but it will also reduce the consequences of the classification decision in circumstances where that decision is less clear.

| **Question 1** |
|---|
| Does the IASB have any comments on the staff analysis of the effect of rights of the entity to alternative settlement outcomes assuming that they are substantive and the entity has the practical ability to exercise them? |

### *Substantive rights*

59. Notwithstanding the stated right of the entity to choose an equity settlement outcome in some claims, the first step of any analysis of a claim is to identify whether that right is, in fact, substantive.

60. IAS 32 includes some requirements to help establish whether a financial instrument establishes an obligation that would meet the definition of a liability indirectly through its terms and conditions.

61. IAS 32 paragraph 20 states that:

> 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. For example:
>
> (a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.
>
> (b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:
>
> (i) cash or another financial asset; or
>
> (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.
>
> Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

62. The requirements in paragraph 20 of IAS 32, would need to be updated to reflect the liability settlement outcomes based on the features under the Gamma approach. For example, a financial instrument would be a financial liability under the Gamma approach not only if it required the transfer of cash or other financial assets, but also if it was an obligations of a specified amount that might be settled by transferring a variable number of equity instruments, or at liquidation.

63. In addition to the requirements in IAS 32:

    (a) IFRS 2 *Share-based Payments* also contains the following requirement when the terms of the arrangement provide the entity with alternative settlement outcomes:

    > The entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (eg because the entity is legally prohibited from issuing shares), or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

    (b) the IASB proposed in the Conceptual Framework ED that:

    > 4.54 All terms in a contract–whether explicit or implicit– are taken into consideration unless they have no commercial substance…
    >
    > 4.55 Terms that have no commercial substance are disregarded. A term has no commercial substance if it has no discernible effect on the economics of the contracts. Terms that have no commercial substance could include, for example:
    >
    > (a) terms that bind neither party; or
    >
    > (b) rights (including options) that the holder will not have the practical ability to exercise.

64. Sometimes the entity's stated right to settle a claim by delivering a fixed number of ordinary shares is 'structurally' out of the money (ie always out of the money, or always unfavourable). This means that it is always favourable for the entity to

pay the cash or other financial assets, or to deliver a variable number of shares, as it is less than the value of the fixed share settlement outcome.

65. Because the value of the share settlement outcome is determined to be greater than the value of the cash settlement outcome, then paragraph 20 of IAS 32 would imply that the cash settlement outcome will be a financial liability.

66. In January 2014, The Interpretations Committee (see paragraphs 30–34) discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument in accordance with IAS 32. The 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. The issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, it must:

    (a) deliver the maximum number of equity instruments specified in the contract; and

    (b) pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

67. The Interpretations Committee noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. In making that assessment, the issuer could consider, along with other factors:

    (a) whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms.

    (b) the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share price.

68. In the staff's view, there are similarities between:

    (a) the indirect obligation requirements of IAS 32; and

(b) the no commercial substance requirements in IFRS 2 and in the Conceptual Framework ED.

69. Paragraph BC9 of the Basis for Conclusions on IAS 32 states that:

> The Board did not debate whether an obligation can be established implicitly rather than explicitly because this is not within the scope of an improvements project. This question will be considered by the Board in its project on revenue, liabilities and equity. Consequently, the Board retained the existing notion that an instrument may establish an obligation indirectly through its terms and conditions (see paragraph 20). However, it decided that the example of a preference share with a contractually accelerating dividend which, within the foreseeable future, is scheduled to yield a dividend so high that the entity will be economically compelled to redeem the instrument, was insufficiently clear. The example was therefore removed and replaced with others that are clearer and deal with situations that have proved problematic in practice.

70. In the staff's preliminary view, the requirements of IAS 32 should be updated to reflect the IASB's current thinking regarding the substance of rights and obligations.

71. In summary, the staff suggest that the indirect obligation requirements in IAS 32 should be aligned with the no commercial substance requirements consistently with the Conceptual Framework ED and IFRS 2.

72. In particular:

(a) a claim with alternative settlement outcomes conditional on rights within the control of the entity is a financial liability if the equity settlement outcome has no commercial substance.

(b) a term may have no commercial substance if it has no discernible effect on the economics of the contracts. Equity settlement outcomes with no commercial substance could include, for example:

(i) equity settlement outcomes for which the entity is legally prohibited from exercising

(ii) equity settlement outcomes that are structured in such a way that their value always exceeds the liability settlement outcome.

| **Question 2** |
|---|
| Does the IASB have any comments on the staff analysis of indirect obligations and commercial substance?<br><br>Does the IASB agree with the staff suggestion that the indirect obligation requirements in IAS 32 should be aligned with the no commercial substance requirements consistently with the Conceptual Framework ED (and IFRS 2)? |

### *Practical ability to exercise a substantive right*

73. Once the entity's right to an equity settlement outcome is established as substantive, the next step of the analysis of a claim is to identify whether the entity has the practical ability to exercise that right.

74. IAS 32 does not include requirements for economic compulsion and the IASB has previously made general statements that, under IAS 32:

(a) a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Factors not within the contractual arrangement are not required, or permitted, to be taken into consideration in classifying a financial instrument.

(b) economic compulsion does not, by itself, create an obligation that is a liability.

75. IFRS 2, like IAS 32, does not consider economic compulsion, however it does use the notion of constructive obligations without using the label.

76. However, in the Conceptual Framework ED, the IASB proposes that a present obligation to transfer economic resources exists if the entity has no practical ability to avoid transferring economic resources.

77. Paragraph 4.32 of Conceptual Framework ED states that:

> An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

78. The 'practical ability to avoid' guidance proposed in the Conceptual Framework ED could be viewed as follows:

    (a) Scenarios in which the equity settlement outcome is potentially unfavourable to the entity establish a financial liability (paragraphs 79–81)

    (b) The favourability of the equity settlement outcome should not affect its classification (paragraphs 82–84)

    (c) A liability is established in scenarios in which facts and circumstances beyond the contractual arrangement result in the entity choosing the liability settlement outcome, even if the equity settlement outcome is more favourable (paragraphs 85–87)

### *Scenarios in which the equity settlement outcome is potentially unfavourable*

79. One view of the proposed Conceptual Framework ED guidance could be that, even if the entity has a substantive equity settlement option, the claim could still establish a financial liability for those scenarios in which the equity settlement outcome is *potentially unfavourable* to the entity.

80. That is, if there is some scenario under which the equity settlement option is unfavourable to the entity, the entity could have no practical ability to avoid the liability settlement outcome, because the economic consequences of exercising the equity settlement outcome would be *significantly more adverse* than the liability settlement outcome in those scenarios. To what extent the outcome is

unfavourable, or probable, may also be important to determining whether it is significantly more adverse.

81. In accordance with this view of the Conceptual Framework ED proposals, a claim would contain a financial liability component representing the entity's obligation to transfer economic resources in the scenarios where the value of the equity settlement outcome is greater than the liability settlement outcome.

*The favourability of the equity settlement outcome should not affect its classification*

82. The other view would be that, if the entity has a substantive unconditional right to avoid the liability settlement outcome, then it does not matter if the value of the equity settlement outcome is potentially greater than the liability settlement outcome. Therefore, the entity does not have a financial liability if the right is substantive, and the entity has the right to choose the more favourable settlement outcome, even if it decides eventually to waive that right on exercise, and choose the unfavourable outcome.

83. In accordance with this view, the entity might be potentially giving up a greater value through the equity settlement outcome if it exercises that outcome when the liability settlement outcome is more favourable.

84. A similar situation arises in IFRS 2 when it is determined that the equity settlement outcome is substantive. IFRS 2 paragraph 43 requires such a share-based payment to be accounted for as equity settled, and:

    (a) if the entity elects to settle in cash, the cash payment shall be accounted for as the repurchase of an equity interest.

    (b) if the entity elects the settlement alternative with the higher fair value as at the date of settlement, the entity shall recognise an additional expense for the excess value given.

*Scenarios in which circumstances beyond the contractual arrangement result in the entity choosing the liability settlement outcome*

85. This view of the proposed Conceptual Framework ED guidance is that, even if the equity settlement outcome is favourable to the entity, a liability is established if,

in some scenarios, facts and circumstances beyond the contractual arrangement result in the entity choosing the liability settlement outcome.

86. Such facts and circumstances might include (for example):

(a) the ability of the entity to obtain cash or issue shares.

(b) the financial position of the entity and the effect of the entity exercising its rights on its other existing economic resources and claims.

87. However, it is not clear whether, and to what extent, the guidance in the Conceptual Framework requires such an analysis. We think there are potential implications of this view that may need to be considered further, including:

(a) to what extent the entity would be required to examine possible scenarios to see whether circumstances might arise, or to what extent that analysis should extend into the future.[6] Such an analysis could be exhaustive.

(b) to what extent the incremental costs of exercising one option or the other, should be included in the analysis of the favourability of the option (and potentially its measurement). For example, the incremental costs of obtaining cash or issuing shares could be included in the calculation of the value of those alternatives.

(c) to what extent future circumstances to be considered are limited in their effect to the outcome of the claim in question, or whether circumstances could be considered that might also affect other economic resources or claims of the entity. If the latter, then to what extent should those circumstances be considered in the classification of the claim in question, or the recognition and measurement of the other economic resources or claims.

(d) whether the dependence of the exercise of the option on other facts and circumstances makes the alternative settlement outcomes, in fact, contingent on uncertain future events.

[6] For example, paragraph B23 of IFRS 10 includes a fairly long, non-exhaustive list of some facts and circumstances that might prevent an entity from exercising a right. However, those requirements are in the context of deciding whether the entity has the current right that gives it power over another entity for the purposes of consolidation.

*Summary and next steps for rights within the control of the entity*

88. The challenge relating to economic compulsion arose when the IFRIC was considering callable preferred shares with dividend resets. As we have illustrated in paragraphs 42–46, such claims would be classified as liabilities under the Gamma approach without the need to consider economic compulsion. We note that this is not necessarily the case under the Alpha approach (see paragraphs 102–105)

89. In addition, we think that some of the other challenges identified could be addressed by updating the indirect obligation requirements as suggested in the previous section (paragraphs 59–72).

90. We could also clarify the accounting for requirements for claims which the entity chooses the higher value outcome (in a similar fashion to IFRS 2 as summarised in paragraph 84). If so, we could consider the accounting for these together with derivatives on own equity classified as equity.

91. We have not yet formed a view as to whether any changes are required as a result of the proposed guidance in the Conceptual Framework ED. However we have identified some areas that may require further analysis, including considering to what extent factors and circumstances beyond the contractual arrangement should be taken into consideration in classifying a financial instrument.

| Question 3 |
| --- |
| Does the IASB have any comments on the staff analysis of whether the entity has the practical ability to exercise alternative settlement outcomes?<br><br>Are there other aspects that the IASB would like the staff to consider in a future meeting? |

### *Determining whether the entity has the practical ability to avoid uncertain future events*

92. Some claims are contingent on events beyond the control of the entity and the counterparty. However, sometimes challenges arise in determining whether a contingent event is, in fact, beyond the entity's control. For example, alternative settlement outcomes that are contingent on:

(a) a change in control of the entity.

(b) the entity undertaking a future transaction.

(c) an entity avoiding a future transaction.

93. Under the existing requirements of IAS 32, a contingency is not within the entity's control even if it is dependent on the entity's future activities or transactions. As per IAS 32 paragraph 25, uncertain future events could include contingencies based on changes in:

(a) a stock market index, consumer price index, interest rate or taxation requirements; or

(b) the issuer's:

(i) future revenues;

(ii) net income; or

(iii) debt-to-equity ratio.

94. Furthermore, paragraphs 25 and AG28 in IAS 32 state than an issuer must disregard a contingent settlement feature if it is 'not genuine'—ie if it is extremely rare, highly abnormal and very unlikely to occur.

95. Paragraph 4.32 of Conceptual Framework ED states that:

> An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

96. One view of the proposed guidance on practical ability to avoid is that, even if, alternative settlement outcomes are contingent on uncertain future events, if the entity has the practical ability to avoid those uncertain future events that would result in the liability settlement outcomes, then it does not have a liability. For example, if a liability settlement outcome is contingent on the entity's future

revenue, then the entity has the practical ability to avoid if it can avoid that future revenue.

97. However, this view of the proposed guidance on practical ability raises similar questions to those in paragraph 87.

98. The Basis for Conclusions on IAS 32 does not elaborate why the IASB reached the conclusion that alternative settlement outcomes contingent on the uncertain future events in paragraph 25 of IAS 32 give rise to a financial liability. In our view, many uncertain future events depend on various risks, and actions of parties, that are beyond its control, even if they somehow relate to the entity's future actions. Thus, events are not within an entity's control even if they are dependent on entity specific matters, such as the entity's share price. That is, as per paragraph 19 of IAS 32, the entity does not have an unconditional right to avoid the liability settlement outcome.

99. The determination of whether an entity does have an unconditional rights will depend on facts and circumstances, including the terms of the financial instrument and its relationship to other rights and obligations.

100. For example, a contingency is beyond the entity's control if it depends on:

(a) the entity entering an uncertain future transaction, unless the entity has the unconditional right to enter into that transaction—Typically, an entity does not have an unconditional right to undertake a future transaction. However, there could be circumstances where the entity does have that right, for example if it has a purchased option that it has the unconditional right to exercise and the counterparty has the obligation to fulfil.

(b) the entity avoiding certain future transactions that it does not have an unconditional right to avoid—Typically an entity does have an unconditional right to avoid future transactions. However, there could be circumstances where the entity does not have that right, for example if it has a present obligation to exchange economic resources, or its future actions are otherwise restricted.

101. Therefore, in our preliminary view, we should carry forward the requirements in paragraphs 19 and 25 of IAS 32. However, these requirements should be updated to reflect the features used to identify a liability under approach Gamma. Under approach Gamma a liability settlement outcome would include either:

(a) an obligation to transfer economic resources other than at liquidation; or

(b) an obligation for a specified amount independent of the entity's economic resources;

**Question 4**

Does the IASB have any comments on the staff analysis of the effect of contingent alternative settlement outcomes on the entity?

Does the IASB agree with the staff suggestion that existing requirements for unconditional rights to avoid a liability settlement outcome and for contingent alternative settlement outcomes should be carried forward and updated to include the relevant features under Gamma (paragraph 101)?

### *Consequences for the other approaches we are developing*

102. As noted in paragraph 38, whether a non-derivative claim meets the definition of a financial liability or of equity will depend on whether it has the relevant features identified. This means that the set of claims with alternative settlement outcomes will be different under each approach:

    (a) Under approach Alpha, only outcomes that result in a transfer of economic resources other than at liquidation would be liability outcomes, all other outcomes would be equity settlement outcomes, including obligations for a specified amount that do not require a transfer of economic resources other than at liquidation.

    (b) Under approach Beta, only outcomes that result in an obligation for a specified amount would be liability outcomes, all other outcomes would be equity outcomes, including obligations to transfer economic resources other than at liquidation that are not also obligations for a specified amount independent of the entity.

103. We do not think that the basic analysis (in paragraphs 59–91) about whether an entity's rights to alternative settlement outcomes are substantive, and whether the entity has the practical ability to exercise those rights, would change under each approach. However, the classification outcomes would be different for some types of instruments.

104. We illustrate the different classification outcomes for some types of instruments that grant the entity the right to alternative settlement outcomes for approaches Alpha and Beta below.

### *Approach Alpha*

105. An equity settlement outcome under Alpha would include the obligation to deliver a variable number of shares, or an obligation for a specified amount that the entity can defer transferring economic resources until liquidation. Based on a similar analysis as in paragraphs 42–58, if the entity has an unconditional right to such equity settlement outcomes that are substantive and can be exercised, then, in

addition to the claims classified as equity under Gamma in paragraph 52, the following claims will be **classified as equity** under the Alpha approach:

(a) Callable preferred shares with resets, if the entity has an unconditional right to avoid transferring economic resources until liquidation.

(b) Various types of claims with variable share settlement outcomes.

106. Claims with contingent variable share settlement outcomes, would also have an equity component. If the only other settlement outcomes would also be an equity settled, then the claim would be equity in its entirety.

### *Approach Beta*

107. An equity settlement outcome under approach Beta would include an obligation to transfer economic resources other than at liquidation, if the amount is not independent of the entity's economic resources. Based on a similar analysis as in paragraphs 42–58, if the entity has an unconditional right to such equity settlement outcomes that are substantive and can be exercised, then, in addition to the claims classified as equity under Gamma in paragraph 52, the following claims will be **classified as equity** under the Beta approach::

(a) Claims with an entity controlled option to settle by transferring economic resources that is not independent of the entity (for example, ordinary shares that are redeemable by the entity for an amount that is some percentage of the share price).

(b) Ordinary shares which grant the entity the right to call them at fair value.

## Appendix A—Summary of relevant requirements

### *In IAS 32*

A1. IAS 32 paragraph 19 states that:

> If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D. For example:
>
> (a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.
>
> (b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

A2. IAS 32 paragraph 20 states that:

> 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. For example:
>
> (a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-

financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

A3. IAS 32 paragraph 25 states that [**emphasis added**]:

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to 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 (or on the outcome of uncertain circumstances) **that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio**. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a

> financial liability) is not genuine;
>
> (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or
>
> (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B [of IAS 32].

### *In the Conceptual Framework ED*

A4. Paragraph 4.32 of that Exposure Draft states that:

> An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

A5. Paragraph 4.33 of that Exposure Draft states that:

> If an entity prepares financial statements on a going concern basis, the entity:
>
> (a) has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or ceasing trading; but
>
> (b) Has the practical ability to avoid (and hence does not have a liability for) a transfer that would be required only on the liquidation of the entity or the cessation of trading.