STAFF PAPER

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Accounting Standards Advisory Forum

Project	**Financial Instruments with Characteristics of Equity research project**		
Paper topic	Economic compulsion		
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Introduction

1. This paper discusses claims against an entity that grant the issuer the right to choose between two alternative settlement outcomes, each of which would meet the definition of a liability (or of equity) in the absence of the other equity (or liability) outcome.

2. The purpose is to obtain ASAF members' views on the circumstances in which 'economic compulsion' should be considered when classifying such claims as liabilities or equity. The Board wishes to consider this topic at the same time as it redeliberates the *Conceptual Framework* proposals.

3. We illustrate some of the challenges using a simple type of claim, a reverse convertible bond, under various scenarios that may result in the issuer choosing the liability settlement outcome.

4. This paper is structured as follows:

   (a) What is the question? (paragraphs 5–10)

   (b) Why is this an issue? (paragraphs 11–18)

   (c) Background (paragraphs 19—37)

   (d) Questions and Case studies (paragraphs 38–45)

What is the question?

5. 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.

6. In classifying such claims as liabilities or as equity, challenges include determining whether the claim, in substance, establishes an obligation that would meet the definition of a liability.

7. Depending on the structure of the entity's rights and other facts and circumstances, there may be economic incentives for the entity to exercise the *liability* settlement option. In some circumstances, those incentives may be so strong that some would view the entity as 'economically compelled' to exercise a liability settlement outcome.

8. In addition to the economic incentives, there may be other barriers to the entity exercising the *equity* settlement outcome, such as regulatory or legal requirements. The Board will consider the implications of these when it discusses the boundary of the contract (ie whether relevant legal and regulatory requirements should be considered) and whether the entity's rights under the claim are substantive.

9. For this paper, we assume that no such barriers exist and hence that the rights of the entity to choose between alternative settlement outcomes are substantive.

10. In other words, we limit the question to whether *economic incentives* that might constrain the entity's decision to exercise its option should be considered when classifying such claims as liabilities or equity.

Why is this an issue?

11. To help illustrate the issue we will consider a reverse convertible bond.

12. A 'typical' convertible bond is convertible at the holder/counterparty's option. The holder has the option to receive either a specified amount of cash, or a fixed number of shares. Effectively, a typical convertible bond obliges the entity to deliver an amount that is equal to the ***higher*** of:

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

(b) the specified amount of cash.

13. In contrast, a 'reverse' convertible bond is convertible at the issuing entity's option. Accordingly, 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. Effectively, this means that the amount of the entity's obligation is limited to the ***lower*** of:

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

(b) the specified amount of cash.

14. Applying IAS 32:

(a) the component of a typical convertible bond that obliges the entity to transfer cash at the option of the holder would be classified as a liability, measured at the present value of the cash settlement alternative. The right of the holder to convert to shares would be a separate equity component. This classification would be the case even if the conversion option is highly likely to be exercised by the holder (for instance because the value of the shares is higher than the cash payment amount). If the holder did not exercise the conversion right, the entity would be obliged to transfer economic resources.

(b) a reverse convertible bond would be classified as equity. This classification would be the case even if it is highly likely that the issuer will settle not by issuing shares but by paying cash instead (for instance because the value of the shares is higher than the cash payment amount). .

15. There are two prevailing views about the requirements of IAS 32:

(a) View A—the classification result in paragraph 14(b) is counterintuitive. The typical convertible bond is highly likely to be converted to shares but is classified as a liability for the present value of the cash settlement alternative. The reverse convertible bond is classified as equity even if the issuer has a strong incentive to settle not by issuing shares but by paying cash instead. To avoid this counterintuitive result, the requirements of IAS 32 should be amended: the economic incentive for the entity to settle the reverse convertible bond by transferring cash needs to be considered when identifying whether there is a liability component in the claim.

(b) View B—the classification result in paragraph 14 is intuitive. For the typical convertible bond, the entity has no right over whether a transfer of economic resources will be required, and hence it is an obligation of the entity to transfer economic resources until the counterparty waives that right. For the reverse convertible bond, the entity has a right over whether a transfer of economic resources will occur, hence it is not an obligation to transfer economic resources until the entity waives its right.

16. An entity typically has the right to satisfy, in whole or in part, all claims against it, including ordinary shares, by transferring economic resources at some point in time. For example by repurchasing the claim on the market, paying a dividend or making some other distribution. Furthermore, from time to time, entities transfer economic resources to change the overall mix of their claims to meet the risk-return demands of their investors. Therefore, there could be a very broad range of facts and circumstances that could factor into an entity's decision to transfer economic resources to holders of both liability and equity claims.

17. Therefore, a number of follow-on questions arise if economic compulsion is to be considered in identifying a liability. These could include:

(a) How significant does an economic incentive need to be for the entity to be 'economically compelled' to transfer economic resources. Is it enough for the liability settlement option to be marginally favourable, or if not, how favourable does it need to be?

(b) Should the assessment of economic compulsion be performed only when classifying the claim at initial recognition, or would the assessment need to be performed continuously to take into consideration changing facts and circumstances?

(c) Should the assessment of economic compulsion consider economic consequences beyond the alternatives in the contract? For instance, effects on the entity's other economic resources (eg from change of control provisions), or claims (eg additional interest on other debt or covenant breaches).

(d) Should the assessment be limited to the current economic consequences at the assessment date (ie an 'intrinsic value' assessment)? Or should the possible future economic consequences from a possible future settlement be considered in the assessment as well?

18. In contrast, View B is consistent with IAS 32's underlying principle of classifying as equity those claims that contain an unconditional right to avoid transferring cash or other financial assets. It is also consistent with deciding the classification of the claim at initial recognition, and only reclassifying if there are changes in the rights and obligations of the claim.

Background

19. This section includes:

(a) Overview of existing IAS 32 requirements (paragraphs 20–23)

(b) Previous considerations of the IFRS Interpretations Committee (paragraphs 24–26)

(c) Conceptual Framework proposals (paragraphs 27–28)

(d) Recent discussions in the Financial Instruments with Characteristics of Equity project (paragraphs 29–37)

Overview of existing IAS 32 requirements

20. In the past, the Board has made general statements that economic compulsion does not, by itself, create an obligation that is a liability.

21. IAS 32 *Financial Instruments: Presentation* states that the substance of a financial instrument, rather than its legal form, governs its classification in the entity's financial statements.[1] IAS 32 does not make reference to economic compulsion.[2]

[1] IAS 32, paragraph 17.

However, in June 2006, and in response to a request from the IFRS Interpretations Committee (the Interpretations Committee), the Board stated that:

(a) 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.

(b) IAS 32 requires an assessment of the contractual arrangement. However, it does not require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.[3]

22. Accordingly, applying IAS 32, an entity classifies as equity any financial instrument that grants the entity the unconditional right to an equity settlement outcome, even if the entity has a significant economic incentive to exercise the liability settlement outcome. One example is an instrument that grants the entity the right to defer payments indefinitely, but that includes a ‘step-up’ clause that increases the amount of the payments if the entity does not redeem the instrument on predetermined dates. Thus, it will be more economically favourable for the entity to exercise its right to redeem the instrument on the predetermined dates than pay the increased payments at some future date. However, the economic incentive to redeem does not create any contractual obligation and therefore the instrument is classified as equity applying IAS 32.

23. However, IAS 32 does require the entity to classify an obligation as a liability if an instrument that may be settled either in cash (or another financial asset), or in shares, establishes an indirect contractual obligation (IAS32.20(b)). This would be the case if the cash settlement alternative was *always less than* the share settlement alternative. Thus, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option. However, many struggle to see the difference in the obligation created by this example and ‘step-up’ instrument in paragraph 22.

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2 IFRS 2, like IAS 32, does not consider economic compulsion.

3 IFRIC *Update*, November 2006.

Previous considerations of the IFRS Interpretations Committee

24. Other examples of instruments that have been considered by the Interpretations Committee include:

    (a) instruments that can be converted to a fixed number of ordinary shares at the issuer's option (considered by the Interpretations Committee in 2013).

    (b) 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 (considered by the Interpretations Committee in 2014 and discussed below in paragraphs 25–26).

25. In January 2014, the Interpretations Committee discussed how an issuer would apply IAS 32 to assess the substance of a particular early-settlement option included in a financial instrument. 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.

26. The Interpretations Committee noted that if the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument. The Interpretations Committee also 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 why 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.

Conceptual Framework proposals

27. The Exposure Draft *Conceptual Framework for Financial Reporting* ('the *Conceptual Framework* Exposure Draft') proposed that an entity has a present obligation to transfer economic resources if, among other things, the entity has no practical ability to avoid the transfer.

28. The *Conceptual Framework* Exposure Draft also proposed additional concepts to explain the term 'no practical ability to avoid'. As explained in Agenda Paper 1A *Conceptual Framework—Concepts to support the liability definition*, IASB staff are developing suggestions for refinements to those concepts. Some of the relevant Exposure Draft proposals are shown below with the IASB staff suggestions marked[4]:

> 4.32 Judgement may be required when deciding whether, and in what circumstances, an entity has no practical ability to avoid a duty or responsibility to transfer an economic resource. An entity ~~has~~ may have 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. However, it ~~It~~ is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

[4] More details about the liability Exposure Draft proposals with the IASB staff suggestions can be found in Agenda Paper 1A

Recent discussions in the Financial Instruments with Characteristics of Equity project

29. The approach to classification the Board is considering in its project on Financial Instruments with Characteristics of Equity is based not only on whether the claim requires the entity to transfer economic resources, but also on the amount of the obligation. In particular, if the obligation is for an amount independent of the economic resources of the entity (eg contractual cash flows, interest rates etc), then the claim would be classified as a liability. This would be the case even if the entity has the right to defer payment indefinitely, or the right to settle the obligation by issuing a variable number of shares equal to that amount.

30. Thus, claims such as those with 'step up' clauses in paragraph 22, and cumulative preference shares, would be classified as liabilities without needing to consider whether the entity is obliged to transfer economic resources. That is, the 'amount' feature of the approach to identifying liabilities would capture claims that are like fixed income debt instruments, but allow the entity to defer payment indefinitely. For these claims, the amount of the payment is known, even though the timing of the payment is unknown. The approach the Board is considering will address the classification concerns about many of the claims that constituents have considered problematic in the past without the need to consider economic compulsion.

31. Nevertheless, applying the approach the Board is considering, there are still other types of claims with alternative settlement outcomes within the control of the entity. The question is whether, when considering whether there is an obligation to transfer economic resources, the economic incentives to settle the claim in a particular way should be considered, and if so, how.

32. Regardless of the classification, the approach the Board is considering would use presentation and disclosure to highlight the differences between reverse convertible bonds and other claims. This includes requirements to attribute amounts within equity to classes of equity other than ordinary shares.

33. For example, if the reverse convertible bond were to be equity classified, the attribution requirements the Board is considering would attribute an amount to the reverse convertible bonds within equity that will depict the difference with ordinary shares.

34. In February 2016, the Board held a preliminary discussion of financial instruments with alternative settlement outcomes. As part of its discussion, the Board considered whether economic compulsion should play any role in classifying liabilities and equity.

35. Some of the issues explored included:

    (a) whether the classification should consider the relative favourability of the alternative settlement outcomes.

    (b) whether an assessment of the favourability of the outcomes is assessed by considering only the relative fair values of the settlement alternatives, or should include incremental costs of exercising the options, such as the incremental costs of obtaining cash or issuing shares. Incremental costs could include, for example, additional interest on other debt, borrowing falling due, losing control of assets, effects of changes in debt/equity ratios.

    (c) the extent to which the assessments above should consider possible future scenarios.[5] For example, should the assessment of the favourability of the outcomes consider only their current favourability, or should the assessment consider the potential favourability in the future?

36. The Board did not reach any conclusions as a result of the February discussion.

37. In April 2016, the Board decided to discuss at a future meeting some of the implications of the liability concepts proposed in the *Conceptual Framework* in conjunction with example instruments that might be relevant for the Financial Instruments with Characteristics of Equity project.

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[5] 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.

Questions and Case study—reverse convertible bonds

38. To help illustrate some of the issues, we will consider how economic compulsion could affect the classification of a particular reverse convertible bond. If economic compulsion is not considered in classifying the instrument, then the instrument would be classified as equity (assuming the rights are substantive).

39. When reading the case study please consider these questions for discussion.

Questions for ASAF members
(a) Would consideration of economic compulsion result in liability classification of the instrument on initial recognition if the cash settlement alternative is currently **not** more economically favourable than the equity settlement alternative? Why or why not? Would you consider the potential economic favourability of the cash settlement alternative in the future?   (b) Would consideration of economic compulsion result in liability classification of the instrument on initial recognition if the cash settlement alternative **is currently more** economically favourable that the equity settlement alternative?? Why or why not? If yes, would it still be a liability in year 20x1 where the cash settlement alternative is currently no longer economically favourable?   (c) Would consideration of economic compulsion result in liability classification of the instrument in any of the subsequent financial years? Why or why not? How favourable does the liability settlement outcome need to be for the entity to be economically compelled?   (d) Would consideration of economic compulsion result in liability classification of the instrument if: (i) the cash settlement alternative was not for a fixed amount of CU1000 and only exercisable at maturity, but increased from CU600 in year 20x1 to CU1000 in year 20x5 and was exercisable at the end of each year?   (ii) the cash settlement alternative was for an amount that was contractually always lower in value than the equity settlement alternative, such as for an amount equal to 80% of 100 ordinary shares?

(e) Would the following factors change your answers to any of the above questions?

(i) the entity could not obtain cash at the end of 20x5.

(ii) the costs of obtaining cash made the liability settlement alternative unfavourable.

(iii) the entity's exercise of the equity settlement alternative triggered other transactions, such as change of control provisions that affected its assets.

(iv) the entity was unable to issue shares in the market at fair value, or only at a significant cost.

Case study

Facts

40. In the period up to maturity of the instruments, a reporting entity's share price changes as follows:

(a) At the end of 20x1, the entity's share price is CU8 (so value of 100 shares is CU800), and the volatility of the share price is 10%.

(b) At the end of 20x3, the entity's share price is CU18 (so the value of 100 shares is CU1,800), and the volatility of the share price is 15%.

(c) At the end of 20x5, the entity's share price is CU20 (so the value of 100 shares is CU2,000).

Instrument terms

41. At the end of year 20x0 the reporting entity issues an instrument with the following terms:

(a) It requires the entity to pay in cash an amount of CU1,000 at the end of year 20x5. No other payments are required.

(b) At maturity, the entity has the right to settle the claim by issuing 100 ordinary shares of the entity instead of paying CU1,000.

(c) The counterparty has no right to select the form of settlement.

42. For simplicity we ignore discounting, so the cash payment is always CU1000.

43. We also consider two scenarios at initial recognition of the instrument. When the instrument is issued and initially recognised (20x0) the price of the entity's ordinary shares could have been either:

(a) Scenario A: CU12 and therefore the cash settlement alternative was more favourable; or

(b) Scenario B: CU6 and therefore the equity settlement alternative was more favourable.

Year	**Cash settlement outcome value**	**Share settlement outcome value**
20x0 Scenario A	CU1,000	CU1,200
20x0 Scenario B	CU1,000	CU600
20x1	CU1,000	CU800
20x3	CU1,000	CU1,800
20x5	CU1,000	CU2,000

Scenario for Question (d)(i)

44. Instead of requiring the entity to pay in cash an amount of CU1,000 at the end of year 20x5, the entity has the option to redeem the instrument at the end of year 20x1 by paying in cash an amount of CU600. If not redeemed, thereafter the amount of cash to settle the instrument increases over time at a rate higher than the entity's incremental borrowing rate, until it reaches CU1000 in year 20x5 when the instrument matures. All other terms are the same.

Year	**Cash settlement outcome value**	**Share settlement outcome value**
20x1	CU600	CU800
20x3	CU800	CU1,800
20x5	CU1,000	CU2,000

Scenario for Question (d)(ii)

45. Instead of requiring the entity to pay in cash an amount of CU1,000 at the end of year 20x5, it requires the entity to pay in cash an amount equal to 80% of the fair value of 100 ordinary shares of the entity at the end of year 20x5. All other terms are the same. As opposed to the scenario for Question (d)(i) which has the possibility for either alternative being favourable or unfavourable, the scenario for Question (d)(ii) results in the cash settlement alternative always being favourable.