

STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity
Paper topic	Alternative settlement outcomes within the control of the entity
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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. In previous meetings, we considered the classification of claims against an entity that grant the *holder* the right to choose between alternative settlement outcomes. In a future meeting we will consider alternative settlement outcomes that are contingent on events beyond both parties.
2. This paper continues to focus on the Gamma approach.
3. This paper is structured as follows:
 - (a) What is the question? (paragraphs 4–11)
 - (b) Why is this an issue? (paragraph 12–20)
 - (c) Discussions to date (paragraph 21–28)
 - (d) Staff Analysis (paragraph 29–55)
 - (e) Summary and recommendation (paragraph 56–60)
 - (f) Appendix A—Issues discuss by the IFRIC and IASB in the past

What is the question?

4. 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.
5. 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.
6. The IFRS Interpretations Committee¹ and the IASB have considered and resolved some of these challenges in the past. Some types of claims considered included²:
 - (a) issued preference shares that the entity is allowed to redeem on specific dates. However, if the entity does not redeem the preference shares, the redemption amount increases at an increasing rate over time (a type of this instrument, ‘callable preferred shares with resets’, was considered by the Interpretations Committee in 2006).
 - (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).
 - (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).
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 even though it has the right to the equity settlement outcome. In some circumstances, those incentives may be so strong that some would view the entity as being ‘economically compelled’ to exercise a liability settlement outcome.

¹ References to the Interpretations Committee include the IFRIC

² Further details are in Appendix A.

8. There continues to be disagreement between interested parties regarding whether the classification of liabilities and equity should consider economic incentives, and if so, how strong those economic incentives need to be to equate to economic compulsion. This is particularly the case for the classification of callable preferred shares with resets applying IAS 32 *Financial Instruments: Presentation*.
9. In addition to the economic incentives, there may be other barriers to the entity exercising the liability or equity settlement outcome, such as regulatory or legal requirements. We will be discussing whether, and if so how, classification should consider relevant legal and regulatory requirements when identifying the substantive rights and obligations in a contract at a future meeting.
10. For this paper, we assume that the entity has no other barriers to exercising its right to choose between alternative settlement outcomes.
11. In other words, we limit the question to whether *economic incentives* that might influence the entity's decision to exercise its option should be considered when classifying such claims as liabilities or equity, and if so how strong those incentives need to be to amount to economic compulsion.

Why is this an issue?

12. To help illustrate the issue we will consider a 'reverse' convertible bond.
13. 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.
14. 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.

15. 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...

16. Furthermore, paragraph AG26 of IAS 32 states that:

... The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

- (a) a history of making distributions;
- (b) an intention to make a distribution;
- (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
- (d) the amount of the issuer's reserves;
- (e) an issuer's expectations of a profit or loss for a period; or
- (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

17. IAS 32 also 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. Paragraph 20 of IAS 32 states that:

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.

18. 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.³
19. Thus, applying IAS 32:
- (a) the component of the typical convertible bond in paragraph 13 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 (assuming it also meets the fixed-for-fixed condition). 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) the reverse convertible bond in paragraph 14 would be classified as equity in its entirety because the entity has the unconditional right to avoid delivering cash by settling the claim by issuing a fixed number of

³ 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.”

ordinary shares. This classification would be the case even if it is highly likely that the issuer will not issue shares but pay cash instead (for instance because the value of the shares is higher than the cash payment amount).

20. There are two prevailing arguments about the classification outcomes that result from the existing requirements of IAS 32:
- (a) View A—the classification results in paragraph 15 faithfully represent the rights and obligations of the entity. For the typical convertible bond, the entity has no right to decide whether to transfer economic resources. That right is controlled by the counterparty 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 to decide whether to transfer economic resources or to transfer a fixed number of shares, hence it is not an obligation to transfer economic resources until the entity waives its right and decides to make the transfer.
 - (b) View B—the classification result in paragraph 19(b) is counterintuitive. The typical convertible bond that 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 that is highly likely to be settled in cash but is classified as equity. 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.

Discussions to date

21. 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.

22. 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.⁴ 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?
23. The Board did not reach any conclusions as a result of the February discussion.
24. 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.
25. In July 2016, Accounting Standard Advisory Forum (ASAF) members were asked for their views on the circumstances in which economic compulsion should be considered when classifying claims as liabilities or equity.
26. Most ASAF members expressed concerns about considering economic compulsion in distinguishing between liabilities and equity. Those members expressed views that:
- (a) classification should be based only on facts and circumstances at the reporting day, without looking through to the maturity of a financial

⁴ 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.

instrument and trying to predict all possible future outcomes. However, reassessment should occur if, and when, conditions change subsequently.

- (b) bifurcating hybrid instruments with two settlement alternatives into liability and equity components, and focusing on the measurement aspects, may be more useful than reclassifying the whole hybrid instrument as a liability or as equity.
- (c) ‘no practical ability to avoid a transfer’ and ‘economic compulsion’ will have limited effect in distinguishing between liabilities and equity as financial instruments are essentially about contractual rights and obligations. This member thought that a more fundamental question is whether the Board intend to use the economic entity approach or the proprietary approach.

27. A few ASAF members agreed that an entity should consider economic compulsion in distinguishing between liabilities and equity, in particular suggesting that:

- (a) if the intention is to apply the *Conceptual Framework* consistently, then consideration of economic compulsion is inevitable. However, ASAF members making this suggestion acknowledged that assessing whether an entity is economically compelled requires judgement, and is open to manipulation. One ASAF member suggested that in applying judgement an entity considers the substance of settlement options.
- (b) the phrase ‘no practical ability to avoid’ is not the equivalent of ‘economic compulsion’, and hence both should be used. The ASAF member making this suggestion gave an example of an entity that continued to fulfil onerous contracts even though cancelling those contracts would have been economically favourable.
- (c) the consideration of economic compulsion should be restricted to situations that require difficult judgments about future economic situations and consequences.

(d) economic compulsion should be considered not only for financial instruments, but also for non-financial instruments within the scope of other IFRS Standards, such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IFRIC 21 *Levies*.

28. Some ASAF members stated that an entity's subsequent reassessment of the original classification decision is essential for faithful representation. Another ASAF member proposed that reassessment of classification should occur only when it is highly probable that an entity will change how it will settle the instrument.

Staff analysis

29. The Gamma 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 the callable preferred shares with resets (see paragraph 6(a)), 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 Gamma approach to classifying 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. Therefore, the approach the Board is considering will address the classification concerns about the callable preference shares with resets that constituents have considered problematic in the past without the need to consider economic incentives and compulsion.

31. Nevertheless, applying the Gamma approach the Board is considering, there will still be other types of claims with alternative liability and equity settlement outcomes within the control of the entity.
32. In addition to the reverse convertible bond described in paragraph X, other instruments that would have alternative settlement outcomes under the Gamma approach include:
- (a) A callable share—A share that includes an unconditional right of the entity to repurchase the share for a fixed amount of cash. The share would be equivalent to an ordinary share but for the embedded call option.
 - (b) A purchased call option—A derivative that is gross physically settled that grants the right to the entity to repurchase a fixed number of ordinary shares, for a fixed amount of cash. Such an instrument is the standalone equivalent to the embedded derivative in the callable share.
33. For the claims in paragraph 32, the question is whether, when classifying the claims as liabilities or equity, the economic incentives to settle the claim in a particular way should be considered, and if so, how strong those incentives need to be to equate to economic compulsion.
34. As noted in paragraph 20, there are two prevailing views about whether economic compulsion should be considered when classifying claims as liabilities or equity:
- (a) View A—Economic incentives should not be considered (paragraphs 35–46)
 - (b) View B—Economic incentives should be considered (paragraphs 47–55)

View A—Economic incentives should not be considered

35. 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.

36. Equity classification is not intended to mean that economic resources will never be transferred to holders of equity claims. If there is no possibility of transferring economic resources, then the question is whether there is a claim at all.
37. This is why it is useful to distinguish between:
- (a) issues concerned with determining whether a claim exists or not; and
 - (b) issues concerned with determining whether an existing claim is classified as a liability or equity based on particular characteristics of the claim.
38. This project is focusing on the classification of an existing claim as a liability or equity based on particular characteristics of the claim. 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.
39. To provide information to help users make 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.

40. Because the entity has the right to settle a reverse convertible bond by delivering a fixed number of equity instruments, classifying it as equity under Gamma will show that:

- (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.

41. The fact that the entity can waive its right to defer payment until liquidation and settle the claim by transferring resources prior to liquidation is not relevant to the analysis. What is relevant is whether the entity has an obligation to transfer resources at a particular point in time other than at liquidation, not whether it is able to do so. As noted in BC8 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* in :

If the terms of the instrument give the entity an unconditional right to avoid delivering cash or another financial asset, the instrument is classified as equity. This is true even if other factors make it likely that the entity will continue to distribute dividends or make other payments.

42. Furthermore, if the entity has a substantive unconditional right to avoid the liability settlement outcome, then it does not matter if the liability settlement outcome is favourable or not. The entity does not have a financial liability if the right is substantive, even if it decides eventually to waive that right, and choose the unfavourable outcome. Again, as noted in paragraph BC12 of IFRIC 2:

The IFRIC observed that a history of redemptions may create a reasonable expectation that all future requests will be honoured. However, holders of many equity instruments have a reasonable expectation that an entity will continue a past practice of making payments. For

example, an entity may have made dividend payments on preference shares for decades. Failure to make those payments would expose the entity to significant economic costs, including damage to the value of its ordinary shares. Nevertheless, as outlined in IAS 32 paragraph AG26 (cited in paragraph A3), a holder's expectations about dividends do not cause a preferred share be classified as a financial liability.

43. However, 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 or otherwise settle it in a way that would meet the definition of a liability. This is because the value of the liability settlement outcome is always less than the value of the equity settlement outcome.
44. An example of this might be an obligation to pay cash equal to the fair value of 80 shares, which can also be settled by delivering 100 shares. Another, more complicated example, would be an 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 (such an instrument was considered by the IFRIC in 2014). Because the value of the share settlement outcome is determined to be greater than the value of the cash settlement outcome, then paragraph 20(b) of IAS 32 would require the claim to be classified as a financial liability.
45. 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) ...
- (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.

46. In the staff's view, the requirements in paragraph 20(b) of IAS 32 for indirect obligations should be retained. However, they will need to be updated to reflect the features that result in liability classification under the Gamma approach (see paragraph 39). A liability settlement outcome would include both obligations to transfer cash or other financial assets prior to liquidation, and obligations for a specified amount independent of the entity's economic resources.

View B—Economic incentives should be considered

47. As mentioned in paragraph 20(b) some interested parties find it counterintuitive that the reverse convertible bond that is highly likely to be settled in cash is classified as equity.
48. In the Conceptual Framework ED, the Board proposed that an entity has an obligation to transfer an economic resource if the entity has no practical ability to avoid the transfer. The feedback on the proposed 'practical ability to avoid' concept in the Conceptual Framework ED was discussed in March 2016 ([Agenda Paper 10E](#)). The Board will be redeliberating those proposals at a future meeting.
49. Paragraph 4.32 of Conceptual Framework ED stated that [emphasis added]:

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.

50. Furthermore, paragraph BC4.75(e) of the Basis for Conclusions on the Conceptual Framework ED states that economic compulsion may be a factor that reduces the entity's practical ability to avoid a future transfer, so it would need to be considered in assessing whether that criteria is met. However, the Conceptual Framework ED did not use the term or define its meaning.
51. The reference to 'economic consequences significantly more adverse than the transfer itself' could support a view that the potential significant favourability of the liability settlement outcome compared to the equity settlement outcome might establish a financial liability.
52. That is, if there is some scenario under which the equity settlement option is significantly unfavourable to the entity, the entity could have no practical ability to avoid the liability settlement outcome. This would be because the economic consequences of exercising the equity settlement outcome would be *significantly more adverse* than the liability settlement outcome in those scenarios. The extent to which the outcome is unfavourable, or probable, will be important in determining whether that outcome is significantly more adverse.
53. Another view of the Conceptual Framework ED proposals could be that they provide guidance that is of greater use in identifying whether a claim against the entity exists, as opposed to setting out the features that should determine the classification of an existing claim as a liability or equity. The Conceptual Framework ED did not include concepts for the distinction between liabilities and equity, which the Board is considering in this project instead.
54. However, regardless of the outcome of the Conceptual Framework project, some interested parties would continue to support considering economic incentives in the classification of liabilities and equity. Some of those parties would support a lower threshold for the economic incentives, such as probable, and others would support a higher threshold for the economic incentives, such as virtually certain.

55. There could be a very broad range of facts and circumstances that could affect an entity's decision to exercise the liability settlement option instead of the equity settlement option. Therefore, a number of follow-on questions arise if economic incentives are to be considered in identifying a liability. These could include:
- (a) The economic incentive to exercise the liability settlement option may range from marginally favourable to deeply in the money. How significant does an economic incentive need to be for the entity to be 'economically compelled' to transfer economic resources?
 - (b) Market changes will result in the significance of the economic incentive changing from period to period. Therefore, 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) 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), or other business factors may influence an entity's decision to exercise a liability settlement option. Should the assessment of economic compulsion consider economic consequences beyond the alternatives in the contract?
 - (d) Options that are subject to risk are typically always *potentially* favourable⁵. Therefore, 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?
 - (e) Furthermore, if the economic incentives of the transfer are being considered for reverse convertible bonds, should they not also be considered from the perspective of the holder for the classification of typical convertible bonds?

⁵ Apart from those that are always structurally in or out of the money (see paragraph x).

Summary and recommendation

56. The challenge relating to economic compulsion arose when the IFRIC was considering callable preferred shares with resets. As we have illustrated in paragraphs 29–30, such claims would be classified as liabilities under the Gamma approach without the need to consider economic incentives or economic compulsion.⁶
57. View A 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 based on the rights and obligations in the contract, and only reclassifying if there are changes in the rights and obligations of the claim. In the staff’s view, such a principle would provide information that is useful to users in making the assessments we identified for the Gamma approach as described in paragraphs 38–42. In addition, we think that some of the other challenges identified could be addressed by updating the indirect obligation requirements as suggested in paragraphs 43–46.
58. View B is not consistent with IAS 32’s underlying principle of classifying liabilities and equity based on the rights and obligations in the contract. Instead, View B considers the likelihood that economic resources would be transferred by the entity regardless of any obligation to do so. Furthermore, such an approach may raise more questions than it answers, in particular if the callable preferred shares with resets are addressed through the Gamma approach anyway, which classifies as liabilities both obligations to transfer economic resources prior to liquidation, and obligations for an amount that is independent of the entity’s economic resources.
59. As a reminder the Board has decided on presentation and disclosure requirements that would help communicate differences between claims with alternative settlement outcomes and other claims against the entity. This includes requirements to attribute amounts within equity to classes of equity other than ordinary shares.

⁶ Of course, this would not be the case under the Alpha approach.

60. Based on the analysis in this paper, in the staff's preliminary view, the potential favourability of the entity's right to exercise a liability settlement outcome *should not* be considered when classifying a claim for which the entity has a substantive unconditional right to avoid the liability settlement outcome.

Question

Does the IASB agree with the staff's preliminary view in paragraph 60?

Appendix A—Previous discussions of the IFRIC and IASB

Callable preferred shares with resets

61. 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.
62. 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.
63. In response to a request from the IFRIC, in June 2006⁷ 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 either⁸:
- (a) to deliver cash or another financial asset to the holder of the instrument,
- or

⁷ June 2006 IASB Update

⁸ Different requirements apply to financial instruments that may or will be settled in the issuer’s own equity instruments.

- (b) to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.
64. 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.
65. 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

66. 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.
67. 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.
68. 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.

69. 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

70. 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.
71. 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.
72. 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.

73. 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.
74. 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.