IFRS

STAFF PAPER

December 2021

IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Contingent settlement provisions: the meaning of 'liquidation' and 'non-genuine'

CONTACT(S)	Zachariah Gorge	zgorge@ifrs.org
	Angie Ah Kun	aahkun@ifrs.org
	Uni Choi	uchoi@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

Purpose of the paper

1. This paper asks the International Accounting Standards Board (IASB) for tentative decisions on proposed clarifications to the terms 'liquidation' and 'not genuine' found in paragraph 25 of IAS 32 *Financial Instruments: Presentation* relating to financial instruments with contingent settlement provisions.

2. At the September 2021 meeting, (Agenda Paper 5C) the IASB discussed potential clarifications to IAS 32 that could resolve practice issues related to the terms 'liquidation' and 'non-genuine' and directed the staff to develop them further. In this paper, the staff present further analysis considering the feedback from IASB members.

3. In developing the potential clarifications, the staff analysed whether the potential clarifications would result in useful information for the users of financial statements about the nature and timing of cash flows arising from financial instruments. The staff also looked at potential unintended consequences that could arise from the potential clarifications.

4. This paper is structured as follows:

   (a) staff recommendation;

(b) staff analysis and question for the IASB on potential clarifications to the following terms:

(i) liquidation; and

(ii) non-genuine.

Staff recommendation

5. The staff recommends that the IASB proposes that the following amendments to IAS 32:

(a) specify that the term 'liquidation' in paragraph 25(b) of IAS 32, refers to when an entity has started the process to permanently cease to trade; and

(b) specify that the assessment of whether a contractual term is 'not genuine' in paragraph 25(a) of IAS 32, is not purely a probability-based assessment. This would clarify that entities are required to apply judgement based on the specific facts and circumstances and the specific terms and conditions of the financial instrument.

Staff Analysis

Potential clarification of 'liquidation'

Why does it matter?

6. Paragraph 25 of IAS 32 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 […] is a financial liability of the issuer unless:

> […] (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** […]

7. Applying paragraph 25(b) of IAS 32, if a financial instrument requires settlement in cash, another financial asset or in such a way that it would be a financial liability only in the event of liquidation of the issuer, it would be classified as an equity instrument. Paragraph BC18 of IAS 32 explains that a contingent settlement provision that applies only in the event of liquidation of an entity should not influence classification because to do so would be inconsistent with the going concern assumption and such a provision is similar to an equity instrument that has priority in liquidation.

8. The interpretation of the term 'liquidation' will therefore affect whether some instruments are classified as financial liabilities or equity applying IAS 32. For example, if 'liquidation' refers to the point at which an entity enters into a process of administration or resolution, more financial instruments would be classified as equity. However, if liquidation refers to the point at which an entity ceases to exist, more financial instruments would be classified as financial liabilities.

9. At the September 2021 meeting, the IASB discussed whether the term 'liquidation' in paragraph 25 of IAS 32 was only intended to refer to the very end point when an entity ceases to exist or an earlier point such as administration. Some IASB members also asked the staff to consider the wording in the *Conceptual Framework for Financial Reporting* (Conceptual Framework) and IAS 1 *Presentation of Financial Statements* which appear to equate 'liquidation' with 'ceasing to trade' and ensure that any clarification to IAS 32 does not create an inconsistency with these IFRS Accounting Standards.

What does liquidation mean in practice?

10. The staff note that, in practice, liquidation is a process rather than a point-in-time event. There are many activities involved in the liquidation process such as selling off assets to pay creditors and shareholders, ending all business affairs, terminating relationships and obligations, etc. While it may not always be clear

when the liquidation process has begun, the liquidation process will typically end with an entity ceasing to exist. In the staff's view, it is important to identify when the liquidation process begins rather than when it ends.

11. As stated in Agenda paper 5C for the September 2021 meeting, there are many terms in practice that are used when an entity is a going concern with financial difficulty and when an entity has entered liquidation. These terms describe events within the entity or activities undertaken by the entity during times of financial difficulties and before or after starting the liquidation process. but have different meanings and occur at different times while an entity passes through financial difficulty. Some of these terms clearly refer to events or activities that occur before the entity has reached the beginning of the liquidation process (eg reorganisation, restructuring, administration) or after the point that liquidation begins (eg selling off assets to settle claims against the entity, strike off). However, for some other terms, it might not always be clear whether they occur before or after the process of liquidation has begun.

12. To determine whether an event or activity occurs before or after the process of liquidation has begun, the staff analysed common events and activities that clearly occur before and after the process of liquidation has begun. The staff found that events and activities that clearly occurred before liquidation has begun had the goal to return the entity to a healthy financial status whereas events and activities that clearly occurred after the liquidation process has begun, had the goal of ending the business.

13. We therefore concluded that the differences in these goals indicated a 'point of no return' in which the entity shifts its goal from attempting to return to resume operations (ie a going concern) to ending the business (ie no longer a going concern). Understanding this distinction will help entities make the classification decision when the financial instruments are issued. This is because it is only settlement in cash or another financial asset (or in such a way that it would be a financial liability) in the event of liquidation of the issuer that would qualify for equity classification.

How does this affect classification in IAS 32?

14. In the staff's view the point at which the liquidation process begins is when the entity reaches the 'point of no return' and cannot return to resume operating. We also think that this is consistent with the explanation in paragraph BC18 of IAS 32 and the requirements in the Conceptual Framework and IAS 1 (see paragraphs 7 and 9 of this paper).

15. However, the staff acknowledge that in practice, determining whether an entity has passed the 'point of no return' requires careful assessment as many activities in and of themselves are not indicative of whether the process of liquidation has started because some activities could also occur before the process of liquidation begins. For example, an entity might lay off employees and sell productive assets during the liquidation process, but might also undertake these activities during a restructuring in an effort to reduce expenses. Similarly, an entity might be forced to stop business activities, or cease trading, when the 'point of no return' has been reached, but entities which are regarded as 'too big to fail' may also be forced to temporarily stop business activities, or have a moratorium on trading, in the midst of a government bailout.

16. For classification purposes, an entity should consider the specific terms and conditions of the financial instrument and which contingent events would lead to settlement in a way it would be a financial liability. It is also important to consider whether the contingent event has the goal to return the entity to a state where it can resume its business activities or to permanently cease trading. For example, in some jurisdictions, certain types of bankruptcy signal that the 'point of no return' has been reached and the entity now has the goal to end the business. Therefore, a financial instrument that is settled in cash only in the event of such bankruptcy would be classified as equity. On the other hand, in the banking industry for example, resolution is a term commonly used to describe the process of enabling an insolvent bank that has been determined to be systemically important to resume its normal business activities. A financial instrument that is settled in, say a variable number of shares, in the event of resolution would be classified as a financial liability.

Potential Clarifications

17. The staff recommend that the IASB clarify that the term 'liquidation' in paragraph 25(b) of IAS 32, refers to when an entity has started the process to permanently cease to trade. This clarification would be consistent with the Conceptual Framework and IAS 1.

18. Clarifying the term 'liquidation' would improve the consistency in classification of financial instruments that contain obligations that arise on events that may seem similar to, but are not, liquidation. Doing so would help reduce diversity in practice. Classifying those financial instruments as financial liabilities would provide users of the financial statements with useful information about the entity's exposure to liquidity risk and its potential cash outflows in liquidation.

Question for the IASB

19. The staff would like to ask the IASB the following question.

Question 1 for IASB members
Do IASB members agree with the potential clarification set out in paragraphs 17-18 of this paper?

Potential clarification of 'non-genuine'

20. Paragraph 25 of IAS 32 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 […] 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** […]

21. In applying paragraph 25(a) of IAS 32, stakeholders often question how to assess whether a contingent event is 'non-genuine', so that the associated obligation is not classified as a financial liability. Although paragraph AG28 of IAS 32 clarifies the meaning of 'non-genuine' as used in paragraph 25 of IAS 32, some stakeholders view the explanation of 'non-genuine' as too narrow because it describes only a very limited set of circumstances.

22. At the September 2021 meeting, the IASB discussed whether assessing if a contingent event is non-genuine, is based purely on a probability-type assessment or if it can be interpreted as a wider notion that also considers the purpose for including particular features in the contractual terms of the instrument. The IASB members acknowledged that the assessment requires judgement to be applied when considering the specific facts and circumstances applying to a financial instrument and tentatively expressed the view that the assessment is not purely based on the probability of the contingent event occurring.

23. The words 'extremely rare, 'highly abnormal' and 'very unlikely' found in paragraph AG 28 of IAS 32 are interpreted by some stakeholders to mean that the 'non-genuine' assessment is a probability assessment. However, the staff are of the view that this is not the case because the wording in paragraph AG28 implies that to be non-genuine, all three descriptions should apply ie the event is expected to be extremely rare, highly abnormal **and** very unlikely. Therefore, considering an event to be non-genuine, is not purely based on the likelihood of the contingent event occurring.

24. The staff think some contingent events would be classified as 'genuine' despite their very low probability of occurrence. For example, terms may be included in a contract for genuine commercial, regulatory or tax purposes despite the likelihood of such an event to occur being extremely low.

25. Consider the following example. A bank issues a financial instrument qualifying as regulatory capital with a ‘regulatory change’ clause which requires the instrument to be settled in cash if the regulation changes in a way that no longer allows the instrument to be classified as regulatory capital. Although such a regulatory change is assessed as very unlikely, the clause is included for a genuine reason, which is to ensure that the bank maintains instruments that qualify as regulatory capital. If the non-genuine assessment was purely based on probability, a change in the regulatory treatment of an instrument might be considered very unlikely on initial recognition and therefore the clause is deemed as non-genuine. However, even if a change in the regulatory treatment is considered very unlikely at initial recognition, such an event might not be extremely rare or highly abnormal and therefore the contingent event cannot be regarded as non-genuine.

Potential Clarifications

26. The staff agree that judgement should be applied based on the specific facts and circumstances including the terms and conditions of a financial instruments We therefore recommend that the IASB clarifies that the assessment of ‘non-genuine’ required by paragraph 25(a) of IAS 32, is not purely a probability-based assessment. However, the staff do not recommend providing further clarification on how to do the assessment or expand or narrow the definition of ‘non-genuine’ to address the various circumstances that could arise in practice.

Questions for the IASB

27. The staff would like to ask the IASB the following question.

Question 2 for IASB members
Do IASB members agree with the staff recommendation as set out in paragraph 26 of this paper?