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STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Contingent settlement provisions and related issues—practice issues and potential solutions (part 1)

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Purpose of this paper

1. In this paper the staff analyse some of the practice issues arising from accounting for contingent settlement provisions covered by paragraph 25 of IAS 32.

2. Before developing proposed clarified principles, the staff will further consider each of the practice questions identified in Agenda Paper 5A to establish whether there are:

    (a) inconsistencies in IAS 32 requirements that need to be addressed;

    (b) underlying principles and rationale that need to be clarified; or

    (c) issues that merit further discussion by the Board.

    Where the staff believe this is the case, we highlight the potential clarifications which the Board could explore and the reporting consequences of the potential clarifications for each practice question discussed. In a future paper and following input from Board members at this meeting, the staff intend to analyse whether any potential clarifications result in useful information for users of the financial statements.

3. Although the objective of this project is not to reconsider the measurement requirements of financial instruments, which are mainly addressed in IFRS 9, the staff acknowledge that there is a close interaction between the classification and measurement of financial instruments and IAS 32 itself touches on some of these measurement aspects. Hence the staff analysed stakeholders' views and questions including the Committee's previous discussion in this area and considered whether any clarification could be made in how the existing measurement requirements would apply to particular financial instruments.

4. This paper is structured as follows:

   (a) staff analysis of the following practice questions:

      (i) order of applying requirements in IAS 32;

      (ii) does probability of a contingent event occurring affect classification?;

      (iii) impact of probability in measurement;

      (iv) discretionary payments; and

   (b) question for the Board.

Staff analysis

Order of applying requirements in IAS 32

5. Paragraph 25 of IAS 32 contains requirements for financial instruments with contingent settlement provisions and refers to a financial liability (not a liability component). Paragraph 28-32 of IAS 32 contain requirements for separating compound instruments into equity and non-equity components. The issue that arose in practice and during past Committee discussions was that when a compound financial instrument contains contingent settlement features, it is not clear whether there is a required sequence or order in which an issuer should apply the requirements in IAS 32. This is because the classification outcome could differ depending on which requirements are applied first.

6. Another common practice question is whether applying paragraph 25 of IAS 32 to financial instruments containing contingent settlement provisions requires

recognition of a financial liability for the full amount that is contingently payable. Whether the probability of a contingent event occurring should affect the measurement of a financial liability, is further discussed in paragraphs 30-52 of this paper.

7. The following table illustrates the possible classification outcomes based on the interpretation of which of these IAS 32 requirements applies first, using two illustrative examples.

<table>
<tr><th>Terms of instrument</th><th>Classification outcomes</th></tr>
<tr><td>Instrument A has no maturity date and has discretionary dividends. It is convertible into a variable number of the issuer’s own shares if the issuer breaches the Common Equity Tier 1 Capital ratio.

The contingent event is outside the control of both the issuer and holder and could potentially occur immediately. Instrument A was issued at par and is convertible into a variable number of shares to the value of the fixed par amount.</td><td rowspan="2">If contingent settlement provision requirements (paragraph 25 of IAS 32) are applied first:

• Liability in entirety (see paragraph 9 of this paper)

If compound instrument requirements (paragraph 28 of IAS 32) are applied first:

• Liability AND equity components</td></tr>
<tr><td>Instrument B is a bond with a fixed maturity date and fixed interest payments. It is convertible into a fixed number of the issuer’s own shares if the issuer’s share price reaches a specified amount (eg the entity's own share price at issuance plus 5%). The contingent event is outside the control of both the issuer and holder.</td></tr>
</table>

8. The Committee discussed Instrument A in July 2013 and published a tentative agenda decision which implied that an entity applies the requirements for compound instruments before the requirements for contingent settlement

provisions—ie, an entity first identifies and recognises the financial liability and equity components. The tentative agenda decision said the instrument is a compound instrument that is composed of: (a) a liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and (b) an equity component, which reflects the issuer's discretion to pay interest.

9. In contrast, if the requirements for contingent settlement provisions were applied first, then the instrument would be recognised entirely as a financial liability, resulting in no equity component. The compound instruments requirements would not apply because the wording in paragraph 25 of IAS 32 refers to a financial instrument being a financial liability rather than being a liability component.

10. As highlighted by respondents to the Committee's tentative agenda decision, the accounting treatment for discretionary distributions is affected by which requirements are applied first (see discussion on discretionary payments in paragraphs 53-63 of this paper). That is because IAS 32 requires interest, dividends, losses and gains relating to a financial liability or a liability component to be recognised in profit or loss, and those of an equity instrument or an equity component to be recognised in equity.

11. The Committee discussed Instrument A again in January 2014 and decided not to finalise the tentative agenda decision. Instead, it noted that the scope of the issues raised in the submission was too broad for it to address in an efficient manner.

12. As mentioned in Agenda Paper 5A of this meeting, when the Board was revising IAS 32 in 2003, it discussed contingent convertible bonds similar to Instrument B in the table above and had concluded that a financial instrument with a contingent settlement provision should be evaluated to determine whether it contains liability and equity components. If so, it should be treated as a compound instrument rather than being classified as a liability in its entirety. However, this conclusion did not make its way into the wording in paragraph 25 of IAS 32.

13. The staff note that the requirement on compound instruments in paragraph 28 of IAS 32 refers to the classification requirements in paragraph 15 of IAS 32 which in turn refers to the definitions of financial liability, financial asset and equity instruments. This suggests that the classification of compound instruments into its

component parts is the starting point. The requirements in other paragraphs of IAS 32 such as paragraph 25 of IAS 32 can therefore be seen as additional requirements that help to interpret or apply the definitions used in the classification.

14. If this were not the case and the compound instruments requirements did not apply to any instruments within the scope of paragraph 25 of IAS 32, then other contractual features in the instrument would effectively be ignored eg discretionary dividend features. The staff believe paragraph 25 of IAS 32 is required to be applied to identify the liability component of a compound instrument with a contingent settlement provision.

15. Furthermore, paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify an instrument in accordance with the substance of the contractual arrangement. The staff believe instruments that are in substance the same should be accounted for in the same way, irrespective of the legal form.

16. In determining whether the issuer has an obligation to settle a bond, there is no conceptual basis to distinguish a bond that is convertible at the option of the holder from a contingent convertible bond which is based on an event outside the control of both the issuer and holder. The convertibility of both instruments is beyond the control of the issuer and the issuer does not have an unconditional right to avoid the obligation to settle in cash in both cases. Depending on their terms, contingent convertible bonds should therefore be assessed to see if they have equity components or embedded derivatives that need to be separated from the financial liability.

17. Applying the above logic to the instruments in the table above, both Instruments A and B would be classified as compound instruments because they contain both liability and equity components. Classifying Instrument B as a compound instrument is also consistent with the classification of a bond convertible at the option of the holder. The liability component is identified first, consistent with the definition of equity being a residual interest. Paragraph 25 of IAS 32 can be applied to identify the liability components. In the case of Instrument A, there will be settlement in a variable number of own shares if a contingent event beyond the control of both parties occurs. In the case of Instrument B, there will settlement of

the par amount in cash if a contingent event beyond the control of both parties does not occur.

Potential clarification

18. In order to improve the clarity of the order of applying the requirements in IAS 32, the Board could consider adding to the requirements on compound financial instruments to clarify that the compound instrument requirements apply first before any specific classification requirements.

19. To reinforce the application of the correct order, the Board could consider adding a reference to a 'liability component' to paragraph 25 of IAS 32, which would indicate that some financial instruments with contingent settlement provisions may be compound instruments.

20. In the staff's view, clarifying that some financial instruments with contingent settlement provisions may be compound instruments is also consistent[1] with the examples of other compound instruments in paragraph AG37 of IAS 32 where settlement is outside the issuer's control:

    (a) a non-cumulative preference share that is mandatorily redeemable for cash in five years with discretionary dividends is a compound financial instrument; and

    (b) a similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ordinary shares calculated to equal a fixed amount.

Does probability of a contingent event occurring affect classification?

21. When a financial instrument contains contingent settlement provisions, the question sometimes arises as to whether the probability of the contingent event (which is outside the control of both parties to the contract) occurring should

[1] In the staff's view, classifying all of these instruments as compound instruments is consistent application of the principle that an obligation that an entity cannot avoid (and that meets the definition of a financial liability) is recognised as a financial liability component and the residual is recognised as an equity component.

affect the classification. For example, if the contingency is not likely to occur, the question arises whether it can be ignored in the classification.

22. The classification of a financial liability in IAS 32 is based on the underlying principle that 'an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation'. The focus is therefore on whether the issuer has the unconditional right to avoid delivering cash or another financial asset. Consider for example, a financial instrument with a contractual obligation that is contingent on a counterparty exercising its right to be repaid. Such a financial instrument is classified as a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset (paragraph 19 of IAS 32).

23. This underlying principle can be seen throughout IAS 32, for example:

    (a) the definition of a financial liability in paragraph 11(a)(i) as 'a contractual obligation to deliver cash or another financial asset to another entity';

    (b) the contingent settlement provision requirements in paragraph 25'.

    (c) paragraph AG8 which states that a contingent right and obligation meets the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements; and

    (d) paragraph AG26 of IAS 32 which states that the classification of a preference share as an equity instrument or a financial liability is not affected by the expectation of a profit or loss for a period.

24. The Board's reasoning is set out in paragraph BC17 of IAS 32 which explains that the contingent settlement provision requirements do not include an exception for circumstances in which the possibility of the entity being required to settle in cash or another financial asset is remote at the time the financial instrument is issued. The Board concluded that it is not consistent with the definitions of financial liabilities and equity instruments to classify an obligation to deliver cash or another financial asset as a financial liability only when settlement in cash is probable. There is a contractual obligation to transfer economic benefits as a result

of past events because the entity is unable to avoid a settlement in cash or another financial asset unless an event occurs or does not occur in the future.

25. As noted in paragraph 16 of this paper, the staff believes the underlying principle should be applied consistently, regardless of whether the alternative settlement outcomes (cash or own shares) are within the control of the holder or dependent on an uncertain future event that is beyond the control of both the issuer and the holder. Both these cases are outside the control of the issuer entity and result in the entity not having an unconditional right to avoid delivering cash or another financial asset to settle the obligation.

26. Contingency in settlement outcomes of a financial instrument does not affect its classification unless the entity controls the settlement outcomes (and hence has the unconditional right to avoid a liability settlement outcome). The probability of a contingent event (which is outside the control of both parties to the contract) occurring is therefore not considered in classification. An instrument is classified as a financial liability as long as the entity has no unconditional right to avoid delivering cash or another financial asset or settling it in such a way that it would be a financial liability.

27. Financial liabilities are different from other types of liabilities for example, provisions and contingent liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in that the recognition is based on contractual terms ie when an entity becomes a party to the contractual provisions of the instrument (and takes on the risks and rewards of the contract) and not based on probabilities of cash outflows. The underlying principle is whether the entity has the unconditional right to avoid the outflow of cash (or another financial asset) ie whether there is no genuine possibility that it will be required to pay cash, regardless of probability or remoteness of a cash outflow occurring. If probabilities were considered in classification, significant judgement would be required (eg how probable should cash payment be before a financial liability is recognised?) and continuous reassessment and reclassification would be needed if, and when probabilities change over time.

Potential clarification

28. The staff believe the underlying principle and the requirements in IAS 32 as set out in paragraph 22 of this paper are clear that if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle an obligation, the obligation is classified as a financial liability even if that obligation is only contingent. The staff do not believe further clarification is required.

29. Additionally, if the Board clarifies the order of application (paragraph 18 of this paper) and how the initial carrying amount is allocated to liability and equity components (paragraphs 49-52 of this paper), the staff believe this would indirectly address this practice question and provide further support to this underlying principle.

Impact of probability in measurement

30. As highlighted in Agenda Paper 5A, there has been much discussion in the past about the measurement of a financial liability with a contingent settlement provision. This issue was extensively discussed (but not resolved) by the Committee in 2013-2014 in the submission about the classification of a financial instrument issued to meet regulatory capital requirements that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event.

31. In this section of the paper, the staff will consider the interaction of the classification requirements with the measurement requirements for instruments with contingent settlement provisions.

32. For example, if these types of instruments are classified as compound instruments, paragraph 32 of IAS 32 contains a clear explanation of how the measurement requirements in IFRS 9 apply to the liability component. The liability component is measured at the fair value of a similar liability that does not have an associated equity component. However, it is not entirely clear what 'the fair value of a similar liability' means in the context of financial instruments with contingent settlement provisions and the staff will explore this matter further.

33. Further, a common practice question that arises both in the case of compound instruments and in the case of non-compound instruments is whether applying

paragraph 25 of IAS 32 to financial instruments containing contingent settlement provisions that could require immediate liability settlement, requires recognition of a financial liability for the full amount that is contingently payable.

34. Regardless of whether there is a compound instrument or not, effectively there are two arguments related to measurement to consider in financial instruments containing contingent settlement provisions that could require immediate liability settlement:

    (a) measure the liability at the full amount of the obligation ie undiscounted amount that the issuer could be required to repay immediately (similar to the fair value of a financial liability with a demand feature). Although the probability of a particular contingent event occurring immediately may be very low, many contingent events that are beyond the control of both the issuer and the holder could, in theory, occur immediately.

    (b) measure the liability at a probability-weighted amount taking into account the likelihood of the contingent event occurring and the timing thereof and therefore the likelihood of a liability settlement outcome.

35. As stated in Agenda Paper 5A and paragraph 11 of this paper, following feedback on the tentative agenda decision, the Committee noted in its final agenda decision in January 2014 that the scope of the issues raised was too broad for it to address in an efficient manner. However, in July 2013, in its earlier tentative agenda decision, the Committee had noted that:

    (a) to measure the liability component, the issuer must consider the fact that the contingent non-viability event could occur immediately because it is beyond the control of the issuer and there is no contractual minimum time period that must elapse before the contingent non-viability event could occur. Consistent with paragraph 23 of IAS 32 which applies to eg particular put options written on the issuer's own equity instruments, the liability component must therefore be measured at the full amount that the issuer could be required to pay immediately.

    (b) the equity component would be measured as a residual and thus would be measured at zero in the fact pattern discussed, because the

instrument is issued at par and the value of the variable number of shares that will be delivered at conversion is equal to that fixed par amount.

What do IFRS Standards say about measuring a financial liability?

36. IFRS Standards contain the following measurement requirements for financial liabilities at their initial recognition:

    (a) an entity shall measure a financial liability at its fair value (paragraph 5.1.1 of IFRS 9)

        (i) Paragraph 9 of IFRS 13 *Fair Value Measurement* defines fair value as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

        (ii) The fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (paragraph 47 of IFRS 13).

        (iii) Compound instruments—the issuer first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying amount of the equity instrument is determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole (paragraph 32 of IAS 32).

    (b) a contract that contains an obligation to purchase own equity instruments for cash or another financial asset is recognised initially at the present value of the redemption amount eg present value of the forward repurchase price, option exercise price or other redemption amount (paragraph 23 of IAS 32). In paragraph BC12 of IAS 32 this amount is referred to as the 'full redemption amount'.

37. The measurement of the financial liability when there are contingent settlement provisions is also mentioned in paragraph BC12 of IAS 32 in the context of the

Board's discussion on obligations to purchase own shares (emphasis added below). We note though that the Basis for Conclusions accompanies, but is not part of IAS 32, nor is it part of the application guidance that is an integral part of the standard:

> Some respondents to the Exposure Draft suggested that when an entity writes an option that, if exercised, will result in the entity paying cash in return for receiving its own shares, it is incorrect to treat the full amount of the exercise price as a financial liability because the obligation is conditional upon the option being exercised. The Board rejected this argument because the entity has an obligation to pay the full redemption amount and cannot avoid settlement in cash or another financial asset for the full redemption amount unless the counterparty decides not to exercise its redemption right or specified future events or circumstances beyond the control of the entity occur or do not occur. The Board also noted that a change would require a reconsideration of other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity's control. These include, for example, (a) **the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation,** (b) the treatment of preference shares that are redeemable at the option of the holder as financial liabilities for the full amount of the conditional obligation, and (c) the treatment of financial instruments (puttable instruments) that give the holder the right to put the instrument back to the issuer for cash or another financial asset, the amount of which is determined by reference to an index, and which therefore has the potential to increase and decrease, as financial liabilities for the full amount of the conditional obligation.

What did stakeholders say about the measurement of the financial liability?

38. The staff considered the comments received on the Committee's tentative agenda decision which were discussed at the January 2014 Committee Meeting and which also reflect issues that arise in practice. The main arguments against measuring the liability at the full amount or arguments highlighting that IAS 32 is unclear were:

    (a) the non-viability condition does not necessarily cause the instrument to be immediately convertible because most financial institutions have at least partial control over the adequacy of their Tier 1 capital.

    (b) expectations about the potential timing of conversion are relevant to measuring the liability component at fair value. Measuring the liability at the full amount that the issuer could be required to pay only in a non-viability event is akin to a non-going concern valuation even if it could occur immediately in theory—which would seem reasonable only when the conversion feature is likely to be triggered—and would be inconsistent with the preparation of financial statements under the going concern assumption.

    (c) paragraph BC12 of IAS 32 is clear that the issuer must assume that the contingent event will occur (and thus the probability of the event occurring should not be a factor in the measurement of the liability) but the paragraph is unclear whether the expected timing of that event should be factored into the measurement.

    (d) the instrument described in the submission is (or may be) different from a demand deposit—and thus it is (or may be) inappropriate to analogise to the measurement requirements in IFRS 13 for a demand deposit. The holder of the instrument does not have the right to demand payment but rather payment is contingent on an uncertain future event that is beyond the control of both the issuer and the holder.

    (e) from a valuation perspective, a market participant would not treat this instrument as if it was 'on demand' when determining the fair value of the liability. Consequently, the measurement of the liability must

reflect a probability-weighted assessment of when the contingent non-viability event might occur; that is, it must be a present value.

39. However, the staff note that there is also a view that measuring the liability based on a probability-weighted assessment of when the contingent non-viability event might occur is (or could be) inconsistent with the measurement for other instruments that oblige the issuer to deliver cash or a variable number of its own equity instruments eg written put options on own equity. In addition, a probability-weighted measurement approach results in recognising a residual amount as equity even though the issuer does not have an unconditional right to avoid settling those amounts.

Illustrative examples

40. Consider the same examples in the table in paragraph 7 of this paper. If the Board clarifies that the compound instruments guidance applies first, these instruments are both compound instruments and the liability and equity components should be identified.

41. In the case of Instrument A, the following components exist:

Liability component	The contractual obligation to settle the instrument in a variable number of issuer's own shares upon a contingent event outside the control of both the issuer and the holder.
Equity component	Discretionary dividends

42. In the staff's view, the requirements in IAS 32 for compound instruments are clear. As explained in paragraph 36(a)(iii) of this paper, an entity applies paragraphs 31–32 of IAS 32 to allocate the initial carrying amount of a compound instrument to its liability and equity components.

43. The question arises how to measure a similar liability excluding the associated equity component. In Instrument A, the equity component represents discretionary dividends, and 'a similar liability without an associated equity component' is an instrument containing an obligation to deliver a variable number of shares upon

the occurrence of a contingent event but that does not pay discretionary dividends. As the associated equity component does not involve a conversion of the obligation into another, the contingency that triggers the obligation is part of the liability component. If the fact that the contingent event could occur immediately is considered, the liability would be measured at the full amount of the proceeds. However if the probability of the contingent event occurring is factored into the measurement, some of the proceeds would be allocated to the equity component.

44. Contingent convertible instruments can have various terms eg they may be convertible into a fixed or variable number of shares in the event of a contingency occurring or not occurring and in addition, coupon payments may be mandatory or discretionary. In February 2021, the Board's discussion on 'perpetual instruments' included contingent convertible instruments with no maturity that are convertible into a fixed number of shares upon the occurrence of a contingent event. These instruments are currently classified as equity instruments applying IAS 32. As noted above, if the probability of the contingent event occurring was considered in calculating the liability component of Instrument A and if the issuer is in a strong capital position and is expected to remain so, it is likely that most of the proceeds would be allocated to the equity component. The staff note that this would not be too different from the classification of the contingent convertible bonds the Board discussed in February 2021.

45. In the case of Instrument B, the following components exist.

Liability component	The contractual obligation to make periodic interest payments and principal repayment on its maturity
Equity component	The conversion of the bond into a fixed number of the issuer's own shares upon the occurrence of an event beyond the control of both parties

46. Unlike Instrument A, the equity component in Instrument B represents the conversion feature to convert the bond into shares upon a contingent event occurring. Applying paragraph 32 of IAS 32, a similar liability without an

associated equity component would be a vanilla bond that does not have a conversion feature. Therefore, in measuring a similar liability excluding the associated equity component, the probability of the contingent event occurring would effectively be ignored. The liability would be measured at the fair value of the interest and principal payments on maturity. The contingency (the probability of the contingent event occurring) would be part of the equity component. The staff note that the paragraphs on compound instruments in IAS 32 can clearly be applied to Instrument B because of its similarity to a traditional convertible bond which is convertible at the option of the holder.

47. There are also other financial instruments with contingent settlement provisions that are not compound instruments. Consider for example if Instrument A did not have discretionary dividends attached to it. Other examples in practice include bonds that are commonly issued with covenants. The bond covenants can contain ratios involving debt, assets, and equity eg if the equity to assets ratio falls below a specified level, then the bond becomes payable immediately. The contingency in these bonds may be similar to that in contingent convertible bonds with non-viability clauses and could have similar likelihood of occurrence. In practice, when the issuer of these bonds measures them, it does not treat them as if they have 'demand features'. The bonds continue to be measured based on the discounted value of the interest and principal payments. This is because a market participant would not assume the bond covenant could be breached immediately as the trigger event is beyond the control of both parties. Similarly, bonds often have change in control or material adverse event clauses that require an accelerated repayment but the issuers of these bonds do not measure the bonds assuming that the events could happen immediately.

48. The staff observe from the above examples that in applying the current requirements in IAS 32, there could be diversity in practice and inconsistencies between:

(a) measuring the liability component amongst compound instruments; and

(b) measuring the liability component of a compound instrument with a contingent settlement provision and the liability of a non-compound instrument with a contingent settlement feature.

Potential clarifications

49. In the staff's view, paragraph 25 of IAS 32 is clear about the existence of a financial liability but not its measurement. In addition, paragraphs 29-32 of IAS 32 provide a clear principle for recognising, and allocating, the initial carrying amount of a compound instrument between its liability and equity components. These paragraphs on compound instruments however discuss the application of the principle in the context of traditional convertible bonds only, thus creating questions about how it applies to other types of compound instruments such as Instrument A. It is also not clear from IAS 32 whether the fact that a financial instrument with a contingent settlement provisions (that could require immediate liability settlement upon a contingent event occurring) should result in similar measurement to a financial liability repayable on demand.

50. The Board could clarify its view on whether the fact that a contingent event could occur immediately and result in settlement in such a way that there would be a financial liability (component) should result in the same measurement consequences as a financial liability repayable on demand. This would affect what is meant by 'a similar liability without an associated equity component' when applying paragraph 32 of IAS 32 to compound financial instruments with contingent settlement provisions such as Instrument A as discussed in paragraphs 40–44 of this paper).

51. The staff summarise and contrast the potential clarifications the Board could make depending on its view in paragraph 50 of this paper. Even though the below table refers to 'similar liability', these clarifications would apply to both compound and non-compound financial instruments with contingent settlement provisions (that could require immediate liability settlement upon a contingent event occurring) in measuring the liability (component) upon initial recognition:

View A	View B
Similar liability: a liability repayable on demand eg demand deposit	**Similar liability:** liability without a demand feature (a liability with a contingent obligation)

Measurement of fair value: full amount of the obligation without taking into consideration the expected probability and timing of the contingent obligation	**Measurement of fair value:** fair value taking into account the expected probability and timing of the contingent obligation
Rationale: the full amount of the obligation could be immediately repayable if the contingent event occurs the very next day. The expected timing cannot be taken into account because the contingent event could occur, in theory, anytime and require the issuer to settle the obligation immediately. This is consistent with the Board's conclusion in BC12 of IAS 32 that the entity has an obligation to pay the full redemption amount and cannot avoid settlement in cash or another financial asset for the full redemption amount unless the counterparty decides not to exercise its redemption right or specified future events or circumstances beyond the control of the entity occur or do not occur.	**Rationale**: the contingent event is outside the control of both parties and cannot be assumed to occur immediately. Taking into account both probability and timing would reflect the fair value of the liability (component). Based on the definition of fair value in IFRS 13, the price that would be paid to transfer an obligation that is contingent on an uncertain future event would reflect the probability and likely timing of that event occurring. When the liability settlement outcome is contingent on an event occurring that is outside the control of both parties, it is often not possible to separate the probability and timing of the contingent event. In such cases, taking into account the expected probability is necessary to taking into account the expected timing.
Board can consider: • incorporating the measurement guidance in paragraph BC12 (full amount	**Board can consider:** • clarifying that the measurement of the contingent settlement obligation should

of the conditional obligation for instruments with contingent settlement provisions) into IAS 32. • clarifying that the 'full amount of the conditional obligation' means[2] the amount repayable assuming the earliest possible repayment date, ie immediate repayment for financial instruments with a contingent settlement provision.	take into account the expected probability and timing of the contingent event. • limiting the scope of this alternative to instruments subject to contingent non-viability events which would include Instrument A. This would be on the premise that non-viability precedes liquidation and would not be expected to occur immediately if the entity is a going concern[3] without financial difficulty.

52. In addition, the Board could consider:

(a) how its views on the initial measurement discussed above, would affect the subsequent measurement of the liability and how to account for changes in expectations. For example, if the Board's view is similar to View A described in paragraph 51 of this paper, questions to consider if the liability is subsequently measured at amortised cost would include:

(i) whether the expected probability and timing of the contingent event occurring would be considered in estimating the *expected* cash flows to determine the effective interest rate; and

[2] However we note that clarifying what is meant by 'full amount of the conditional obligation' would then affect preference shares redeemable at the option of the holder which is also measured at the 'full amount of the conditional obligation' per BC12.

[3] Non-viability is not inconsistent with and does not violate the going concern assumption. In other words, an entity could be non-viable and still a going concern, albeit a going concern with financial difficulty. This is because an entity is required to prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. (See discussion on the meaning of liquidation in Agenda Paper 5C.)

(ii) how paragraph B5.4.6 of IFRS 9 would apply, which requires the amortised cost of a financial liability to reflect the present value of the *estimated* future contractual cash flows).

(b) regardless of view A or view B above, clarifying the principle behind recognising 'financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation', (which was noted in paragraph BC12 of IAS 32). This is especially important if the wording is increasing diversity in practice.

(c) how to account for the difference if the full amount of the obligation is higher or lower than the proceeds on issue e.g. a non-derivative instrument is issued for its initial fair value of 100 but is redeemable at 120 in the event of a contingency, or an instrument issued at a premium and repayable at par in the event of a contingency).

(d) whether notional interest should be recognised on a liability already measured at its redemption amount.

Discretionary payments

53. In some compound instruments, the equity component represents the discretionary dividend or interest amounts rather than the conversion of the principal amount into a fixed number of ordinary shares. The question that arose in practice was how an entity accounts for any subsequent discretionary distributions made if all of the issuance proceeds are allocated to the liability component at initial recognition ie the equity component is measured at zero.

54. Some stakeholders believe there is an apparent contradiction between paragraph 36 of IAS 32 (dividend payments on shares wholly recognised as liabilities are recognised as expenses in profit or loss in the same way as interest on a bond) and paragraph AG37 of IAS 32 (discretionary dividends paid relate to the equity component and are recognised in equity as a distribution of profit or loss). The staff do not believe there is any contradiction between these paragraphs in IAS 32 because there is a difference between recognising a financial instrument wholly as a liability and recognising a compound instrument where all the value is allocated

to the liability component. In the latter case, an equity component exists, albeit measured at zero.

55. The staff note that the Board's discussion on discretionary payments is subject to its discussion on the order of applying the requirements in IAS 32 and its discussion on the measurement of the liability component of a compound instrument with a contingent settlement provision. For example, the particular issue discussed here is only relevant if the Board decides that the compound instruments guidance is applied first and all the issuance proceeds are allocated to the liability component. If some of the issuance proceeds are allocated to the equity component, there is no practice question about where to recognise the discretionary dividends paid (directly in equity in accordance with paragraph AG37 of IAS 32). Similarly, if the Board decides that the contingent settlement provision requirements are applied first such that there is no compound instrument, there is also no practice question about where to recognise the discretionary dividends paid (in profit or loss in accordance with paragraph 36 of IAS 32).

56. This issue was extensively discussed by the Committee in 2013-2014. In the Committee's tentative agenda decision on a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event (see Agenda Paper 5A and Instrument A in this paper), the Committee noted that the equity component exists and therefore, consistent with paragraph AG37 of IAS 32, if the issuer pays any interest on the instrument, those payments relate to the equity component and would be recognised in equity.

57. Feedback on the Committee's tentative agenda decision on this issue revealed that some respondents equate recognising a compound instrument where all the value is allocated to the liability component to recognising a liability in its entirety. Feedback included the following:

    (a) some respondents questioned whether the guidance in paragraph AG37 of IAS 32 is relevant if 100% of the issuance proceeds is allocated to the liability component at initial recognition. They believed that the instrument could be viewed wholly as a liability (ie because the equity component is valued at zero)—and thus interest paid on the instrument

should be recognised as interest expense in profit or loss. These respondents expressed the view that this would result in a symmetrical outcome in the balance sheet and the income statement (ie a liability in the balance sheet with the related interest expense in the income statement).

(b) treating the dividend as interest expense is consistent with the accounting for transaction costs on compound financial instruments which are proportionately allocated amongst the components (ie if zero value is ascribed to the equity component then all transaction costs on the instrument would be recognised as part of the liability and ultimately recognised in the income statement as part of the effective yield).

(c) an entity should choose an accounting policy—to be applied consistently—to recognise discretionary distributions in profit or loss or equity when 100% of the instrument's proceeds is allocated to the liability at initial recognition.

58. This issue is relevant to (and may affect) the ongoing discussion of written put options on non-controlling interests ('NCI puts')—specifically whether any discretionary dividends paid to non-controlling interest holders should be recognised as expenses or equity distributions when a gross liability has been recognised and the non-controlling interest (equity) has been derecognised.

59. As discussed above, the Board's discussion on the order of applying the requirements in IAS 32 will affect its discussion on discretionary payments. For example, if the Board tentatively decides, taking into account the argument in paragraph 13 of this paper, that the compound instrument requirements are applied before the contingent settlement provision requirements in paragraph 25 of IAS 32, then paragraph AG 37 of IAS 32 applies and there is no conflict between paragraphs 36 and AG37 of IAS 32. Therefore if an instrument is classified as a compound instrument (even if no amount is allocated to the equity component initially), discretionary dividends relate to the equity component and are recognised in equity. The staff believe it would not be appropriate to recognise

the dividends in profit or loss (and nothing in equity) in this case as this would effectively negate the conclusion that the instrument is a compound instrument.

Potential clarifications

60. As explained in paragraph 54 of this paper, the staff think the principle in IAS 32 is clear that the recognition of interest, dividends, losses and gains relating to a financial instrument follows its classification, ie those related to a financial liability (component) are recognised in profit or loss and those related to an equity instrument (component) are recognised directly in equity. However, given the practice question described in paragraphs 54 and 57 of this paper, the staff think the Board could consider clarifying in paragraph 28 of IAS 32 that a compound instrument with a zero-value equity component is still a compound instrument with a liability and an equity component. It would clarify that such a compound instrument is different from a financial instrument that is wholly recognised as a financial liability.

61. This clarification would become more relevant if the Board decides that the compound instruments requirements are applied first to an instrument such as Instrument A and the full amount of the proceeds should be allocated to the liability component, with the equity component recognised at zero. The clarification will make it clear that AG 37 of IAS 32 would naturally be applied to the dividends paid on such compound instruments.

62. The staff think the above clarification would be sufficient to address the practice question described in this section. However, to avoid any further perceived inconsistency within IAS 32, the Board could also clarify the scope of paragraphs 36 and AG37 of IAS 32. It could do this by specifically clarifying that the requirement on dividends paid on compound instruments in paragraph AG37 of IAS 32 applies even if the equity component is initially measured at zero. Alternatively, it could specifically clarify that 'shares wholly recognised as liabilities' mentioned in paragraph 36 of IAS 32, does not include compound instruments even if the entire issuance proceeds are allocated to the financial liability component. These clarifications would make it clear that paragraphs 36 and AG37 of IAS 32 would apply to different fact patterns.

63. Alternatively, the Board could also consider deferring this discussion until the Board discusses NCI puts to ensure a consistent principle is clarified or developed that will address all relevant and similar issues.

Question for the Board

64. The staff would like to ask the Board the following question.

Question for the Board
Do Board members have any initial views or questions on the staff's analysis of the practice questions or the potential clarifications that the Board could consider which are set out in this paper?