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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 2)

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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. This paper is structured as follows:

   (a) staff analysis of the following practice questions:

      (i) assessing control;

      (ii) meaning of 'non-genuine';

      (iii) meaning of 'liquidation'; and

   (b) question for the Board.

Staff analysis

Assessing control

4. Applying paragraph 25 of IAS 32 requires considering whether contingent events are beyond the control of the issuer and the holder of the instrument. The issuer is the reporting entity which is defined in the Conceptual Framework for Financial Reporting (Conceptual Framework) as 'an entity that is required, or chooses, to prepare general purpose financial statements.' The holder of the instrument could be the holder of a debt instrument or the holder of an equity instrument (ie the owner). Paragraph 7 of IAS 1 defines 'owners' as 'holders of instruments classified as equity'.

5. Questions have arisen in practice as to when an event is within the entity's control and particularly, when shareholders are acting as on behalf of the entity in their capacity as owners instead of as investors in particular financial instruments. For example, in classifying preference shares, an issuer considers, amongst others, the contractual term that a preference dividend must be paid in cash if cash dividends are paid on ordinary shares. If cash dividends on ordinary shares require approval by a simple majority of ordinary shareholders in a general meeting, the question is whether ordinary shareholders are acting on behalf of the entity when approving dividends.

6. IAS 32 does not provide specific requirements on classifying a financial instrument when the contractual obligation to deliver cash is at the discretion of the issuer's shareholders. It also does not include any application guidance on determining which decisions are within, or out of, the control of the entity. The

staff will therefore explore further the issues of (i) how to assess whether a decision is within the entity's control, (ii) what is not within the entity's control and (iii) what is unclear as to whether within the entity's control or not.

(i) How to assess whether a decision is within the entity's control

7. IAS 32 does not define what is meant by control. The Conceptual Framework defines control of an economic resource as 'the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it.' IFRS 10 *Consolidated Financial Statements* defines control of an investee by reference to power over the investee and power is defined as 'existing rights that give the current ability to direct the relevant activities.' Both these uses of the notion of control refer to the notion of directing something eg directing the relevant activities. In an entity, it is usually the board of directors (or similar governing body) and management that are responsible for decision-making and corporate governance activities. The staff believe the board of directors, appointed by the shareholders of the entity as their representatives, and management can therefore be seen as an extension of the entity.

8. Where a decision is to be made by the board of directors of an entity, it would therefore follow that such a decision is within the entity's control. In some instruments, redemption in cash may be contingent on the entity entering into a specific transaction eg launching an IPO. If the board of directors could decide to avoid entering into that specific transaction, the contingent event would be regarded as within the entity's control. However, decisions of the board of directors and management are often subject to shareholders' approval. Furthermore, shareholders have the power to appoint or remove directors or management of the entity. The question then arises whether the shareholders of the entity can be viewed as an extension of the entity or whether they are acting as investors in particular instruments.

9. In addition, paragraph 10 of IFRIC 17 *Distributions of Non-cash Assets to Owners* discusses the date of liability recognition and what is meant by the 'discretion of the entity' in this context. It states:

> The liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity, which is the date:
>
> (a) when declaration of the dividend, eg by management or the board of directors, is approved by the relevant authority, eg the shareholders, if the jurisdiction requires such approval, or
>
> (b) when the dividend is declared, eg by management or the board of directors, if the jurisdiction does not require further approval.

10. It is therefore clear that decisions of management or the board of directors are decisions of the entity. However, it is not entirely clear from this paragraph whether the shareholders can be seen as part of the entity. One could argue the shareholders are an extension of the entity because the dividend is no longer at the discretion of the entity only after it is approved by the shareholders. Alternatively, one could argue that the shareholders are not part of the entity because they are distinct from management or the board of directors and referred to as 'the relevant authority' that approves the dividend.

11. Consider the following example of a decision required to be made by preference shareholders which will also lead to cash payments to those preference shareholders: An entity receives venture capital funding from investors through the issue of preference shares (that are convertible to ordinary shares and entitle them to priority payments), which entitles them to vote on particular decisions to be made. In addition, these preference shareholders share in the proceeds of a sale of the business through various exit mechanisms (trade sale, share sale or initial public offering). Decisions about the sale of the business are voted on by all shareholders with voting rights, including the preference shareholders. In classifying the preference shares, the question is whether such exit decisions are considered to be within the control of the entity (suggesting equity classification) or alternatively, are made by those preference and ordinary shareholders in their capacity as investors in respective instruments and therefore outside the control of the entity (suggesting liability classification).

12. Another example in which similar questions may arise, is with respect to a special purpose acquisition company (SPAC) that is created to acquire one or more companies or operating businesses. For example, the SPAC has two types of shares: class A shares and class B shares. It has a fixed period from the listing date to acquire a target. The acquisition will require an approval by a majority of two-thirds of shares of each class. If there is an acquisition, Class B shareholders can require the SPAC to redeem their shares if they voted against the acquisition. One of the questions that arises in practice is whether the SPAC has an obligation to deliver cash or another financial asset to the shareholders of B shares or can avoid such settlement. This depends on whether the shareholders' decisions to vote against the acquisition can be considered as decisions of the SPAC entity itself.

13. In analysing whether shareholders can be viewed as an extension of the entity, the staff believe the following questions arise:

    (a) is it all voting shareholders or a particular class of shareholders, eg ordinary shareholders whose voting rights are not conditional rather than preference shareholders that can be acting as part of the entity?

    (b) does it make a difference whether the entity is a public company (with shares that are freely tradeable on the open market) or a private company (with restrictions on selling shares to external parties)?

    (c) does the type of decision affect the capacity in which the shareholder is acting in eg change of control decision vs decision to pay dividends?

Type of shareholder

14. In most cases it is the ordinary shareholders that have unconditional voting rights ie that can make decisions at annual general meetings such as approving the payment of dividends. However, some classes of ordinary shareholders and preference shareholders (or investors in other equity instruments) may have voting rights only in certain circumstances. The conditional voting rights usually exist to protect their interests for example, the preference shareholders may be entitled to vote to declare a preference dividend if the entity skips coupon payments for x times.

15. The staff believe the type of shareholder on its own would not determine whether a decision is within the control of the entity or not, but what is important is whether a shareholder has rights to make decisions (usually via voting rights) and whether those rights are conditional. In the staff's view, voting rights being conditional can be an indicator that the shareholder will be acting as the investor in a particular instrument rather than as the owner of the entity when it exercises its voting rights. Therefore, the type of voting rights is more important than the type of shareholder.

Type of entity

16. Amongst other differences, the legal form of the entity may influence the ease with which shares can be transferred, and hence the ownership of the entity, but share transfers are generally possible regardless of the type of entity. The staff do not think the ease with which ownership transfers could be made, result in the shareholders being less of an owner of the entity.

17. In addition, there are many other activities of the entity (other than share transfers) on which decisions need to be made so distinguishing shareholders based on the ease with which they can transfer their shares is not sufficient to establish whether shareholders are acting as an extension of the entity. The staff believe what is important is determining what is within an entity's control, rather than the type of entity.

Type of decision

18. Decisions made by shareholders are often made at the (annual) general meeting as part of the normal operating and corporate governance processes of an entity eg approving the payment of interim and annual dividends. In practice, these decisions are often regarded as routine and therefore shareholders in these cases are often regarded as acting as an extension of the entity. Recently, during the Covid-19 pandemic, many banks in response to requests from regulators refrained from paying dividends in the interest of preserving capital, providing liquidity to individuals and businesses and investing in their business. It could thus be argued that the decision to pay or not pay dividends is often done in the interest of the entity rather than the interest of shareholders.

19. However, in other types of decisions, shareholders may be regarded as acting in their own interests ie when decisions are taken as investors in particular instruments. The staff considered which decisions are made by shareholders in their own interests ie in the capacity as an investor in an equity instrument. For example, a shareholder cannot individually decide on the amount of dividends it will receive but it can decide to sell its shares to a new owner. In some cases, the shareholder can decide to vote for a change of control of the entity and its decision would affect the value of its individual shareholding. The staff believe the type of decision is therefore relevant because it affects whether shareholders are acting in their own interests and therefore are outside the control of the entity.

20. The staff also note that in some circumstances, different types or classes of shareholders stand to benefit differently from a particular decision. For example, both preference shareholders and ordinary shareholders may be entitled to vote on the sale of the business but the proceeds are not shared equally among them. Preference shareholders may be entitled to a specified fixed amount from the sale of the business whereas ordinary shareholders may be entitled to the remaining proceeds. In the staff's view, such differences in how a decision affects different types of shareholders can be an indicator that particular shareholders will be acting as investors in particular instruments when they make the decision.

21. The notion of 'owners acting in their capacity as owners', although it is not specifically defined, is found in various IFRS standards, including:

    (a) IAS 1 requires transactions with owners in their capacity as owners to be recognised in the statement of changes in equity rather than in the statement of comprehensive income.

    (b) with regards to foreign currency denominated rights issuances as described in paragraph 16(b)(ii) of IAS 32, a pro rata issue of rights to all existing shareholders to acquire additional shares is a transaction with an entity's owners in their capacity as owners (paragraph BC4I of the Basis for Conclusions on IAS 32).

    (c) the scope paragraph of IFRIC 17 clarifies that it applies to non-reciprocal distributions of assets by an entity to its owners acting in their capacity as owners.

(d) The scope of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* specifically excludes transactions where the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder. The Basis for Conclusions on IFRIC 19, acknowledges that determining whether the issue of equity instruments to extinguish a financial liability in such situations is considered a transaction with an owner in its capacity as an owner would be a matter of judgement depending on the facts and circumstances.

22. In finalising the Committee's agenda decision in March 2010 on shareholder discretion (see Agenda Paper 5A), the Committee acknowledged that the different situations identified in relation to that issue indicates that there is a range of specific contractual terms and conditions that may require the delivery of cash to the holder at the discretion of the issuer's shareholders and there is no overall principle of how the financial statements should reflect the actions of the shareholders of a reporting entity in IFRSs.

(ii) What is not within the entity's control

23. Paragraph 25 of IAS 32 gives examples of future events that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. Some of these examples were carried forward from SIC 5 *Classification of Financial Instruments—Contingent Settlement Provisions*.

24. We note that some stakeholders are of the view that some of these events such as the issuer's future revenues, net income, financial position ratios or own share price are at least partially within the control of the entity and they would like better articulation of the notion of control in this regard and improved wording to remove potential confusion or diversity in practice.

25. In the staff's view, for the purpose of applying paragraph 25 of IAS 32, if an event is not fully within control of the entity, it is treated as beyond the control of the entity. That is because partial control does not give the entity an unconditional right to avoid a contractual obligation.

26. Other examples of contingencies that are generally regarded as outside the control of both the issuer and the holder include: changes in exchange rates, changes in commodity prices, changes in regulatory capital requirements, changes in control, changes in listing status (such as successfully completing an IPO) and cross-default settlement clauses.

(iii) What is unclear whether within the entity's control or not

27. In practice, it is generally accepted that judgement is often required in determining whether an event is within the entity's control or not. This determination may not be so straightforward for example in the following cases: (a) full repayment of an instrument in case of fraud in the company; (b) distributions that are required to be made to holders unless excess capital is reinvested in the business; or (c) repayment of an instrument in case of deadlock on key decisions.

Potential clarifications

28. The Board could consider adding some overall principles to IAS 32 to address the following:

    (a) how an entity determines whether an event is within its control—the Board could further explore what factors an entity should consider in applying judgment. The Board could then provide guiding principles and supplement the principles with examples of what is and what is not within the entity's control. It could also consider articulating the notion of control in this context.

    (b) what to consider when classifying an instrument where settling the obligation in cash or another financial asset is subject to shareholder approval. For example, an entity could consider the types of voting rights held by shareholders as well as the type of decisions which may affect the capacity in which the shareholder is acting.

    (c) how to determine the capacity the shareholder is acting in—the Board could provide guiding principles for an entity to consider in applying judgment. It could supplement the principles with examples of when the shareholder is acting in their individual capacity as an investor in a particular instrument and when it is acting as an extension of the entity.

29. In the staff's view, the above principles would clarify the link between shareholder decisions and events outside the control of the entity—where the shareholder is acting in their individual capacity as an investor in a particular instrument, it is not acting in the capacity of the entity and such decisions are therefore outside the control of the entity.

Meaning of 'non-genuine'

30. In applying paragraph 25 of IAS 32, stakeholders often question whether a contingent event can be seen as 'non-genuine' so that the associated obligation is not classified as a financial liability. In particular they question whether 'non-genuine' is a wider notion that also considers the purpose for including such features in the terms of the instrument even if that contingent event is extremely rare, highly abnormal or very unlikely to occur.

31. 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 as limited. Paragraph AG28 states:

> […]Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

32. In considering whether there is a need to further clarify the meaning of non-genuine, the staff researched some of the Board's prior discussions on this topic. When developing the revised IAS 32 in 2003, the Board tentatively agreed in April 2003 that contingent settlement provisions that have no realistic possibility of affecting the manner of settlement should be disregarded when classifying a financial instrument as equity or a financial liability. During that discussion, the Board considered a number of possible phrases to describe 'non-genuine' provisions such as 'no commercial reality', 'lack substance', 'no genuine

commercial possibility of affecting the manner of settlement' and considered that contingent settlement provisions which are virtually certain should be treated as certain.

33. The addition to the revised IAS 32 in 2003 of the exceptions to financial liability classification for 'non-genuine' and 'liquidation' provisions seems to have been in response to respondents' comments on the removal of the remoteness exception which was in SIC 5 as well as a majority of respondents disagreeing with the proposed addition ("and without regards to probabilities of the manners of settlement") in the Exposure Draft. The respondents argued substance over form and that clearly artificial and unrealistic conditions should be disregarded when evaluating the substance of a financial instrument. The staff at that time also noted that the assessment of non-genuine could itself be seen as an assessment of probability because either there is virtually no probability of it occurring or full probability of it occurring.

34. Since the 2008 financial crisis, regulators have looked to strengthen the capital base of financial institutions, particularly banks. To comply with these new regulatory requirements, financial institutions commonly issue financial instruments containing contingent 'bail-in'/'non-viability' features such as the instrument discussed in Agenda Paper 5A that is mandatorily convertible into a variable number of shares upon a contingent non-viability event (breach of Tier 1 Capital ratio). These bail-in/non-viability features were added so that creditors would absorb losses when a financial institution is on the brink of failure instead of a bailout, which involves the rescue of a financial institution by external parties, typically governments, using taxpayers' money for funding.

35. Some stakeholders question whether the non-viability event should always be regarded as genuine despite its likelihood of occurrence. The staff believe it would be difficult to argue that such features are non-genuine when there is a specific purpose for including the contingent non-viability event in the contract.

Potential clarifications

36. The Board could consider the following clarifications:

    (a) whether the non-genuine assessment is purely a type of probability assessment (that considers the extremes of very unlikely to occur or not

occur) or if it can be interpreted as a wider notion that also considers the purpose for including particular features in the terms of the instrument. In other words, the Board can clarify if a feature that would be regarded as non-genuine because, for example, the contingent event is extremely rare, highly abnormal and very unlikely to occur, could still be regarded as genuine when there is a specific purpose for including it in the contract. If the board thinks there is merit in making this clarification the staff will consider how the Board could provide further guidance.

(b) adding further application guidance that explains the meaning of non-genuine in paragraph AG28 of IAS 32 to assist entities in applying the contingent settlement provision requirements in paragraph 25 of IAS 32 eg clarifying that non-genuine means there is no realistic possibility of the contingent event affecting the manner of settlement.

Meaning of 'liquidation'

37. If a financial instrument requires settlement in cash or another financial asset only in the event of liquidation of the issuer, applying paragraph 25 of IAS 32, it would be classified as an equity instrument. Paragraph BC18 of IAS 32 says 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.

38. When the Board discussed events that are inconsistent with the going concern concept (in the context of contingent settlement provisions) in 2003, the terms 'bankruptcy', 'winding up' and 'insolvency proceedings' were used. However, in practice and across jurisdictions, these and various other terms are used when an entity is in financial difficulty (for example, resolution, insolvency, receivership, administration, business rescue). See paragraphs 43-44 of this paper for further explanation.

39. The question that arises is whether the reference to 'liquidation' in paragraph 25 of IAS 32 was only intended to refer to the very end point when an entity ceases to exist either by liquidating its assets to pay its creditors and shareholders or is

otherwise dissolved. The interpretation of 'liquidation' will affect how some financial instruments are classified.

40. In discussing the definition of a liability, paragraph 4.33 of the Conceptual Framework seems to equate liquidation with ceasing to trade ie ceasing to carry on the business. It says: "A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade." Further, paragraph 25 of IAS 1 says "…an entity shall 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…"

41. Liquidation or ceasing to trade can thus be seen as the end point of the spectrum of different states an entity could find itself in. At the opposite end is an entity that is a going concern with no indication of any financial difficulty. However, there is an intermediate zone in-between, where an entity is a going concern with financial difficulty but is neither liquidating nor ceasing to trade. Arguably, paragraph 25 of IAS 1 recognises this intermediate zone by requiring disclosures when management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern.

42. In applying paragraph 25(b) of IAS 32 to assess whether a financial instrument, that requires settlement in cash or another financial asset only in the event of liquidation of the issuer, would be classified as an equity instrument, the question arises whether 'liquidation' can be interpreted as broader than just 'ceasing to trade'. If settlement in cash or another financial asset is required when the entity is in such intermediate zone (see paragraph 41 of this paper), the question arises whether the entity is in a similar to state to being in liquidation. If for example, an entity concludes that its intermediate state is not similar to liquidation, the obligation would be classified as a financial liability and related gains or losses would be recognised in profit or loss. However, if an entity concludes that its intermediate state is similar to liquidation, the obligation would be classified as an equity instrument without any remeasurement of the carrying amount.

43. In practice, there are many terms that are used when an entity is a going concern with financial difficulty. These various terms have different meanings (which could also vary across jurisdictions) and are not necessarily interchangeable. As an example, a company may go into dissolution (which generally means the end of the company as a legal entity) without being liquidated (which is generally the process of selling off the assets of the company to pay the creditors and shareholders) and a company may be liquidated without being insolvent (insolvent generally means the liabilities exceed the assets). Other terms which the staff researched are:

    (a) administration—generally aims to help the company repay its debts in order to avoid insolvency but a company administration could end in liquidation.

    (b) receivership—generally when a creditor appoints a receiver over one or more of the insolvent company's assets or properties specified within a secured loan agreement.

    (c) bankruptcy—the legal process to resolve the issue of insolvency.

    (d) winding up—generally involves ending all business affairs, terminating relationships and obligations and includes the closure of the company (including liquidation or dissolution).

    (e) business rescue—a procedure aimed to facilitate the rehabilitation of a financially distressed company. The company is placed under the temporary supervision of a business rescue practitioner who manages the affairs of the company.

    (f) strike off—the process of removing a business from the registrar of companies so that it ceases to exist.

44. Another term encountered amongst banks is that of resolution. Resolution is seen as an exception to be allowed only if liquidation under national insolvency proceedings would not be warranted. This is the case when the bank provides critical functions to the economy, or when its liquidation might threaten financial stability. A key resolution tool is the use of bail-in procedures which for example, requires a write-down of debt owed by a bank to creditors or requires conversion

of the debt into equity in the event of resolution. Bail-in procedures protect taxpayers from having to provide funds to cover these liabilities, while allowing the critical functions of the bank (eg deposit-taking, lending, operation of payment systems) to continue.

45. In addition, the question sometimes arises in practice whether the reference to 'liquidation' in paragraph 25(b) of IAS 32 includes a pre-determined liquidation (eg when an entity has a finite life) or where liquidation is at the option of instrument holders which are in the scope of paragraph 16C-D of IAS 32. The requirements in paragraph 25(c) of IAS 32 only refer to the exception from liability classification for puttable instruments having the features and meeting the conditions in paragraphs 16A and 16B of IAS 32. This could imply that the requirement in paragraph 25(b) of IAS 32 that refers to liquidation and allows equity classification overrides the requirements in paragraph 16C-D of IAS 32 for those instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. However, the staff note that this is not the case and there is no internal inconsistency in IAS 32. This is because paragraph 25 on contingent settlement provisions does not apply to a predetermined liquidation that is certain to occur or where liquidation is at the option of one of the parties ie the instrument holders. Paragraphs 16C-16D of IAS 32 apply to these scenarios and provide an exception from liability classification if particular conditions are met. The staff do not think any further clarification is necessary.

Potential clarifications

46. The Board could consider clarifying whether the reference to 'liquidation' in paragraph 25(b) of IAS 32 refers only to the very end point when an entity ceases to exist or ceases to trade (as implied by the Conceptual Framework and IAS 1).

Question for the Board

47. 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?