
IASB[®] meeting

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Project	Financial Instruments with Characteristics of Equity (FICE)
Topic	Contingent settlement provisions (Cover paper)
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Purpose of this meeting

1. The purpose of this meeting is to begin the IASB's redeliberation on the proposals in the Exposure Draft *Financial Instruments with Characteristics of Equity* (the ED) issued in November 2023, related to classifying financial instruments containing contingent settlement provisions.
2. In the agenda papers for this meeting, the staff summarises and analyses the feedback received from comment letters and outreach on the ED on this topic. This cover paper includes a summary of the general feedback. The specific feedback will be summarised and analysed by sub-topics in the following agenda papers:
 - (a) Agenda Paper 5A *Contingent settlement provisions—Scope and discretionary payments*;
 - (b) Agenda Paper 5B *Contingent settlement provisions—Measurement*; and
 - (c) Agenda Paper 5C *Contingent settlement provision—Liquidation and not genuine*.
3. Agenda Papers 5A, 5B and 5C also contain the staff's recommendations for proposed amendments to IAS 32 *Financial Instruments: Presentation* after considering the

stakeholder feedback on contingent settlement provisions. At this meeting, the staff will ask the IASB if it agrees with its recommendations.

4. In these agenda papers, we use the following terms to broadly indicate the portion of respondents that reported a particular view:
 - (a) almost all—all except a very small minority;
 - (b) most—large majority, with more than a few exceptions;
 - (c) many—small majority or large minority;
 - (d) some—small minority, but more than a few; and
 - (e) a few—a very small minority.

5. This paper is structured as follows:
 - (a) [background and questions in the ED](#);
 - (b) [general feedback on the proposals](#); and
 - (c) [appendix A](#)—proposed amendments to IAS 32 in the ED related to contingent settlement provisions.

Background and questions in the ED

6. Paragraph 25 of IAS 32 sets out the requirements for classifying a financial instrument containing a contingent settlement provision when the issuer does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). For example, a financial instrument that is settled in cash upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument, is required to be classified as a financial liability, unless:
- (a) the part of the contingent settlement provision that could require settlement in cash is not genuine;
 - (b) the issuer can be required to settle the obligation in cash only in the event of liquidation of the issuer; or
 - (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B of IAS 32 for puttable instruments.
7. Questions in practice arise about:
- (a) whether to classify a financial instrument with a contingent settlement provision as a financial liability in its entirety, even if it is a compound financial instrument with both liability and equity components;
 - (b) whether to reflect the probability and estimated timing of occurrence of the contingent event in the measurement of a financial liability (or a liability component) arising from a contingent settlement provision, on and after initial recognition;
 - (c) the assessment of ‘not genuine’ in paragraph 25(a) of IAS 32; and
 - (d) the meaning of the term ‘liquidation’ in paragraph 25(b) of IAS 32.

8. The ED included proposed amendments to IAS 32 to clarify how an entity would apply the requirements in paragraph 25 of IAS 32 related to contingent settlement provisions. The IASB asked these questions in the ED:

Question 4—Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)

The IASB proposes to clarify that:

- (a) some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A);
- (b) the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A);
- (c) payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37);
- (d) the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations (paragraph 11); and
- (e) the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring (paragraph AG28).

Paragraphs BC94–BC115 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

General feedback on the proposals

9. Most stakeholders that submitted comment letters on the ED provided feedback on the contingent settlement provision proposals. Stakeholders generally acknowledged the diversity in practice when accounting for financial instruments with contingent settlement provisions and appreciated the IASB's efforts to clarify the related requirements.
10. Some stakeholders (across the main stakeholder groups) that commented on the contingent settlement provision proposals generally agreed with them. They believed that the proposals would reduce diversity in practice by providing a pragmatic solution to long-standing application ambiguities, particularly regarding measurement. The proposed measurement approach was viewed as consistent with the rationale in paragraph BC12 of the Basis for Conclusions on IAS 32—the entity cannot avoid settlement for the full redemption amount or the full amount of the conditional obligation.¹
11. However, many other stakeholders (including standard-setters, preparers, accounting firms and accountancy bodies) provided mixed views. They agreed with some of the contingent settlement provision proposals but disagreed with others. Areas where they disagreed with the principles clarified in the ED included:
 - (a) measurement of the financial liability—disregarding the probability and timing of contingent events was in their view, a new measurement approach that deviates from the principles in IFRS Accounting Standards and does not provide useful information to users of the financial statements. They said

¹ Paragraph BC12 of the Basis for Conclusions on IAS 32 states: '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 reconsideration of other provisions in IAS 32...for example, (a) the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation...'

introducing such a measurement basis goes beyond the scope of IAS 32. The staff notes that concerns regarding the measurement proposal may have been exacerbated due to a perceived confusion about which financial instruments the contingent settlement provision requirements apply to (see Agenda Paper 5A for this meeting).

- (b) accounting for discretionary payments—recognising discretionary interest payments in equity would disrupt some hedge accounting practices, because such payments would not affect profit or loss and would be ineligible as hedged items under IFRS 9 *Financial Instruments*.
- (c) definition of 'liquidation'—the proposed definition was seen as too narrow and subject to inconsistent interpretations across different legal jurisdictions.

12. Only a small number of users of financial statements commented on classification topics.² Those that commented on the measurement of the financial liability arising from the contingent settlement provision expressed mixed views:

- (a) some supported the proposal for its consistent and prudent approach to measuring financial liabilities. They said the approach avoids the complexities and uncertainties associated with estimating probabilities and timings, which can vary significantly between entities and over time. They favoured a wholistic presentation of financial liabilities from a risk perspective, supplemented with accompanying disclosures about related terms and conditions. This would enable them to apply their own judgments and incorporate their own estimates of probabilities of contingent events into the financial analyses.
- (b) others expressed concerns that ignoring the probability or timing of contingent events could create a substantial liability, especially when the likelihood of the triggering event is extremely low. Moreover, a user group reported that the

² [Agenda Paper 5A](#) for the July 2024 IASB includes a summary of the feedback from users of financial statements on the proposals in the ED.

proposal could cause a significant change to the accounting and regulatory classification of some types of regulated instruments in their jurisdiction and may cause entities in their jurisdiction to not issue those instruments.

Appendix A—Proposed amendments to IAS 32 in the ED related to contingent settlement provisions

A1. The IASB proposed amending or adding the following paragraphs to IAS 32 related to contingent settlement provisions (new text is underlined and deleted text is struck through):

Paragraph 11:

The following terms are used in this Standard with the meanings specified:

...

Liquidation is the process that begins after an entity has permanently ceased its operations.

Paragraph 25:

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that the instrument (or a component of it (see paragraph 28)) ~~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. Examples of such uncertain future events or uncertain circumstances are, ~~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. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that the instrument (or a component of it) ~~it~~ would be a financial liability). Therefore, it 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;
- (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; or

(c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B.

Paragraph 25A:

The occurrence or non-occurrence of uncertain future events (or the outcome of uncertain circumstances) described in paragraph 25 that would require settlement, are outside the issuer's control. Therefore, the probability and estimated timing of occurrence or non-occurrence of uncertain future events (or the outcome of uncertain circumstances) have no effect on the initial or subsequent measurement of the financial liability arising from the contingent settlement provision. An entity measures the financial liability on initial recognition and subsequently at the present value of the settlement amount. The settlement amount is discounted, assuming settlement will occur at the earliest possible settlement date specified in the contract. Any gains or losses on remeasurement of the financial liability are recognised in profit or loss.

Paragraph 31:

Except as stated in paragraph 25A, IFRS 9 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

Paragraph 32A:

Paragraph 28 applies to all compound financial instruments, including compound instruments with contingent settlement provisions (see paragraph 25). Therefore, an entity determining whether such an instrument contains both a liability and an equity component applies paragraph 25 to identify the liability component and paragraph 25A to measure the liability component. Any discretionary dividends or payments are part of the equity component even if, applying paragraph 25A, an entity allocates on initial recognition the carrying amount of the compound instrument entirely to the liability component. An entity, therefore, recognises any dividends paid as a distribution of profit or loss (see paragraph AG37). For example, consider a contingent convertible instrument that has no maturity date, but is convertible into a variable number of ordinary shares equal to the value of the contractual amount upon the occurrence of a contingent event that is beyond the control of both the issuer and the holder. Dividends are payable at the issuer's discretion. This instrument contains a liability component (the issuer's obligation to issue a variable number of its own equity instruments) and an equity component (the discretionary dividends).

Paragraph AG28:

Paragraph 25 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that the instrument would be ~~in another way that would result in the instrument being~~ a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. 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 are not genuine, ~~have no genuine possibility of~~

occurring, classification as an equity instrument is appropriate. Assessing whether a contingent settlement provision is not genuine requires judgement based on the specific facts and circumstances (including the terms and conditions of the instrument) and is not based solely on the probability or likelihood of the contingent event occurring. A settlement provision based on a contingent event that might be very unlikely to occur could be genuine if the nature of the contingent event is neither extremely rare nor highly abnormal. For example, a bank might issue a financial instrument qualifying as regulatory capital that includes a clause that 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 (known as a 'regulatory change clause'). Although such a regulatory change might be assessed as very unlikely to occur at initial recognition of the instrument, the clause is included for a genuine reason, which is to ensure the bank maintains sufficient levels of regulatory capital.

Paragraph AG37:

The following example illustrates the application of paragraph 35 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in profit or loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised as a distribution of profit or loss. This treatment of dividends paid would apply even if the initial carrying amount of the equity component was zero (see paragraph 32A). 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 or an amount

based on changes in an underlying variable (eg a commodity price). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.