
IASB[®] meeting

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Project	Financial Instruments with Characteristics of Equity (FICE)
Topic	Proposed amendments: Contingent settlement provisions— Measurement
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Introduction

1. In this paper, the staff summarises the feedback from comment letters and outreach on the proposals in the Exposure Draft *Financial Instruments with Characteristics of Equity* (the ED) related to the measurement of the financial liability arising from a contingent settlement provision. We also provide our analysis and recommendation on this topic.
2. At this meeting, we will ask the IASB whether it agrees with the staff recommendation.
3. This paper is structured as follows:
 - (a) [staff recommendation](#);
 - (b) [questions for the IASB](#);
 - (c) [summary of feedback](#); and
 - (d) [staff analysis and recommendation](#).

Staff recommendation

4. The staff recommends that the IASB not proceed, as part of the FICE project, with the proposed requirements related to the measurement of the financial liability arising from a contingent settlement provision as set out in the ED. We recommend addressing the measurement-related issues as part of the IASB's project on Amortised Cost Measurement.

Questions for the IASB

Questions for the IASB

1. Do you have any questions on the summary of feedback set out in paragraphs 5-30 of this paper or the staff analysis set out in paragraphs 31-39 of this paper?
2. Do you agree with the staff's recommendation in paragraph 4 of this paper?

Summary of feedback

5. The ED proposed that the financial liability arising from a contingent settlement provision is measured, on initial recognition and subsequently, at the present value of the settlement amount, assuming settlement will occur at the earliest possible settlement date specified in the contract. The probability and estimated timing of the contingent event occurring are therefore disregarded when measuring the financial liability (draft paragraph 25A of IAS 32 *Financial Instruments: Presentation*).
6. The staff notes that these measurement proposals attracted the most feedback within the contingent settlement provision proposals, with some stakeholders commenting exclusively on them.¹ We summarised the feedback related to measurement by themes:

¹ Please refer to Agenda Paper 5 for this meeting for explanations of the terms used to broadly indicate the portion of respondents that reported a particular view. The feedback analysis on specific matters is based on the comments specifically made on that matter. Therefore, the terms that are used to indicate the portion of respondents that expressed a view are based on the population of respondents who specifically commented on each topic.

- (a) [agreement with the proposals](#);
- (b) [disagreement with the proposals](#);
- (c) [interaction with other IFRS Accounting Standards](#);
- (d) [practical concerns about application](#);
- (e) [other concerns](#); and
- (f) [suggestions on measurement approach](#).

Agreement with the proposals

7. Some stakeholders (across the main stakeholder groups) agreed with requiring the same measurement approach for initial and subsequent measurement of the financial liability based on the full settlement amount. They viewed the proposals as an appropriate and pragmatic solution which would:
- (a) provide a faithful reflection of liquidity risk. Requiring entities to measure the financial liability at the present value of the settlement amount would result in a more prudent outcome than other measurement bases (for example, a probability-weighted amount).
 - (b) avoid complexities and costs associated with the periodic remeasurement of financial liabilities in accordance with IFRS 9 *Financial Instruments* and increase consistency and comparability between entities. There would be no need to estimate the probability or timing of the contingent event occurring to determine the discount rate. The proposed approach would also avoid potentially numerous catch-up adjustments being recognised over the instrument's life.
 - (c) balance the interests of investors and preparers. The benefits to investors of the measurement taking into consideration estimated probability and timing of the contingent event, would not outweigh the costs to preparers. A user group

noted that even if it were practicable to consider the probability and estimated timing of the occurrence of eg a non-viability event, such information would not necessarily be reliable.

- (d) align with the requirement in paragraph 23 of IAS 32 for measuring obligations to purchase own equity instruments at the present value of the redemption amount.

Disagreement with the proposals

8. Despite welcoming the IASB's efforts to resolve the application questions and diversity in practice while increasing comparability between entities, most other stakeholders (across the main stakeholder groups) generally disagreed with the proposals.
9. One of the primary reasons for their disagreement arose from their concerns about the proposals' failure to align measurement with the perspective of market participants and provide relevant information to users of financial statements. They noted that paragraph B5.1.1 of IFRS 9 states that the fair value of a financial instrument at initial recognition is normally the transaction price. Fair value is defined in IFRS 13 *Fair Value Measurement* as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. These respondents said that in their view, the proposed measurement requirements are inconsistent with the assumption that the transaction was negotiated at arm's length.
10. In their view, the proposals introduced a new measurement basis for particular financial liabilities in IAS 32. They believe that the current amortised cost or fair value measurement approaches in IFRS 9 should be applied to all financial liabilities.
11. In their view, the measurement proposals would fail to appropriately capture the expected value of the entity's obligation, both at initial recognition and subsequently. They considered the proposals to be a rather blunt approach that has the potential:

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- (a) to overstate financial liabilities by recognising the full settlement amount. In cases where the probability of the contingent event occurring is very remote, measuring the liability at this full amount would significantly overstate the obligation compared to its fair value.
 - (b) to understate financial liabilities for some instruments with multiple redemption clauses. Measuring such an instrument based on the earliest possible settlement date—which may be a lower amount than the amount on subsequent dates—would result in a carrying amount that is not reflective of the more probable or larger settlement amount at a subsequent date.
 - (c) to not reflect the economic substance of a transaction.
 - (d) to reduce, instead of increase, comparability of financial information.
12. With regards to the feedback in paragraph 11(c) of this paper, respondents disagreed with the explanation in paragraph BC99 of the Basis for Conclusions on the ED and said that in their view, there is a difference between:²
- (a) a contingent settlement liability which is outside the control of both the issuer and the holder of the instrument; and
 - (b) a demand liability which is outside the control of the issuer but within the control of the holder of the instrument (ie subject to counterparty behaviour).
13. They noted that from an economic and valuation perspective, a holder's unconditional right to demand repayment at any time, is very different from a right to repayment only on the occurrence of a contingent event like a non-viability event. Therefore, the price that market participants would expect to pay to transfer a liability with a contingent settlement provision would be different from the price of a liability with a demand feature.

² Paragraph BC99 of the Basis for Conclusions on the ED states: 'The Board noted that the approach in paragraph BC98(a) is consistent with other requirements in IAS 32—for example, paragraph 23 of IAS 32, which requires the obligation to purchase an entity's own equity instruments to be measured at the present value of the redemption amount.'

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14. In relation to the feedback in paragraph 11(d) of this paper, respondents said that the proposals could result in one of two outcomes:
- (a) different measurements for some economically similar instruments; or
 - (b) similar measurement for different instruments.
15. For example, two financial instruments may have the same contingent settlement provision, but one has discretionary coupons and the other has an obligation to pay contractual coupons. In their view, the instrument with the discretionary coupon would be accounted for as a compound financial instrument applying the proposals (as discussed in Agenda Paper 5A for this meeting) and the liability recognised at the full settlement amount. However, the instrument with the contractual obligation to pay the coupon would be measured at fair value at initial recognition and subsequently applying IFRS 9. In their view, there is no economic or conceptual reason for the difference in the measurement of the financial liabilities in this example.
16. Respondents also noted that the proposals could result in an accounting outcome that seems counter-intuitive. For example, an entity may issue contingently convertible preference shares and contingently convertible subordinated debt with the same contingent settlement provision related to the entity's capital ratio. Applying the proposed measurement requirements, the contingently convertible preference shares would be a compound financial instrument and the liability component measured at the full settlement amount. On the other hand, the contingently convertible subordinated debt would be measured applying IFRS 9, where both amortised cost and fair value measurement would consider the probability and timing of the contingent event occurring.
17. In both of these examples, the different measurement requirements for seemingly similar financial liabilities could lead to significantly different carrying amounts being recognised at initial recognition and over the life of the instrument. And in the case of compound financial instruments, this difference would also affect the residual amount allocated to the equity component.

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18. On the other hand, financial instruments with the same contingent settlement provision (ie redeemable in cash if a successful initial public offering does not occur within a specified period) could be issued by different entities and market participants might have significantly different expectations about the likelihood of the contingent events occurring for each entity. And because of the difference in the probability of the contingent event occurring, the fair value of these financial instruments would be different. However, the proposed measurement requirements would lead to the financial liabilities being recognised at the same amounts, being the full settlement amounts.
19. Respondents therefore did not consider the proposed measurement requirements to result in information that faithfully reflects the economic substance of the financial instruments or provides useful information to users of the financial statements.

Interaction with other IFRS Accounting Standards

20. Some stakeholders were concerned about the interaction of the measurement proposals with other IFRS Accounting Standards. The measurement proposals were perceived to be creating a new measurement basis, which:
- (a) deviates from the general measurement principles (such as those in IFRS 9, IFRS 3 *Business Combinations*, IFRS 13 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) which typically require the measurement of liabilities to consider timing and probability when determining expected cash flows, fair value, best estimate, etc.
 - (b) conflicts with the going-concern assumption in paragraph 3.9 of the Conceptual Framework for Financial Reporting and paragraph 25 of IAS 1 *Presentation of Financial Statements*.³ For example, for most financial

³ In April 2024, the IASB issued IFRS 18 *Presentation and Disclosure in Financial Statements* which replaces IAS 1. The IASB retained some paragraphs from IAS 1 in IFRS 18 and moved some paragraphs from IAS 1 to IAS 8 *Basis of Preparation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*. The requirement in paragraph 25 of IAS 1 has been incorporated into paragraph 6K of IAS 8.

institutions, contingent events are often those related to resolution, such as bail-in or loss-absorption events. Stakeholders said that ignoring the remote probability of such resolution events would result in some financial liabilities being measured on something that is akin to a non-going concern basis because they viewed these events as, in substance, similar to liquidation events.

- (c) disconnects from the disclosure requirements. For example, paragraphs 8 and 20 of IFRS 7 *Financial Instrument: Disclosures* require entities to disclose amounts separately based on categories of financial liabilities (ie, financial liabilities measured at amortised cost, and financial liabilities measured at fair value through profit or loss). It is uncertain how financial liabilities applying the ED's measurement approach would be categorised for disclosure purposes.

Practical concerns about application

- 21. Many stakeholders, including those that agreed with the measurement proposals, raised questions or practical concerns about applying the proposed requirements. Some stakeholders also cautioned that, while the proposals might resolve some of the current practice issues, there is a high risk that the proposals will give rise to new application issues or result in other critical measurement questions remaining unresolved.
- 22. Application questions raised by stakeholders included:
 - (a) how to account for day one gains or losses, ie a difference between the settlement amount and transaction price on initial recognition.
 - (b) how to determine the discount rate for calculating the present value of the settlement amount on initial measurement, whether to update the discount rate subsequently and how to account for any differences arising from the updates.

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- (c) how to determine the settlement amount on initial recognition and subsequently where there are multiple contingent settlement provisions, or when the settlement amount is dependent on future performance targets or performance metrics.
 - (d) how the measurement approach interacts with requirements in IFRS 9 for separating embedded derivatives from the host financial liability. Respondents noted that different treatments have been observed in practice (either full recognition of a financial liability without accounting for an embedded derivative or recognition of both a financial liability and an embedded derivative).
23. With regards to the questions in paragraph 22(a) of this paper, respondents said that paragraph B5.2.1A of IFRS 9 specifies how the difference between the fair value at initial recognition and the transaction price is accounted for. However, as financial liabilities arising from contingent settlement provisions are not measured at fair value on initial recognition, it is not clear how any difference between settlement amount and transaction price is accounted for. These stakeholders said that if the IASB proceeds with finalising the proposals, it needs to include requirements in this regard. Suggestions made by some stakeholders included:
- (a) recognising any differences directly in equity to avoid affecting profit or loss.
 - (b) capping initial measurement of the financial liability at fair value (transaction price). Any settlement feature for an amount above the initial fair value (transaction price) could be treated as an embedded derivative and/or reflected in the liquidity risk disclosures in IFRS 7.
24. With regards to the feedback in paragraph 22(c) of this paper, respondents said that for instruments with different contingent settlement clauses that are mutually exclusive and could require settlement at different amounts, it is unclear:

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- (a) whether the settlement amount is the maximum of potential settlement amounts, the earliest settlement amount, or a probability-weighted average of the possible amounts;
 - (b) when the ‘earliest possible settlement date’ is if there is no date or it is not specified in the contract; or
 - (c) how to account for changes in the measurement if one of the contingencies is no longer applicable.
25. When the settlement amount is based on performance, respondents asked whether the measurement should be based on the maximum potential obligation, expected obligation by projecting future performance, most likely obligation, obligation determined based on current performance levels, or another measure.

Other concerns

26. Other concerns raised by some stakeholders related to the potential for structuring opportunities to achieve a particular accounting outcome and recognising artificial gains in profit or loss. They gave the example of a compound instrument which contains a contingent settlement provision that is highly unlikely to occur, with the settlement amount contractually specified as 150% of par value.
27. Applying the proposals, such an instrument would initially be recognised at 150% of the par value. However, if this instrument is settled at par without the contingent event occurring, the entity would recognise a gain for the 50% of the par value in profit or loss in accordance with the derecognition requirements in IFRS 9. Stakeholders were concerned that, not only would measurement at 150% of par be misleading to investors, but such measurement requirements could lead to contingent settlement provisions being misused in some contracts to create future gains.
28. A few respondents were also concerned about the disruption to practice for entities that currently measure these financial liabilities applying IFRS 9. In their view, applying the proposed measurement approach could result in significant costs, eg

banks might need to renegotiate contracts and regulators might need to enact necessary changes to regulations if the proposed measurement of particular financial liabilities negatively affects regulated entities' regulatory capital.

Suggestions on measurement approach

29. Some respondents were of the view that the proposed measurement requirements are outside the scope of IAS 32 and/or the FICE project. They said that IAS 32 and the FICE project should focus only on the classification of financial liabilities and equity instruments, instead of measurement.
30. Other stakeholders made suggestions for the IASB to consider, including:
 - (a) withdrawing the proposed measurement approach and maintaining the status quo—preparers and auditors could use their judgement in determining how financial instruments with contingent settlement provisions are measured.
 - (b) aligning the measurement with the general measurement requirements in IFRS 9—consider the probability and estimated timing of the contingent event occurring for both initial and subsequent measurement. Stakeholders did not think factoring in probability and estimated timing of contingent events would be complex for entities to measure. A preparer group said many publicly traded entities are well-equipped to incorporate probability of contingent events into the measurement by using the fair value of their own credit-linked derivatives or debt instruments as proxies to approximate the probability of some contingent settlement provisions being triggered.
 - (c) conducting field testing to ensure the proposed approach would not result in potential unintended consequences—especially in those jurisdictions where the proposed clarifications would lead to a change in the regulatory classification or measurement of financial instruments with contingent settlement provisions.
 - (d) considering the measurement of financial liabilities with contingent settlement provisions as part of the IASB's project on Amortised Cost Measurement or as

part of a separate and broader review of the IFRS 9 measurement requirements to ensure greater consistency.

Staff analysis and recommendation

31. In this section, we consider the best way for the IASB to respond to the feedback on the measurement proposals in the ED, including respondents' suggestions on the way forward (as summarised in paragraph 30 of this paper), taking into account the objective of the proposals.

Objective of the proposals

32. The objective of the IASB's proposals related to contingent settlement provisions, as for the project generally, was to address known application questions without fundamentally changing the requirements. The clarification related to measurement was aimed at reducing diversity in practice and thereby improving consistent application in financial reporting across entities and jurisdictions.
33. At the time the IASB acknowledged that there are different financial reporting consequences depending on whether probability or expectations about timing of settlement are taken into account in the measurement of a financial liability. One of the key objectives of the proposals was to align the initial measurement of these financial liabilities with the subsequent measurement and eliminate the potential for gains or losses to arise between day one and day two accounting because of different measurement requirements.
34. The IASB considered the rationale used in developing the requirement in paragraph 23 of IAS 32 to measure obligations to purchase own equity instruments at the present value of the redemption amount. This rationale is included in paragraph BC12 of the

Basis for Conclusions on IAS 32, which also mentions the measurement of a financial instrument with contingent settlement provisions.⁴

35. In developing the measurement proposals for instruments with contingent settlement provisions, the IASB therefore focused on a measurement approach that would be consistent with the measurement approach for obligations to purchase own equity instruments because in both cases settlement is triggered by an event outside the control of the entity.

Overall consideration of feedback

36. However, the staff acknowledges the strength and merits of stakeholder feedback, the additional application issues identified and the other concerns raised by a broad range of stakeholders on the measurement proposals. We are therefore of the view that finalising the proposed measurement requirements without significant changes or refinements, would not achieve the IASB's objectives.
37. We share respondents' concerns that the proposals are inconsistent with the principles in IFRS 9 and would likely increase, rather than decrease, diversity in application because measurement of a financial liability would differ depending on how that liability arises ie from a contingent settlement provision or from another type of contractual obligation. We also acknowledge that even though the measurement of a financial instrument with contingent settlement provisions is mentioned in paragraph BC12 of the Basis for Conclusions on IAS 32, the Basis for Conclusions accompanies, but is not part of IAS 32 and cannot override any requirements in the Standard.

⁴ 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 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.'

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38. The staff disagrees with the suggestion in paragraph 30(a) of this paper to simply withdraw the proposals and maintain the status quo. The measurement of financial liabilities subject to contingent settlement provisions was included in the scope of the FICE project because of the pervasiveness of the diversity in practice and the material effects this could have on entities' financial statements. These reasons have been confirmed through the feedback on the proposed measurement requirements, therefore we recommend proceeding with attempts to resolve these issues.
39. However, we no longer believe that resolving these issues in the FICE project or in IAS 32—a Standard that relates to classification and presentation of financial instruments—would be appropriate or could be done efficiently. Solving all the measurement concerns raised would involve addressing this topic in a more comprehensive and fundamental manner.

Staff recommendation

40. The staff considered other suggestions from stakeholders on the way forward and we note that the underlying question about how to reflect contingent events that affect the principal amount in the measurement of a financial liability, is similar or related to some of the questions the IASB is considering in the project on Amortised Cost Measurement. That project aims to make targeted improvements to the amortised cost measurement requirements in IFRS 9 by clarifying their underlying principles and adding accompanying application guidance.
41. Through the outreach and feedback received on the ED, the IASB has already received extensive information and input on the matters to consider and we think the IASB would be able to better solve these issues within the current measurement requirements in IFRS 9.
42. Furthermore, addressing measurement as part of the Amortised Cost Measurement project would also enable the IASB to complete its redeliberations on the other topics in the FICE project in a timely manner.