
IASB[®] meeting

Date	April 2026
Project	Financial Instruments with Characteristics of Equity (FICE)
Topic	Proposed amendments: Contingent settlement provisions— Liquidation and not genuine
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Introduction

1. In this paper, the staff summarises and analyses the remaining feedback on the proposals in the Exposure Draft *Financial Instruments with Characteristics of Equity* (the ED) related to contingent settlement provisions—in particular the meaning of ‘liquidation’ and ‘not genuine’ in paragraph 25 of IAS 32 *Financial Instruments: Presentation*.
2. The staff also recommends refinements to the proposed requirements. At this meeting, we will ask the IASB whether it agrees with the staff recommendations for the proposed amendments to IAS 32.
3. This paper is structured as follows:
 - (a) [summary of staff recommendations](#);
 - (b) [question for the IASB](#);
 - (c) definition of ‘liquidation’:
 - (i) [summary of feedback](#);

- (ii) [staff analysis and recommendations](#);
- (d) whether a contractual term is ‘not genuine’:
 - (i) [summary of feedback](#); and
 - (ii) [staff analysis and recommendations](#).

Summary of staff recommendations

4. The staff recommends that the IASB proceed to finalise the proposed requirements related to the meaning of ‘liquidation’ and ‘not genuine’ as set out in the ED, subject to minor drafting improvements and some targeted refinements:
- (a) to describe liquidation as the process that includes converting assets, paying obligations, and settling equity claims, with the objective of permanently ceasing an entity’s operations.
 - (b) to clarify that when assessing whether a contractual term is ‘not genuine’, an entity considers both the probability and nature of the contingent event, including whether there is a substantive business purpose for the contingent event. A contractual term with a substantive business purpose would be considered genuine, even if the probability of the event is remote.

Question for the IASB

Questions for the IASB

Do you agree with the staff’s recommendations on the proposed requirements as summarised in paragraph 4 of this paper?

Definition of ‘liquidation’

Summary of feedback

5. Paragraph 25(b) of IAS 32 states that a contingent settlement provision that could require settlement in cash only in the event of liquidation of the issuer, is not a financial liability. To clarify the meaning of the term ‘liquidation’ in this paragraph, the ED proposed defining liquidation in paragraph 11 of IAS 32 as ‘the process that begins after an entity has permanently ceased its operations’.
6. Some stakeholders provided specific feedback on the proposed definition of liquidation.¹ Among the respondents who specifically commented on this topic, some stakeholders (across the main stakeholder groups) agreed with the proposed definition. In their view, it would enhance consistent application, because it clarifies that the reporting entity itself (instead of merely a component of the entity) will not revive its operations in the future. Furthermore, they believed that this definition was necessary given the different legal definitions of liquidation across jurisdictions.
7. However, many other stakeholders (including standard-setters, preparers, accounting firms and accountancy bodies) did not agree with the proposed definition. Some of these respondents did not agree with any aspects of the proposed definition, while others did not agree with particular aspects.
8. One of the reasons given by stakeholders for why they disagreed with the proposals, was because of a perceived inconsistency with other IFRS Accounting Standards. They were not convinced by the rationale in paragraph BC115(b) of the Basis for Conclusions on the ED, that the *Conceptual Framework for Financial Reporting* equates liquidation with ceasing to trade. In their view, the *Conceptual Framework* and IAS 1 *Presentation of Financial Statements* both require that for an entity to be a

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.

going concern, it has neither the intention nor the need to ‘enter liquidation’ or to ‘cease trading’.² In their view, ‘liquidation’ and ‘ceasing to trade’ refer to two separate events, because these terms are mentioned together.

9. Others did not consider that ceasing operations should be the key determinant for liquidation, although they generally agreed with liquidation being an irreversible process.
10. However, respondents said that overall, there is a lack of clarity on what is meant by ‘permanently ceased its operations’, how to determine when an entity has ceased its operations and when such cessation becomes ‘permanent’. They were concerned that determining when an entity has permanently ceased its operations may require significant judgement and could lead to different interpretations, therefore adding further confusion and complexity. They noted that:
 - (a) liquidation could involve different stages (such as the sale of assets, the payment of debts to creditors and the distribution of remaining assets among shareholders) depending on local laws and regulations;
 - (b) the objective of the liquidation process is to formally conclude all operations and obligations of the company, so that it legally ceases to exist as a corporate entity; and
 - (c) the liquidation process may take significant time to complete the final close of the business.
11. Other respondents were concerned about the potential inconsistency between the proposed definition and local laws and regulations. They said the meaning, timing and

² Paragraph 3.9 of the Conceptual Framework states: ‘Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to enter liquidation or to cease trading...’ Paragraph 25 of IAS 1 requires an entity 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. 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.

process of liquidation are driven by local laws and regulations, therefore, the legal definitions and process of liquidation could differ across jurisdictions. These respondents said that, for example, in some jurisdictions, liquidation could begin before or at the time the entity permanently ceases its operations—in other words, liquidation leads to the cessation of business instead of being a consequence of the entity permanently ceasing its operations.

12. A few respondents also said that the proposed definition is unnecessarily restrictive and narrower than the current practice. They noted that:
 - (a) a regulated entity in the banking sector facing severe financial distress, might go through a recovery and resolution process rather than winding up the entity. They said that resolution events are similar in substance to liquidation events and in their view, should not influence classification.
 - (b) instruments may contain obligations triggering payment to their holders on a winding-up event triggered, for instance, by a court order/resolution for the winding-up of the issuer; or by a declaration/notice from an administrator of the issuer that it intends to declare and distribute a final dividend. They questioned whether a winding-up event arises before liquidation.
13. A few stakeholders noted that there may be legal remedies available for entities to suspend or reverse a liquidation in very exceptional circumstances. However, their views on revising the proposed definition of liquidation differed between:
 - (a) focusing on the permanent closure of the business with no possibility to reverse liquidation; or
 - (b) focusing on the *anticipation* of permanently ceasing operations rather than on whether liquidation is ‘irreversible’ or ‘permanent’.
14. To further clarify the meaning of liquidation, stakeholders’ suggestions included:

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- (a) providing additional application guidance (eg clarifying the meaning of ‘the process for permanently ceasing operations’ and how it interacts with resolution, administration processes and insolvency), illustrative examples or educational materials to address the potential practical challenges.
 - (b) providing a revised definition of liquidation:
 - (i) that is not based on ‘cessation of operations’ but instead on the irreversible process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all operations.
 - (ii) that is broader and distinguishes liquidation-related operations from other operations—for example by defining it as a process initiated by an entity after it has permanently ceased its operations except for those related to liquidation, and this process is irrevocable.
 - (iii) that focuses on whether the entity is no longer a going concern or no longer prepares accounts on the going concern basis, to be consistent with paragraph BC18 of the Basis for Conclusions on IAS 32.³
 - (c) withdrawing the definition given the absence of significant difficulties in interpreting the concept of liquidation in practice. They said determining when an entity enters liquidation is often subject to specific facts and circumstances which may require application of significant judgement. In their view, it may lead to unintended outcomes if entities were prevented from applying judgement.

³ Paragraph BC18 of the Basis for Conclusions on IAS 32 explains that contingent settlement provisions that would apply only in the event of liquidation of an entity should not influence the classification of the instrument because to do so would be inconsistent with a going concern assumption. A contingent settlement provision that provides for payment in cash or another financial asset only on the liquidation of the entity is similar to an equity instrument that has priority in liquidation and therefore should be ignored in classifying the instrument.

Staff analysis and recommendations

15. Based on the feedback summarised in paragraphs 5-14 of this paper, we think the main themes that emerged relate to:
- (a) the relationship between liquidation and ceasing operations, particularly whether ceasing operations needs to precede liquidation;
 - (b) lack of a clear principle-based description of what liquidation means; and
 - (c) potential practical challenges in applying the definition to specific cases, in particular resolution in the financial services sector.
16. We believe, after considering all stakeholder feedback on this topic, that there is greater merit in clarifying the description of liquidation. Accordingly, in paragraphs 17-29 of this paper, we consider potential refinements to address the concerns raised.

The relationship between liquidation and ceasing operations

17. The proposed definition states that liquidation is the process that begins *after* an entity has permanently ceased its operations. The staff agrees with stakeholders that the proposed definition (albeit unintentional) creates a sequential relationship—requiring operations to permanently cease *before* the liquidation process can begin. This sequencing introduces unnecessary tension with other IFRS Accounting Standards and with local laws and regulations.
18. Paragraph 3.9 of the Conceptual Framework and paragraph 6K of IAS 8 *Basis of Preparation of Financial Statements* require that an entity is a going concern unless it either intends to liquidate the entity or to cease trading. The staff observes that entering into liquidation and ceasing to trade are similar concepts because they both signify a departure from the going concern basis and occur when the entity is not intending to continue its business. The Conceptual Framework and IAS 8 do not prescribe that one must precede the other; they simply acknowledge that both concepts are inconsistent with the going concern assumption.

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19. The staff notes that a few stakeholders disagreed with equating liquidation with ceasing to trade. We understand that the perceived inconsistency (paragraph 8 of this paper) may be due to cases where liquidation and ceasing to trade do not overlap such as when an entity temporarily continues to trade or temporarily ceases to trade. For example, in some cases an entity may enter into liquidation while continuing to trade in order to maximise asset value for creditors, and in other cases, an entity may cease trading by suspending operations without entering into liquidation.
 20. The staff acknowledges that when developing the ED, the IASB's focus was on the concept of permanently ceasing operations as the critical event. The stakeholder feedback suggests that by specifying that liquidation begins *after* an entity has permanently ceased operations, the definition was more restrictive than was intended.
 21. The staff thinks that for the purposes of a clearer description, the focus should not be on whether the liquidation process begins before or after ceasing operations but instead on the objective of the process—to not continue the business.
 22. In our view, focusing on the fact that there was a decision to permanently cease operations, and to undertake activities associated with liquidation, serves an important role in connecting the description to the non-going concern concept as explained in paragraph BC18 of the Basis for Conclusions on IAS 32.

Lack of a clear principle-based description of what liquidation means

23. The staff acknowledges that liquidation is defined and governed by diverse legal frameworks across jurisdictions. Different terms are referred to in legislation which may be synonymous with liquidation, such as winding up, bankruptcy, insolvency proceedings, and dissolution. Given the differences in terms, or the different ways in which liquidation could be initiated in different circumstances, the staff does not think it would be possible to define liquidation in a way that encompasses all the legal definitions and processes.

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24. Instead, the staff recommends developing a clear principles-based description of what liquidation means for the purposes of classifying financial instruments. As a reminder, from an accounting perspective, the critical question is whether an entity has a contractual obligation to make payments at a time other than on liquidation. Obligations to make payments before liquidation result in financial liabilities, whereas payments as part of, or in liquidation result in equity classification. Therefore, the question is whether a process with the objective of ending the entity's business has started.
25. Such a process could involve many activities over an extended period of time such as selling off assets to pay creditors and equity holders, terminating contracts and relationships, settling obligations and transferring residual assets (if any) to equity holders. The staff notes that some of these activities may also be undertaken outside of a liquidation process. For example, during a restructuring in an effort to reduce expenses, an entity might lay off employees and sell productive assets.
26. We therefore think it would improve the understanding of the process the IASB had in mind when referring to liquidation, if the refined description makes it clear that the focus is not on whether particular activities are being undertaken but instead on **why** those activities are being undertaken.

Potential practical challenges

27. The feedback from stakeholders in the banking sector highlights resolution regimes as a practical example of the challenges with the proposed definition. The staff continues to believe that a resolution procedure is not a liquidation event. This is consistent with the IASB's discussion when developing the ED proposals. In paragraph 16 of [Agenda Paper 5B](#) of the December 2021 IASB meeting, resolution and liquidation are described as distinct processes with different purposes. Resolution is typically designed to preserve financial stability and restore viability and normal business activities, rather than ending the business.

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28. The staff notes that while resolution may in rare cases result in liquidation, it does not usually do so because the purpose of resolution is fundamentally different from that of liquidation.
29. The staff considered whether to develop illustrative examples to assist stakeholders in understanding the intended meaning of liquidation. However, given the diverse legal frameworks and factual circumstances across jurisdictions, the staff does not think it would be helpful to provide illustrative examples. There is a risk that a single fact pattern could be applied by analogy to different scenarios, potentially leading to unintended consequences. We think providing a principle-based description is more appropriate and provides the appropriate foundation for consistent application while allowing entities to exercise judgement based on their specific circumstances.

Staff recommendation

30. Based on the analysis in paragraphs 15-29 of this paper, the staff recommends revising the description of liquidation to focus on the process that includes converting assets, paying obligations, and settling equity claims, with the objective of permanently ceasing the entity's operations.
31. We think that such a revised description would best address stakeholder concerns while maintaining consistency with the principles underlying IFRS Accounting Standards—thereby achieving the objective of enhancing consistent application of the requirements to classify financial instruments as financial liabilities or equity.

Whether a contractual term is 'not genuine'

Summary of feedback

32. The ED proposed amending paragraph AG28 of IAS 32 to clarify that the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement and is not based solely on the probability or likelihood of

- the contingent event occurring. The ED also included an example of a ‘regulatory change clause’ in a financial instrument that would be considered genuine.
33. Some stakeholders provided specific feedback on this proposal. Among the respondents who specifically commented on this topic, most stakeholders (across the main stakeholder groups) agreed that the approach should be principles-based. They said the use of judgement is necessary in assessing whether a contingent settlement provision is genuine or not, acknowledging that facts and circumstances can vary significantly across contracts. In contrast, a standard-setter observed that under usual circumstances, terms are included in a contract for an economic purpose and would therefore be deemed as genuine.
34. However, mixed views were provided on including a ‘regulatory change clause’ as an example of a contingent settlement provision that would be genuine. Some stakeholders welcomed the example saying that it effectively illustrates the underlying principle and aligns with current practice. Others expressed concerns about the example. They think:
- (a) the example needs to be updated to further analyse whether the regulatory change is extremely rare and highly abnormal.
 - (b) there is a potential risk of misinterpretation that any contractual term that refers to regulatory changes is genuine. They explained that the circumstances and wording of this type of clause could differ from the example given. For example, in some jurisdictions the industry regulator might not apply such changes retrospectively.
35. To further clarify the assessment of ‘not genuine’, stakeholders suggested it would be helpful to provide additional examples, application guidance and disclosures on assessing whether a contractual term is ‘not genuine’. In particular, suggestions included that the IASB:

- (a) focuses on whether the nature of a contingent event has a substantive business purpose rather than focusing on whether the nature of a contingent event is extremely rare or highly abnormal. A few stakeholders interpreted the example of a regulatory change clause as indicating that the nature of the event has a substantive business purpose.
- (b) clarifies that if there is a commercial reason for including contractual terms (such as non-viability clauses) in a contract, those terms are likely to be genuine, *even if* they are very unlikely to occur and the nature of the contingent event is expected to be extremely rare or highly abnormal.
- (c) provides additional guidance on the concepts of ‘extremely rare’ and ‘highly abnormal’, to limit the degree of judgement involved in assessing the genuineness of contingent clauses and increase consistent application. It was also noted that many stakeholders consider ‘very unlikely’ to be synonymous with ‘extremely rare’.
- (d) considers explicit disclosure requirements to describe the specific facts and circumstances considered in determining that a contractual term is ‘not genuine’, to improve transparency for users of the financial statements.
- (e) considers how ‘not genuine’ is used in other IFRS Accounting Standards and other refinements, such as defining ‘not genuine’ or using an alternative term to reduce the risk of unintended consequences and misinterpretations.

Staff analysis and recommendations

36. The staff acknowledges stakeholder feedback regarding the assessment of whether a contractual term is ‘not genuine’. While stakeholders generally agreed with the principles-based approach in the ED, feedback highlighted two areas where further clarification would be beneficial:

- (a) the need for additional application guidance on which factors, beyond probability, should be considered when assessing whether a contractual term is ‘not genuine’; and
- (b) the need to clarify the proposed example of a regulatory change clause to avoid any misinterpretation that all regulatory change clauses would be regarded as genuine.

Assessing whether a contractual term is ‘not genuine’

37. Paragraph AG28 of IAS 32 describes a contingent settlement provision as ‘not genuine’ if settlement is based on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur. The ED proposed to clarify that the assessment of whether a contractual term 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.
38. The staff observes that:
- (a) while stakeholders generally agree that probability is not the sole factor, the feedback indicated a lack of clarity about whether the substantive business or commercial purpose was an additional factor to be considered.
 - (b) the boundaries between the characteristics are inherently challenging to assess individually. Some stakeholders consider ‘very unlikely’, ‘extremely rare’ and ‘highly abnormal’ as part of the probability assessment, others consider only ‘very unlikely’ and ‘extremely rare’ as part of the probability assessment.
39. In our view, substantive business purpose is a key factor when assessing the *nature* of a contingent event, for the purpose of determining whether a contractual term is

- genuine or not. Specifically, when the contingent settlement provision serves a substantive business purpose, it would be genuine even if the probability is remote.
40. Clarifying that the assessment of the nature of a contingent event includes considering whether the contingent event has a substantive business purpose, would enhance stakeholder understanding without creating new challenges because:
- (a) the factor is already implied in the proposed regulatory change clause example, which considers whether the clause is included for a genuine reason, which is to ensure the bank maintains sufficient levels of regulatory capital.
 - (b) the term ‘substantive business purpose’ is not new to IFRS Accounting Standards. Paragraph B.6 of the Guidance on Implementing IFRS 9 *Financial Instruments* uses this term when assessing whether two non-derivative transactions are aggregated and treated as a derivative.
 - (c) [the January 2014 Agenda Decision of the IFRS Interpretation Committee](#) clarifies that to determine whether the early settlement option in a mandatorily convertible instrument is substantive, the issuer needs to understand whether there are actual economic or other business reasons that the issuer would exercise the option.
41. The staff thinks the IASB could clarify that in assessing whether a contingent settlement provision is ‘not genuine’, an entity considers both qualitative and quantitative factors. In other words, both the nature of the contingent event and the probability or likelihood of the event occurring, should be considered in determining whether a contractual term is ‘not genuine’.
42. When assessing nature, an entity would consider whether the nature of the contingent event has a substantive business purpose. Clarifying that both the nature and probability of the contingent event should be considered would help reduce confusion about the wording and eliminate the need for entities to identify which of the characteristics relate to probability and which of the characteristics relate to nature. In

addition, a contractual term with a substantive business purpose would be considered genuine, even if the probability of the contingent event is remote.

43. The staff also notes that considering factors beyond the probability is consistent with the assessment of genuine when determining whether contractual cash flows are solely payments of principal and interest applying IFRS 9. Paragraph B4.1.18 of IFRS 9 states that ‘a cash flow characteristic is not genuine if it affects the instrument’s contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur’. Paragraph B4.1.13 of IFRS 9 also explains in the analysis of Instrument E that contractual terms are *genuine* even if the probability of a contingent event occurring is remote.
44. The staff also considered the suggestion related to explicit disclosure requirements to describe the specific facts and circumstances considered by an entity when a contractual term is determined to be ‘not genuine’ (paragraph 35(d) of this paper). The staff notes that draft paragraph B5A of IFRS 7 would require entities to disclose the judgements that management has made in classifying a financial instrument, or its component parts, if those judgements are among the judgements that have the most significant effect on the amounts recognised in the entity’s financial statements.
45. We think this proposed requirement is sufficient to cover judgements made when considering whether a contractual term is ‘not genuine’, and it is not necessary for the IASB to expand it to be more targeted. In addition, there will be a number of judgements made by entities when classifying financial instruments as financial liabilities or equity, including those arising from other classification topics in this project. However, feedback on draft paragraph B5A of IFRS 7 along with other proposed disclosure requirements will be discussed at a future IASB meeting.

Regulatory change clause example

46. Regarding the regulatory change clause example, the staff acknowledges stakeholder concerns mentioned in paragraph 34 of this paper. To address the misinterpretation that all regulatory change clauses would be considered genuine, the staff will consider

revising the example when drafting the final amendments. The staff thinks it would also be helpful to demonstrate an alternative fact pattern where a contingent settlement provision would be considered ‘not genuine’.

47. The staff further thinks the proposed example, including the contrasting fact pattern, should be relocated to the Illustrative Examples accompanying IAS 32. This relocation signals that the example illustrates the application of the principles, thereby reducing the risk of misinterpretation that the IASB established a general rule for all regulatory change clauses.

Staff recommendation

48. Based on the analysis in paragraphs 36-47 of this paper, the staff recommends the IASB finalise the proposed requirements related to the meaning of ‘not genuine’ as set out in the ED, subject to clarifying the assessment of whether a contractual term is ‘not genuine’:
- (a) an entity would consider both the probability and nature of the contingent event;
 - (b) in assessing the nature, an entity would also consider whether the contingent event has a substantive business purpose; and
 - (c) a contractual term with a substantive business purpose would be considered genuine, even if the probability of the contingent event is remote.