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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—introduction	
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Purpose of this paper

1. At the October 2019 Board meeting (Agenda Paper 5), the Board discussed the project plan for the FICE project, including the practice issues that it could address as part of the project. One of the topics discussed was accounting for financial instruments that contain contingent settlement provisions.

2. The objective of this paper is to begin the Board's discussion on accounting for financial instruments that contain contingent settlement provisions. In particular, the staff will explore as part of this discussion what clarifications could be made to the underlying principles in IAS 32 *Financial Instruments: Presentation*, without asking the Board to make any decisions. At this meeting, the staff seek the Board's view on the direction of the staff's future work. Based on the Board's feedback provided at this meeting, the staff will develop a proposal for the clarified principles and bring back a further analysis at a future Board meeting.

Introduction

3. Many entities in different jurisdictions issue contracts containing contingent settlement provisions. This topic has also been discussed by the IFRS Interpretations Committee (the Committee) in prior years. After the 2008 global financial crisis and in recent years, there has been an increase in the number of instruments issued by financial institutions that have loss absorption features using a contingent conversion mechanism—for example, an obligation for the issuer to convert the instrument into a variable number of own shares if the issuer's Common Equity Tier 1 ratio falls below a specified threshold or if a relevant authority deems the issuer to be non-viable.

4. Some instruments with contingent settlement provisions also have discretionary dividend features which brings into question whether these instruments are compound instruments containing both equity and liability components. While there are other types of financial instruments with contingent settlement provisions, these types of instruments continue to be the most common and prevalent type of such financial instruments.

5. Consistent with the description in paragraph 25 of IAS 32, a 'contingent settlement provision' in this paper refers to a contractual term in a financial instrument that requires the issuer to:

   (a) deliver cash or another financial asset; or

   (b) settle it in such a way that 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.

6. Agenda Papers 5B-5C mainly focuses on practice issues arising from accounting for contingent settlement provisions covered by paragraph 25 of IAS 32. However, there are also other instruments with contingent settlement features to which paragraph 25 of IAS 32 does not apply, for example derivatives that require settlement in a fixed number of shares on the occurrence of a contingent event. Agenda Paper 5D will explore some of the issues arising from classifying these other instruments involving contingent events to see if any clarifications to IAS 32 are needed.

7. This paper is structured as follows:

   (a) Current requirements in IAS 32;

   (b) Background

      (i) Brief history of the contingent settlement provision requirements;

      (ii) Proposals in the 2018 DP;

      (iii) IFRS Interpretations Committee discussions; and

   (c) Practice questions.

Current requirements in IAS 32

8. Paragraph 25 of IAS 32 sets out the following requirements for the classification of financial instruments containing contingent settlement provisions:

> A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that 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, 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 it would be a financial liability). Therefore, it is a financial liability of the issuer unless:
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> (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.

9. Paragraph 28 of IAS 32 sets out the classification requirement for compound instruments:

> The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.

Background

Brief history of the contingent settlement provision requirements

10. In December 2003, the Board revised IAS 32 as part of its project to improve IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*. The objective of the project was to reduce complexity by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations.

11. The revised IAS 32 incorporated the conclusion previously in SIC 5 *Classification of Financial Instruments—Contingent Settlement Provisions* that a financial instrument for which the manner of settlement depends on 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, is a financial liability. The revised IAS 32 did not carry forward the exception in SIC 5 from liability classification where the possibility of the issuer being required to settle in cash or another financial asset is remote at the time of issuance (hereafter referred to as 'the remote exception'). The revised IAS 32 clarified that contingent settlement provisions do not affect the classification when they apply only in the event of liquidation of the issuer or are not genuine.

12. The Basis for Conclusions on IAS 32 explains that the amendments do not include the remote exception in SIC 5 because the Board concluded that it is not consistent with the definitions of financial liabilities and equity instruments to classify an obligation to deliver cash as a financial liability only when settlement in cash is probable. However, similar to the Basis for Conclusions on SIC 5, the Basis for Conclusions on IAS 32 explains that there is a contractual obligation to transfer economic benefits as a result of past events because the entity is unable to avoid a settlement in cash or another financial asset unless an event occurs or does not occur in the future.

13. Prior to finalising the 2003 revised version of IAS 32, in April 2003 the Board discussed issues related to the classification of financial instruments with contingent settlement provisions. At that meeting, the Board confirmed that a financial instrument with a contingent settlement provision should not be classified as equity when settlement in shares is not wholly within the issuer's control. It also tentatively agreed that:

    (a) 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 liability.

    (b) a financial instrument with a contingent settlement provision should be evaluated to determine whether it contains liability and equity components. If so, it should be treated as a compound instrument rather than being classified as a liability in its entirety.

    (c) the proposed addition ("and without regards to probabilities of the manners of settlement") to paragraph 19 of IAS 32 should be deleted.

14. The staff note that the tentative decisions from April 2003 resulted in the current exceptions to financial liability classification in paragraph 25 (a)-(b) of IAS 32 for 'non-genuine' and 'liquidation' provisions. However, the tentative decision related to compound instrument accounting was not finalised.

Proposals in the 2018 DP

15. Although the Board tentatively decided in September 2019 not to pursue the classification approach proposed in the 2018 Discussion Paper *Financial*

Instruments with Characteristics of Equity ('2018 DP'), the staff considered the proposals for compound instruments in the 2018 DP and whether any feedback could assist in clarifying the underlying principles in IAS 32.

16. The 2018 DP carried forward the requirement in IAS 32 that the issuer of a non-derivative financial instrument should evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components would continue to be classified separately as financial liabilities, financial assets or equity instruments. The 2018 DP acknowledged that many compound instruments include derivative components, for example, convertible bonds while other compound instruments include liability and equity components that are both non-derivatives.

17. The following clarifications were proposed in the 2018 DP:

    (a) the order of identifying a liability and an equity component—an entity would identify the obligation that has the feature(s) of a non-derivative financial liability first.

    (b) the treatment of conditionality in settlement outcomes —any conditionality would be included in the derivative ie the non-derivative liability component is treated as if it is unconditional. For example, the conversion of a contingently convertible bond is conditional on a specified contingent event occurring. The DP proposed that an entity classify the obligation to settle the bond by delivering cash as a financial liability as if the obligation to pay cash is unconditional and any conditionality be included in the derivative obligation to exchange the bond with own shares, which may or may not meet the definition of equity instruments.

    (c) the treatment of alternative settlement outcomes[1] that are controlled by the holder (eg conversion option in a traditional convertible bond) and those that are contingent on an uncertain future event that are

[1] If a financial instrument has 'alternative settlement outcomes', there is more than one way the instrument may be settled. For example, a traditional convertible bond may be settled by the issuer delivering cash or delivering the issuer's own shares. The cash and share settlement outcomes are alternative settlement outcomes.

beyond the control of both the holder and the issuer—they are treated the same for the issuer's classification purposes.

18. In the June 2019 Board meeting, the staff analysed the feedback on the 2018 DP and noted that most respondents that commented specifically on compound instruments supported the Board's preferred approach for compound instruments because it is consistent with the current requirements in IAS 32 and addresses some application issues in practice. Key messages from respondents included the following:

    (a) some supported the additional clarity that the liability component of a compound instrument should not be probability-weighted based on the likelihood of the liability settlement outcome occurring, especially if the settlement outcomes are within the control of the holder. Their concerns related to the reliability of the discounted amount of a contingent settlement obligation including the issuers' estimates of the likelihood and timing they expect to be liquidated or otherwise considered non-viable, (if that is the trigger event).

    (b) some believed factoring the conditionality into the measurement of the non-derivative liability is conceptually stronger because it reflects the characteristics of the liability and how future cash flows of the entity could be affected and fits better with the measurement requirements in IFRS 9.

IFRS Interpretations Committee discussions

19. There is evidence of accounting diversity in practice in the application of the contingent settlement provision requirements. In addition to the feedback on the 2018 DP confirming this diversity, specific questions have been submitted to the Committee in the past that remain unresolved. Two such submissions are described in paragraphs 20-21 below and the staff's analysis in Agenda Papers 5B–5C of this meeting will refer to them as we seek to address the specific practice questions as part of this project.

20. In March 2010, the Committee discussed whether a financial instrument, in the form of a preference share that includes a contractual obligation to deliver cash, is

a financial liability or equity, if the payment of cash is at the ultimate discretion of the issuer's shareholders. The Committee identified that diversity may exist in practice in assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the entity's shareholders, and consequently whether a financial instrument should be classified as a financial liability or an equity instrument. The Committee recommended the Board address this issue as part of its then on-going FICE project.

21. In January 2014, the Committee discussed how an issuer would classify a particular financial instrument which did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments if the issuer breached the Tier 1 Capital ratio (the contingent non-viability event). Interest payments on the instrument are payable at the discretion of the issuer. Specifically, the Committee discussed the following issues:

    (a) whether the financial instrument meets the definition of a financial liability in its entirety or must be classified as a compound instrument comprised of a liability component and an equity component (and, in the latter case, what those components reflect); and

    (b) how the financial liability (or liability component) identified in (a) would be measured.

    The discussion of these issues included consideration of whether any discretionary interest paid on the instrument should be recognised in profit or loss or in equity. The Committee noted that the scope of the issues raised in the submission was too broad for it to address in an efficient manner.

Practice questions

22. Based on the background and history discussed in paragraphs 10-21 of this paper, the questions that have arisen in practice regarding the application of paragraph 25 of IAS 32 (reproduced in paragraph 8 of this paper) can be summarised as follows:

(a) the order of applying the requirements for contingent settlement provisions in paragraph 25 of IAS 32 and the requirements for compound instruments in paragraph 28 of IAS 32. This question affects whether a financial instrument with a contingent settlement provision is classified as a financial liability in its entirety or as a compound instrument comprised of a liability component and an equity component;

(b) whether probability of the contingent event occurring should be factored into the classification of a financial instrument with contingent settlement provision;

(c) whether and how probability of the contingent event occurring should affect the measurement of the financial instrument;

(d) how to account for discretionary interest or dividend payments if the entire proceeds are allocated to the liability component of a compound instrument, and whether there is an inconsistency between paragraphs 36 and AG37 of IAS 32;

(e) how to determine whether an event is within the entity's control for example, an event contingent on shareholders' approval;

(f) how to interpret the meaning of 'non-genuine' in paragraph 25(a) of IAS 32; and

(g) how to interpret the meaning of 'liquidation' in paragraph 25(b) of IAS 32 in the context of processes that are similar to liquidation.

23. Other questions arising from practice issues involving contingent events are:

(a) how an 'all or nothing settlement contingency'[2] affects the classification of financial instruments; and

[2] In this paper, 'all or nothing settlement contingency' refers to a contractual term that requires the issuer to settle the instrument by exchanging a fixed number of own shares and a fixed amount of cash (or the fixed amount of principal) based on 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. There is an 'all or nothing' outcome because the alternative is no settlement eg zero ordinary shares.

(b) whether there is an inconsistency between the contingent settlement provision requirements in paragraph 25 of IAS 32 and the indirect obligation requirements in paragraph 20(b) of IAS 32 where alternative settlement outcomes exist and the issuer has the choice of settlement.

24. The staff will analyse these practice questions in Agenda Papers 5B-5D of this meeting 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.