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STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Contingent settlement provisions and related issues—practice issues and potential solutions (part 3)

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Purpose of this paper

1. In this paper the staff analyse some of the practice issues arising from classifying other financial instruments with contingent settlement features to which paragraph 25 of IAS 32 does not apply.

2. Before developing proposed clarified principles, the staff will further consider each of the practice questions identified in Agenda Paper 5A to establish whether there are:

   (a) inconsistencies in IAS 32 requirements that need to be addressed;

   (b) underlying principles and rationale that need to be clarified; or

   (c) issues that merit further discussion by the Board.

   Where the staff believe this is the case, we highlight the potential clarifications which the Board could explore and the reporting consequences of the potential clarifications for each practice question discussed. In a future paper and following input from Board members at this meeting, the staff intend to analyse whether any potential clarifications result in useful information for users of the financial statements.

3. This paper is structured as follows:

   (a) staff analysis of the following practice questions:

      (i) 'all or nothing' settlement contingencies;

      (ii) issuer's choice of settlement; and

   (b) question for the Board.

'All or nothing' settlement contingencies

4. Some instruments contain contingent features which affect whether there will be a settlement in a fixed number of own shares or no settlement at all (in this paper we refer to these features as 'all or nothing settlement contingencies'). Consider two examples:

   (a) Example 1—a stand-alone derivative on own equity requires the exchange of a fixed number of shares for a fixed amount of cash if event A occurs. If event A does not occur, there is no exchange. Event A is outside the control of the issuer and the holder. Not settling the derivative if event A does not occur is similar to an option that lapses if not exercised by the holder.

   (b) Example 2—a mandatorily convertible note, with a fixed maturity date and a nominal value that is mandatorily convertible into a fixed number of ordinary shares unless a non-viability event occurs. If a non-viability event occurs, the instrument is written down to zero, ie the instrument is extinguished for zero consideration. We understand that some stakeholders question whether this instrument obliges the issuer to deliver a variable number of own shares (variable as in zero shares or a fixed number of shares) and should therefore be classified as a financial liability.

5. In both of these cases, the contingency affects whether or not there will be settlement in a fixed number of own shares. This creates an 'all or nothing'

outcome because the alternative is zero consideration and zero ordinary shares. This is different from other contingencies which result in either cash or share settlement or some contingently exercisable derivatives.

6. An example of a contingently exercisable derivative is a derivative that become exercisable by the holder or the issuer when the gold price reaches x. The staff believe paragraph 26 of IAS 32 would apply if these derivatives ultimately give one party a choice over how it is settled. This paragraph states that when a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

7. In financial instruments with these types of ‘all or nothing’ settlement contingencies, the only type of possible settlement outcome is settlement in a fixed number of own shares. In both examples, the issuer’s obligation to settle the instrument in a fixed number of own shares is contingent on the occurrence or non-occurrence of an event that is outside the control of both parties. Therefore, similar to the logic in applying paragraph 25 of IAS 32, the staff think an entity recognises all obligations that it does not have the unconditional right to avoid. In these examples, the obligation to deliver a fixed number of own shares meets the definition of an equity instrument. These instruments do not have any other obligations that meet the definition of a financial liability.

8. In Example 1, the derivative is only settled with a fixed number of shares for a fixed amount of cash if the contingent event occurs. Because the contingent event is outside the control of the issuer, the issuer cannot avoid the settlement if the contingent event occurs. The staff believes the ‘settlement contingency’ would result in equity classification of the instrument. Such settlement would represent an exchange of a fixed number of own shares for a fixed amount of functional currency units and is therefore consistent with the principles for the fixed-for-fixed condition and equity classification discussed by the Board in April 2020

9. In Example 2, the nominal value is written down to zero if the contingent event occurs and the entity is released from its obligation to deliver a fixed number of

ordinary shares. The change in obligation from a fixed number of shares to zero shares, is not the same as settling the instrument with a variable number of shares because the contingent event extinguishes the obligation to deliver any shares.

10. Therefore, the staff believe the requirements for contingent settlement provisions in paragraph 25 of IAS 32 is not applicable in this case as there is no manner of settlement that would result in liability classification. The write-down feature itself is not settled in cash or shares and merely requires the otherwise equity instrument to be extinguished for zero consideration. Because the contingent event is outside the control of the issuer, the issuer cannot avoid the settlement in a fixed number of shares if the contingent event does not occur. The staff therefore believes the 'settlement contingency' would result in equity classification of the instrument.

11. The staff think that the classification outcomes explained in paragraphs – of this paper are also consistent with the logic in the requirement in paragraph 26 of IAS 32, which focuses on the settlement outcomes. Although in these examples there is no choice over the manner of settlement, instruments with all or nothing settlement contingency have no settlement outcomes that meet the definition of financial liabilities and therefore these instruments are classified as equity instruments.

Potential clarifications

12. The Board could consider clarifying that settlement contingencies which create 'all or nothing' outcomes where the only type of possible settlement outcome is settlement in a fixed number of own shares create obligations to deliver a fixed number of own shares. An issuer should be required to recognise that obligation to deliver a fixed number of own shares because it does not have the unconditional right to avoid settlement in such manner. The Board could also consider including the examples as described in paragraph 4 as application guidance to illustrate the principle.

13. In addition, the Board could clarify that paragraph 26 of IAS 32 would apply to contingently exercisable derivatives as long as these derivatives ultimately give one party a choice over how it is settled.

14. The Board could also consider clarifying that a change in settlement from a fixed number of shares to zero shares upon a contingent event, is not the same as settling the instrument with a variable number of shares and therefore paragraph 25 of IAS 32 would not apply in such cases.

Issuer's choice of settlement

15. In some cases, the contractual terms of an instrument may give the entity, as issuer, a choice between settlement in cash or settlement in own shares upon the occurrence of a contingent event that is beyond the control of both the issuer and the holder. The question that arose in practice was whether the indirect obligation requirements in paragraph 20(b) of IAS 32 are aligned with the contingent settlement provision requirements in paragraph 25 of IAS 32 or whether applying these requirements might lead to what some stakeholders believe to be contradictory outcomes.

16. Paragraph 20(b) of IAS 32 applies when an issuer has a choice of settlement and explains when an obligation is established indirectly through a financial instrument's terms and conditions even though there is no explicit contractual obligation to deliver cash or another financial asset. Paragraph 20(b) states:

> […] (b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:
>
> (i) cash or another financial asset; or
>
> (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.
>
> Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21).

17. Some stakeholders pointed out that where alternative settlement outcomes are contingent on an event not within the control of the issuer or the holder, for an instrument to be classified as equity applying paragraph 25 of IAS 32, the issuer should have the ability to avoid paying cash in all genuine scenarios. Therefore, they believe an instrument will generally not be classified as equity where contingent settlement options exist.

18. These stakeholders also said that where alternative settlement outcomes are controlled by the entity, for an instrument to be classified as equity applying paragraph 20(b) of IAS 32, the equity settlement outcome should be preferable to the cash alternative only in some scenarios that are genuine and not in all of them. Therefore, they believe an instrument will generally be classified as equity where the entity controls alternative settlement outcomes.

19. The staff believe the requirements in paragraph 20(b) and paragraph 25 of IAS 32 apply in mutually exclusive scenarios even though both require the recognition of a financial liability if specific conditions are met. Paragraph 25 of IAS 32 applies where there is an event outside the control of both parties that would result in settlement in such a way that the instrument would be a financial liability and the issuer does not have an unconditional right to avoid such settlement. Paragraph 20(b) of IAS 32 applies where the issuer has a choice of settlement but the value of the share settlement alternative is such (substantially exceeds the cash alternative) that the entity will settle in cash and therefore has an indirect obligation. This is because the entity's right to settle a claim by delivering a fixed number of shares is 'structurally out-of-the-money' ie always 'out-of-the-money' or always unfavourable to the entity.

20. If there are some scenarios where the equity settlement outcome is preferable to the cash alternative, then the staff believe paragraph 20(b) of IAS 32 would not result in financial liability recognition. Similarly, if the entity still has a choice to avoid cash settlement even after an event outside the control of both parties occurs, then the staff believe paragraph 25 of IAS 32 does not apply because the entity can still avoid the obligation to settle in cash.

21. The instrument referred to in paragraph 15 of this paper would thus be classified as an equity instrument in the absence of any indirect obligations. In the staff's view it makes no difference whether the issuer has the choice of settlement and can avoid settlement in cash from inception or whether an uncertain event outside the control of both parties triggers the issuer's settlement rights. In both these cases, if the issuer has the right to choose settlement in cash or a fixed number of own shares, the instrument is classified as equity because the issuer can avoid settlement in cash. This view is consistent with the Committee's decision discussed below.

22. In May and September 2013, the Committee discussed how an issuer would classify three financial instruments that had no maturity date but each gave the holder the contractual right to redeem at any time. The holder's redemption right was described differently for each of the three financial instruments; however in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments if the holder exercised its redemption right. The issuer was not required to pay dividends on the three instruments but could choose to do so at its discretion. The Committee noted that a non-derivative financial instrument that gives the issuer the contractual right to choose to settle in cash or a fixed number of its own equity instruments meets the definition of an equity instrument in IAS 32 as long as the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions.

23. However, concerns have been raised by stakeholders in the past about classifying an instrument as equity in its entirety where the issuer has the choice of settling in cash or shares but it is unlikely to exercise the equity settlement option or it lacks economic effect but is not 'structurally out-of-the-money' so would not fall in the scope of paragraph 20(b) of IAS 32. The Board has in the past clarified that the fact that the entity can waive its right to the equity settlement outcome is not relevant to the analysis. What is relevant is whether the entity has an unavoidable obligation to pay cash. Furthermore, economic incentives are not rights or obligations, but are factors that impact the likelihood of an entity or holder exercising particular rights and they may change over time.

24. The staff note that the *Conceptual Framework* has guidance on disregarding terms that have no substance. Paragraph 4.61 of the *Conceptual Framework* states:

> Terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example:
>
> (a) terms that bind neither party; or
>
> (b) rights, including options, that the holder will not have the practical ability to exercise in any circumstances.

25. In addition, in January 2014 the Committee also discussed the guidance in paragraph 20(b) of IAS 32 in the context of determining whether a contractual term was substantive and should be considered in the classification assessment. The Committee noted that the guidance is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment. This issue related to a financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle early by delivering the maximum (fixed) number of shares. The Committee noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons for the issuer to exercise the option. The Committee highlighted factors to be considered in making that assessment eg whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms.

26. The staff note that paragraph 15 of the annotated version of IAS 32 includes a reference to this agenda decision. This paragraph applies when an entity classifies financial instruments in accordance with the substance of the contractual arrangement. The revised Due Process Handbook (August 2020) includes an improved description of agenda decisions. It states that the explanatory material [in agenda decisions] derives its authority from IFRS Standards and, accordingly, a company is required to apply the applicable IFRS Standards reflecting the explanatory material.

27. Some respondents to the 2018 DP suggested the Board incorporate the agenda decision as part of IAS 32 but this suggestion was made before the revised Due Process Handbook clarified the objective and the nature of agenda decisions. Given the clarification made in the revised Due Process Handbook, the staff think there is no longer a strong need to incorporate the agenda decision into IAS 32.

Potential clarifications

28. The staff do not propose any clarifications and see no reason to align the wording in paragraph 20(b) with paragraph 25 of IAS 32 because these requirements apply in mutually exclusive scenarios. However, to address the concerns described in paragraph 26 of this paper, the Board could consider whether the reference to the agenda decision in paragraph 15 of IAS 32 is sufficient to address these concerns. Agenda decisions usually apply to specific fact patterns but its reference in paragraph 15 of IAS 32 could be interpreted as having wider application. If the Board decides that the particular agenda decision has wider application and that further clarification is required it could consider:

(a) clarifying how an entity should determine whether settlement outcomes are substantive, by:

   (i) using some of the language in the *Conceptual Framework* for disregarding terms that have no substance (see paragraph 25 of this paper); and/or

   (ii) adding Application Guidance to IAS 32 to explain when an issuer's right to avoid a liability settlement outcome should be seen as substantive and when there are grounds to disregard that right for classification purposes.

(b) explicitly extending the indirect obligation requirements in paragraph 20(b) of IAS 32 to some additional cases where the equity settlement option is not 'structurally out-of-the-money'. This means for example, that an indirect obligation could arise even if the equity settlement option is in some cases favourable to the cash settlement option. For that to be the case, the equity settlement option would need to be non-substantive. However the staff do not recommend the Board pursue this alternative because it would have wider implications and could result in unintended consequences or structuring opportunities.

Question for the Board

29. The staff would like to ask the Board the following question.

Question for the Board
Do Board members have any initial views or questions on the staff's analysis of the practice questions or the potential clarifications that the Board could consider which are set out in this paper?