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Financial Instruments with Characteristics of Equity

Update on Contingent settlement provisions and the effects of laws on contractual terms

Objective

- 1 The objective of this agenda paper is to provide EFRAG TEG members an update on the IASB discussions on Contingent settlement provisions and the effects of laws on contractual terms.

Introduction

- 2 In its September 2021 meeting, the IASB's staff sought the IASB Board members feedback on their initial proposals and asked for direction on how to proceed. Based on the feedback provided by the IASB Board members, the IASB staff will develop its proposals and bring them back at a future IASB meeting. The IASB Board members were not asked to make any decisions.

Contingent settlement provisions

- 3 Many entities in different jurisdictions issue contracts containing contingent settlement provisions. After the 2008 global financial crisis, there has been an increase in the number of instruments issued by financial institutions that have loss absorption features using a contingent conversion mechanism. These instruments may also have discretionary dividend features, which brings into question whether these instruments are compound instruments containing both equity and liability components.
- 4 Many issues related to contingent settlement provisions have been discussed by the IFRS Interpretations Committee in the past, including:
 - (a) the classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event;
 - (b) the accounting for financial instruments in which the manner of settlement is conditional on rights within the control of the entity. In particular, whether in substance there is an obligation that would meet the definition of a liability as a result of economic compulsion, indirectly through the terms and conditions or barriers to the entity exercising the equity settlement outcome; and
 - (c) payments at the ultimate discretion of the issuer's shareholders.
- 5 In September 2021, the IASB discussed the following potential clarifications to address the issues that arise in practice:
 - (a) The order of applying the requirements for contingent settlement provisions in paragraph 25 of IAS 32 *Financial Instruments: Presentation* and the requirements for compound instruments in paragraph 28 of IAS 32. This

question affects whether a compound 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.

- (i) *IASB Staff preliminary views:* the compound instrument requirements (paragraphs 28-32 of IAS 32) apply first to identify the components of the financial instrument before any specific classification requirements (this is because paragraph 15 of IAS 32 already clarifies the order of applying the requirements in IAS 32).
- (b) Whether probability of the contingent event occurring should be factored into the classification of a financial instrument with contingent settlement provision.
 - (i) *IASB Staff preliminary views:* the probability of a contingent event (which is outside the control of both parties to the contract) occurring should not be considered in classification.
- (c) Whether and how probability of the contingent event occurring should affect the measurement of the financial instrument (i.e., whether the liability that arises from financial instruments containing contingent settlement provisions should be measured at the full amount or at probability-weighted amount taking into account the likelihood and timing of the contingent event).
 - (i) *IASB Staff preliminary views:* presented two possible views: measure at the full amount or at probability-weighted amount.
- (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.
 - (i) *IASB Staff preliminary views:* a compound instrument with a zero-value equity component is still a compound instrument with a liability (measured at the full amount that the issuer could be required to pay immediately) and an equity component (residual, which is zero). Thus, if the issuer pays any discretionary interest on the instrument, those payments relate to the equity component and would be recognised in equity.
- (e) How to determine whether an event is within the entity's control, for example, an event contingent on shareholders' approval (i.e., when shareholders are acting as on behalf of the entity in their capacity as owners instead of as investors).
 - (i) *IASB Staff preliminary views:* the IASB could further explore what factors an entity should consider in applying judgment of what is and what is not within the entity's control. Also, guidance on how to determine the shareholder is acting in their individual capacity.
- (f) How to interpret the meaning of 'non-genuine' in paragraph 25(a) of IAS 32 (i.e., whether a contingent event can be seen as 'non-genuine' so that the associated obligation is not classified as a financial liability);
 - (i) *IASB Staff preliminary views:* clarify whether the non-genuine assessment is purely a probability assessment. For example, clarify that if a feature that would be regarded as non-genuine because the contingent event is extremely rare, highly abnormal and very unlikely to occur, could still be regarded as genuine when there is a specific purpose for including it in the contract. Also add further application guidance on the meaning of non-genuine.

- (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.
 - (i) *IASB Staff preliminary views:* clarify whether the reference to 'liquidation' in paragraph 25(b) of IAS 32 refers only to the very end point when an entity ceases to exist or ceases to trade (as implied by the Conceptual Framework and IAS 1).
 - (h) How an 'all or nothing settlement contingency' affects the classification of financial instruments.
 - (i) *IASB Staff preliminary views:* clarify 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.
 - (i) 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.
 - (i) *IASB Staff preliminary views:* No clarifications and no alignment of 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 about equity classification, the IASB could consider whether the reference to the agenda decision in paragraph 15 of IAS 32 is sufficient to address these concerns. If the IASB decides that further clarification is required, it could clarify how an entity should determine whether settlement outcomes are substantive and explicitly extend 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.'
- 6 In general, when discussing the issues above, the IASB Board members considered that any changes to IAS 32 in the future should be narrow and that the IASB should proceed with caution to avoid any significant changes to current requirements in IAS 32, particularly when there is no diversity in practice or uncertainty, or knock-on effects on other standards (e.g., IFRS 9 *Financial Statements*).

EFRAG Secretariat analysis

- 7 The IASB has not made any tentative decisions at this stage. Nonetheless, the EFRAG Secretariat:
- (a) welcomes that the IASB is considering possible improvements to IAS 32 to clarify the classification of financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event (in January 2014 the Interpretations Committee decided not to add this issue to its agenda as the scope of the issues raised in the submission was too broad for it to address in an efficient manner). EFRAG acknowledges that the IASB's staff proposals have the benefit of being aligned with the Committee previous discussions on this topic. However, the EFRAG Secretariat considers that measuring a liability at a probability-weighted amount taking into account the likelihood and timing of the contingent event (as mentioned in paragraph 5 above) would be a significant change to current requirements (and not simply a clarification);
 - (b) welcomes that the IASB is considering possible improvement to IAS 32 on the accounting for financial instruments in which the manner of settlement is conditional on rights within the control of the entity. EFRAG Secretariat recalls that in its comment letter, EFRAG welcomed the DP's proposal to clarify that

economic incentives that might influence the issuer's decision to exercise its rights would not be considered when classifying a financial instrument as a financial liability or equity instrument as it may raise more questions than answers. In addition, EFRAG also considered that improvements to the indirect obligations requirements (e.g. incorporate the notion of 'no commercial substance' which is currently used in paragraph 41 of IFRS 2) may alleviate some of the issues related to economic compulsion.

- (c) welcomes that the IASB is considering possible improvement to IAS 32 on payments at the ultimate discretion of the issuer's shareholders. However, the EFRAG Secretariat acknowledges that there are mixed views on this issue and notes the difficulty and subjectivity of developing guidance on how to determine when the shareholders are acting in their individual capacity.

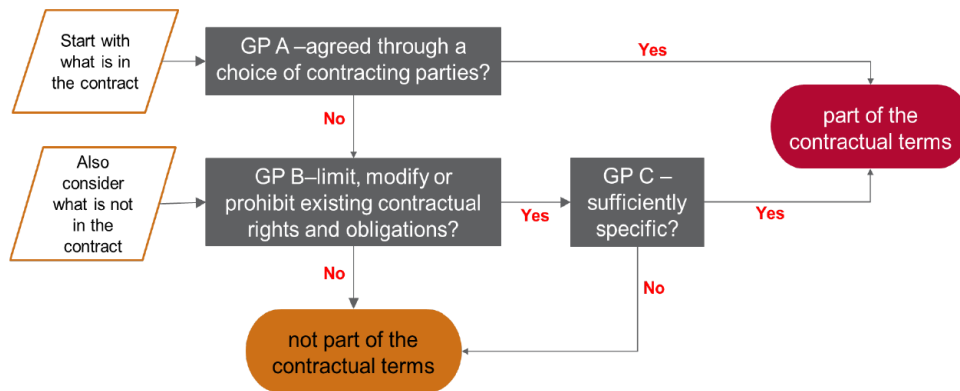
Questions for EFRAG TEG members

- 8 Do EFRAG TEG members have any comments or concerns on the IASB's initial discussions on contingent settlement provisions?

The effects of laws and regulations

- 9 In the context of this project, understanding the meaning of 'contractual' is a critical element for classification of a financial instrument as a financial liability or an equity instrument.
- 10 Currently IFRS Standards are not consistent when dealing with the 'contractual rights and obligations' and 'regulatory and legal' requirements. For example, IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* considers the effects of legislative requirements for classification purposes while IFRS 9 does not. In addition, paragraph 4.31 of the Conceptual Framework for Financial Reporting states that many obligations are established by contracts, legislation or similar means. The latter could indicate that even if an obligation is not established by contract, an obligation could arise as a result of the legislation.
- 11 The overarching question is whether, and if so to what extent, a legal requirement is part of the contractual terms and must therefore be considered in classifying a contract as a financial liability or an equity instrument.
- 12 In particular, whether a legal requirement that is not reproduced or referred to in the contract, but is implied by law is part of the contractual terms (ie whether the laws in a particular jurisdiction that affect the rights and obligations established in a contract should be considered as part of the contractual terms (e.g. bail-in instruments, ordinary shares with statutory minimum dividends, Mandatory Tender Offers).
- 13 The 2018 DP proposed no changes to IAS 32 on the topic. Some respondents who agreed with the IASB's view noted that taking into consideration the overall effects of laws would represent a significant change to current requirements and could have unintended consequences. However, most respondents urged the IASB to provide guidance on what should be considered as part of the contractual terms and whether, and how, an entity should consider the effects of relevant laws in classifying financial instruments, stating some deficiencies of a strict contract-only approach.
- 14 In September 2021, the IASB explored a number of potential guiding principles to help determine whether legal requirements or terms that are required by law should be regarded as part of the contractual terms regardless of whether a term is explicitly stated in the contract and should be considered in classifying a financial instrument

as a financial liability or an equity instrument. More specifically, the IASB discussed the following potential guiding principles:



- 15 More specifically, the following steps should be considered to determine whether a legal term or requirement should indeed be treated as part of the contractual terms:
- Guiding principle A: Are the terms negotiable and agreed through a choice of contracting parties?* If a term is subject to a negotiation between parties to the contract to determine the specifics and creates rights and obligations that are in addition to, or more specific than, the legal requirements, then it is part of the contractual terms (explicit terms). An entity would have to consider, for example, whether the term applies in the same way even if it is not reproduced in the contract or whether the term can be negotiated.
 - Guiding principle B: Do laws limit, modify or prohibit an existing right and obligation in a contract?* If a law affects an existing right or obligation in a contract in a way that permits or requires the contracting parties to avoid such an obligation or makes it unenforceable in its original form, the effects of such law have to be considered part of the contractual terms. This is based on the fact that the contract terms cannot contradict or go against the law but that law can contradict the contractual terms, eg legal restrictions on share issuances.
 - Guiding principle C: Are the terms sufficiently specific to allow reasonable determination of contractual rights and obligations?* If the terms are not sufficiently specific to allow reasonable determination of contractual rights and obligations, then they are not part of the contractual terms. For example, for bail-in instruments, it is likely difficult for an entity to determine the specific rights and obligations they might have because they are subject to the regulator's discretion. This principle would limit the situations in which obligations that lack specificity are treated as contractual and are classified as a financial liability.
- 16 The IASB Staff rejected an all-inclusive approach where all explicit and implied terms would be considered to be part of the contractual terms.
- 17 The IASB Staff also rejected an approach which distinguishes contractual terms based on the way a term that is required by law or a legal requirement itself is reproduced or referred to in the contract. This is because this approach would result in the classification outcome depending on the way the contractual term is referenced to future changes in the law rather than focusing on the nature of the rights and obligations.
- 18 If the IASB decides to proceed with the guiding principles described above, new disclosures could be developed, including for example,

- (a) disclosures of legal requirements that could affect the timing and amount of future cash flows of financial instruments an entity issued even if they do not affect their classification.
 - (b) disclosure of legal requirements that limit, modify or prohibit the contractual obligations so that users of financial statements can understand their impact on a contract.
- 19 Again, in general the IASB Board members were not very supportive of approaches that would fundamentally change current requirements in IAS 32 as any changes could have knock-on consequences on IFRS 9. On the guiding principles related to the effects of law and regulation, it was suggested that they could be included in the basis for conclusions to avoid a change in IAS 32, which would have as a consequence preparers assessing all their instruments against those principles.

EFRAG Secretariat analysis

- 20 The EFRAG Secretariat welcomes the IASB's discussions on the effects of law and regulation.
- 21 The IASB's discussions are aligned with EFRAG request to the IASB to further work on the interaction between the terms and conditions of a contract and legal requirements to avoid a blanket rejection of the effects of the law from classification and to discuss with regulators the challenges that arise with imposed regulation. In particular, when considering bail-in instruments where different jurisdictions face challenges on how to take into account the interaction between the contractual rights and obligations and regulation (such as the Bank Recovery and Resolution Directive (BRRD)) when classifying these instruments. Considering the challenges that arise in practice, particularly with bail-in legislation, we recommend the IASB to continue to explore guidance that may assist entities in addressing these issues.
- 22 The EFRAG Secretariat is also not in favour of an all-inclusive approach as taking into consideration the overall effects of regulation and legislation in the classification model would represent a significant change to current requirements and could have unintended consequences.
- 23 When the IASB discussed Mandatory Tender Offers in October 2019 and September 2021, the IASB noted that solving the mandatory tender offers issue would require a fundamental re-write of IAS 32 and would be beyond the scope of the current project. Thus, EFRAG Secretariat considers that the IASB's discussions do not seem to solve the issue of mandatory tender options. In its comment letter, EFRAG had requested the IASB to address this issue in the future.
- 24 Finally, EFRAG welcomes that the IASB does not intend to reconsider the requirements in IFRIC 2 given that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice and that it is not aware of any challenges to its application.

Questions for EFRAG TEG members

- 25 Do EFRAG TEG members have any comments or concerns on the IASB's initial discussions on the effects of law and regulation?

Order of applying requirements in IAS 32	
<p><i>Issue</i></p> <p>When a compound financial instrument contains contingent settlement features, whether there is a required sequence or order in which an issuer should apply the requirements in paragraph 25 and 28-32 of IAS 32.</p> <p>In July 2013 the IFRS IC published a tentative agenda decision which implied that an entity applies the requirements for compound instruments before the requirements for contingent settlement. That is, an entity first identifies and recognises the financial liability and equity components. However, the Committee decided not to finalise the tentative agenda decision.</p>	<p><i>Potential clarifications considered by the IASB</i></p> <p>The IASB should clarify that the compound instrument requirements (paragraphs 28-32 of IAS 32) apply first before any specific classification requirements.</p> <p>This would be aligned with the Committee previous discussions on this topic; aligned with the IASB previous discussions on contingent convertible bonds when revisiting IAS 32 in 2003; consistent with the requirements on other compound instruments in paragraph AG37 of IAS 32; and would ensure that classification of an instrument is in accordance with the substance of the contractual arrangement.</p>
Does probability of a contingent event occurring affect classification?	
<p><i>Issue</i></p> <p>Whether the probability of the contingent event occurring should affect the classification. For example, if the contingency is not likely to occur, whether it can be ignored in the classification.</p>	<p><i>Potential clarifications considered by the IASB</i></p> <p>The IASB should reinforce the idea that the contingent settlement provision requirements do not include an exception for circumstances in which the possibility of the entity being required to settle in cash or another financial asset is remote at the time the financial instrument is issued (as explained in BC17 of IAS 32).</p> <p>That is, the probability of a contingent event (which is outside the control of both parties to the contract) occurring should not be considered in classification. If probabilities were considered, significant judgement would be required and continuous reassessment and reclassification would be needed if, and when probabilities change over time.</p>

Impact of probability in measurement:	
<p>Issue</p> <p>Whether applying paragraph 25 of IAS 32 to financial instruments containing contingent settlement provisions that could require immediate liability settlement, requires recognition of a financial liability for the full amount that is contingently payable.</p>	<p>Potential clarifications considered by the IASB</p> <p>1. Reinforce the idea that financial instruments with contingent settlement provisions should be measured as financial liabilities for the full amount of the conditional obligation' (i.e. the liability component must be measured at the full amount as if the issuer could be required to pay immediately). This would be in line with previous discussions from the Committee, is consistent with BC12 of IAS 32, consistent with notion that the full amount of the obligation could be immediately repayable if the contingent event occurs the very next day;</p> <p>or</p> <p>2. Financial instruments with contingent settlement provisions should be measured as financial liabilities taking into account the expected probability and timing of the contingent obligation as the contingent event is outside the control of both parties and cannot be assumed to occur immediately.</p>
Discretionary payments	
<p>Issue</p> <p>How an entity accounts for any subsequent discretionary distributions made if all of the issuance proceeds are allocated to the liability component at initial recognition ie the equity component is measured at zero.</p>	<p>Potential clarifications considered by the IASB</p> <p>The IASB could clarify that a compound instrument with a zero-value equity component is still a compound instrument with a liability and an equity component. As the equity component exists, thus, consistent with paragraph AG37 of IAS 32, if the issuer pays any interest on the instrument, those payments relate to the equity component and would be recognised in equity.</p>

Assessing control	
<p>Issue</p> <p>When an event is within the entity’s control and particularly, when shareholders are acting as on behalf of the entity in their capacity as owners instead of as investors in particular financial instruments. For example, in classifying preference shares, an issuer considers, amongst others, the contractual term that a preference dividend must be paid in cash if cash dividends are paid on ordinary shares. If cash dividends on ordinary shares require approval by a simple majority of ordinary shareholders in a general meeting, the question is whether ordinary shareholders are acting on behalf of the entity when approving dividends.</p>	<p>Potential clarifications considered by the IASB</p> <ol style="list-style-type: none"> 1. <i>How an entity determines whether an event is within its control - the IASB could further explore what factors an entity should consider in applying judgment.</i> The IASB could then provide guiding principles and supplement the principles with examples of what is and what is not within the entity’s control. It could also consider articulating the notion of control in this context. 2. The IASB could provide guidance on what to consider when classifying an instrument when settling the obligation in cash or another financial asset is subject to shareholder approval. For example, an entity could consider the types of voting rights held by shareholders as well as the type of decisions which may affect the capacity in which the shareholder is acting 3. The IASB could provide guidance on how to determine the shareholder is acting in their individual capacity (guiding principles for an entity to consider in applying judgment). It could supplement the principles with examples of when the shareholder is acting in their individual capacity as an investor in a particular instrument and when it is acting as an extension of the entity.
Meaning of ‘non-genuine’	
<p>Issue</p> <p>Whether a contingent event can be seen as ‘non-genuine’ so that the associated obligation is not classified as a financial liability. In particular, questions on whether ‘non-genuine’ is a wider notion that also considers the purpose for including such features in the terms of the instrument even if that contingent event is extremely rare, highly abnormal or very unlikely to occur.</p>	<p>Potential clarifications considered by the IASB</p> <ol style="list-style-type: none"> 1. The IASB can clarify that if a feature that would be regarded as non-genuine because, for example, the contingent event is extremely rare, highly abnormal and very unlikely to occur, could still be regarded as genuine when there is a specific purpose for including it in the contract. 2. Adding further application guidance that explains the meaning of non-genuine in paragraph AG28 of IAS 32 to assist entities in applying the contingent settlement provision requirements in paragraph 25 of IAS 32 e.g.

	clarifying that non-genuine means there is no realistic possibility of the contingent event affecting the manner of settlement.
Meaning of liquidation	
<p>Issue</p> <p>In applying paragraph 25(b) of IAS 32 to assess whether a financial instrument, that requires settlement in cash or another financial asset only in the event of liquidation of the issuer, would be classified as an equity instrument, the question arises whether ‘liquidation’ can be interpreted as broader than just ‘ceasing to trade’. For example, if settlement in cash or another financial asset is required when there are significant doubts upon the entity’s ability to continue as a going concern (such as resolution) but is neither liquidating nor ceasing to trade, the question is whether this situation would be similar to ‘liquidation’ and the obligation could be classified as an equity instrument without any remeasurement of the carrying amount.</p> <p>In addition, the question arise on whether the reference to ‘liquidation’ in paragraph 25(b) of IAS 32 includes a pre-determined liquidation (eg when an entity has a finite life) or where liquidation is at the option of instrument holders which are in the scope of paragraph 16C-D of IAS 32.</p>	<p>Potential clarifications considered by the IASB</p> <p>The IASB could consider clarifying whether the reference to ‘liquidation’ in paragraph 25(b) of IAS 32 refers only to the very end point when an entity ceases to exist or ceases to trade (as implied by the Conceptual Framework and IAS 1).</p>
‘All or nothing’ settlement contingencies	
<p>Issue</p> <p>Questions on the classification of some instruments that contain contingent features which affect whether there will be a settlement in a fixed number of own shares or no settlement at all. For example, 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</p>	<p>Potential clarifications considered by the IASB</p> <p>The IASB 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 IASB could also</p>

<p>consideration. Questions have been raised on 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.</p>	<p>consider including the examples as described in paragraph 4 as application guidance to illustrate the principle.</p>
<p>Issuer's choice of settlement</p>	
<p>Issue</p> <p>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. For example, a financial instrument without a maturity date but the holder has contractual right to redeem at any time and the issuer 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. Concerns have been raised by stakeholders 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.</p> <p>Similarly, 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.</p>	<p>Potential clarifications considered by the IASB</p> <p>No clarifications and no alignment of the wording in paragraph 20(b) with paragraph 25 of IAS 32 because these requirements apply in mutually exclusive scenarios.</p> <p>However, the IASB could clarify how an entity should determine whether settlement outcomes are substantive.</p> <p>In addition, it could explicitly extend 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.</p>