IFRS

STAFF PAPER

January 2014

IFRS Interpretations Committee Meeting

Project	**IAS 32 *Financial Instruments: Presentation***		
Paper topic	Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event		
CONTACT(S)	Liz Figgie	efiggie@ifrs.org	+44 (0)20 7246 6410

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Background

1. In 2013 the IFRS Interpretations Committee (the Interpretations Committee) received a request to address the accounting for a particular financial instrument that converts into a variable number of the issuer's own equity instruments upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument.

2. The submission noted that in the wake of the financial crisis, prudential regulators are looking to strengthen the capital base of financial institutions, particularly in the banking sector. Some financial institutions are complying with these new regulatory requirements by issuing financial instruments that convert into a variable number of the issuer's own ordinary shares if the institution breaches a minimum regulatory requirement. This type of contingent event is called a 'non-viability' event. The submission asked how the issuer should classify such a contingently convertible financial instrument in accordance with IAS 32 *Financial Instruments: Presentation*.

3. These instruments vary in practice because national regulators have discretion in specifying particular terms and conditions—but the submission described the key features as follows:

   (a) The instrument does not have a stated maturity date. However the issuer may choose to call the instrument for cash (equal to its par

amount) on specific dates, subject to the regulator's approval and particular other restrictions.

(b) The instrument has a stated interest rate (eg 10%) but the issuer may cancel any interest payment for any reason on a non-cumulative basis; ie interest on this instrument is paid at the issuer's discretion. In addition, the regulator may force the issuer to cancel interest payments in some circumstances.

(c) If the issuer breaches the required 'Tier 1 Capital ratio' (the contingent non-viability event), the instrument mandatorily converts into a variable number of the issuer's own ordinary shares. The value of the shares delivered at conversion equals the fixed par amount of the instrument; ie the number of shares delivered varies on the basis of the current share price.

4. The submission stated that the contingent non-viability event is 'genuine'[1] and therefore cannot be ignored for the purposes of applying IAS 32. The submission also noted that the instrument is issued at par and the issuer receives the full proceeds upon issuance.

5. The submission set out five alternative views that are being applied in practice (or that practice considers to be acceptable views). Agenda paper 18 for the July 2013 meeting described each view in detail—but a summary of those alternative views is set out below:

(a) **View 1: The instrument is a liability in its entirety**—The issuer has a contractual obligation to deliver a variable number of its own ordinary shares if the contingent non-viability event occurs (ie if the issuer breaches the required Tier 1 Capital ratio). Therefore the instrument must be classified as a financial liability in its entirety in accordance with paragraphs 11 and 25 of IAS 32. If the issuer pays any interest on the instrument, those payments would be recognized in profit or loss.

[1] Paragraphs 25 and AG28 of IAS 32 state that a contingent settlement feature does not affect classification if that feature is 'not genuine'. A contingent settlement feature is not genuine if the occurrence of the uncertain future event is extremely rare, highly abnormal and very unlikely to occur.

(b) **View 2: The instrument is a compound instrument**—The instrument is comprised of (i) a liability component, which reflects the issuer's obligation to deliver a variable number of its own ordinary shares if the contingent non-viability event occurs and (ii) an equity component, which reflects the issuer's discretion to pay interest. When measuring the liability component, View 2 would consider the expected timing of the contingent non-viability event occurring—and discount the liability accordingly. The difference between the fair value of the compound instrument in its entirety and the measurement of the liability component would be assigned to the equity component. If the issuer pays any interest on the instrument, those payments relate to the equity component and thus would be recognized in equity.

(c) **View 3: The instrument is a compound instrument but the equity component has a value of zero**—View 3 is similar to View 2 but the liability component would be measured differently. View 3 considers the fact that the contingent non-viability event could occur immediately and hence the liability component would be measured at the amount that the issuer could be required to pay immediately. Therefore, the equity component (a residual) would have a value of zero. Consistent with View 2, if the issuer pays any interest on the instrument, those payments relate to the equity component and thus would be recognized in equity.

(d) **View 4: The instrument is a compound instrument comprised of an equity host with an embedded derivative for the conversion feature**—On the basis of the requirements in IAS 39 *Financial Instruments: Recognition and Measurement* (or IFRS 9 *Financial Instruments*) for financial instruments with embedded derivative features, the instrument is comprised of (i) an equity component, which reflects the fact that the instrument does not have a stated or pre-determined maturity date and represents a residual interest in the entity's net assets and (ii) a non-equity derivative, which reflects the

conversion feature that obliges the issuer to settle the instrument by delivering a **variable** number of its own ordinary shares.

(e) **View 5: The instrument is equity in its entirety**—View 5 is similar to View 4 because it classifies the host instrument as equity because it has no stated or pre-determined maturity date and represents a residual interest in the entity's net assets. But View 5 notes that the conversion feature obliges the issuer to exchange one form of its own equity (ie an instrument with no stated or predetermined maturity date) for another form of its own equity (ie ordinary shares) and such an embedded derivative is closely related to the host instrument because it contains similar equity characteristics. Accordingly, under View 5, the financial instrument should be classified as an equity instrument in its entirety.

Summary of the Interpretation Committee's discussion in July 2013

6. At its July 2013 meeting, the Interpretations Committee tentatively decided not to add this issue to its agenda and noted the following:

   (a) IAS 32 sets out the relevant requirements for classifying financial instruments (or their components), from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments.

   (b) The instrument described in the submission is a compound instrument that is composed of the following two components:

      i. a liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and

      ii. an equity component, which reflects the issuer's discretion to pay interest.

   (c) Paragraph 11 of IAS 32 states that a financial instrument meets the definition of a financial liability if the issuer is obliged to deliver a variable number of its own equity instruments. Paragraph 25 of that Standard provides guidance on applying that definition to an instrument

with a contingent settlement provision and clarifies that a financial liability exists if the settlement of the obligation is contingent upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder (subject to particular limitations, which are not relevant to this instrument). The contingent non-viability event is beyond the control of both the issuer and the holder.

(d) To measure the liability component, the issuer must consider the fact that the contingent non-viability event could occur immediately because it is beyond the control of the issuer and there is no contractual minimum time period that must elapse before the contingent non-viability event could occur. Hence, the liability component must be measured at the full amount that the issuer could be required to pay immediately. This measurement is consistent with paragraph 23 of IAS 32, which sets out the requirements for an issuer's obligation to purchase its own equity instruments for cash or another financial asset, including those obligations that are conditional on the holder exercising its right; eg particular put options written on the issuer's own equity instruments. Paragraph BC12 in the Basis for Conclusions on IAS 32 discusses the IASB's view that a financial liability must be measured at the full amount of the obligation if the occurrence of the contingent event is beyond the control of the issuer, irrespective of whether that event is within the control of the holder.

(e) The equity component would be measured as a residual and thus would be measured at zero in the fact pattern discussed, because the instrument is issued at par and the value of the variable number of shares that will be delivered at conversion is equal to that fixed par amount. Nevertheless, the equity component exists and therefore, consistently 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 recognized in equity.

7. The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, neither an interpretation nor an amendment to a Standard was necessary and consequently tentatively decided not to add the issue to its agenda.

Comments received

8. We received twelve comment letters on the Interpretations Committee's tentative agenda decision, which are set out in Agenda paper 9A for this meeting.

9. There were three broad views expressed in those letters:

   (a) Some respondents **agreed** that the liability must be measured at the full amount that the issuer could be required to pay immediately. However they **disagreed** that any interest paid on the instrument must be recognized in equity.

   (b) Some respondents **disagreed** that the liability must be measured at the full amount that the issuer could be required to pay immediately.

   (c) Some respondents said that the relevant requirements in IAS 32 are **unclear**.

The liability must be measured at the full amount and any interest payments should be recognized as an expense

10. Five respondents (Westpac Banking Corporation; Commonwealth Bank of Australia; Australian Bankers' Association; Australia and New Zealand Banking Group Limited; and National Australia Bank Limited) provided similar comments. They:

    (a) **agreed** that the contingent non-viability event could occur immediately—and therefore **agreed** that the liability component must be measured at the full amount that the issuer could be required to pay immediately.

    but

(b) **disagreed** that if the issuer pays any interest on the instrument, those payments relate to the equity component and must be recognized in equity.

11. While acknowledging that the instrument could be a compound instrument, these respondents noted that, in the fact pattern described, 100% of the issuance proceeds is allocated to the liability component at initial recognition. Therefore they believed that the instrument could be viewed wholly as a liability (ie because the equity component is valued at zero)—and thus interest paid on the instrument should be recognized as interest expense in profit or loss. These respondents expressed the view that this would result in a symmetrical outcome in the balance sheet and the income statement (ie a liability in the balance sheet with the related interest expense in the income statement). They noted paragraph 36 of IAS 32, which states (emphasis added):

> The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond.

12. These respondents acknowledged the guidance in paragraph AG37 of IAS 32, which discusses the treatment of discretionary dividends and states that such amounts are classified as an equity component.[2] However they expressed the view that the instrument described in the submission is different from the

---

[2] Paragraph AG37 of IAS 32 states:

> The following example illustrates the application of paragraph 35 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in profit or loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised as a distribution of profit or loss. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ordinary shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (eg commodity). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.

instruments described in paragraph AG37. Specifically, paragraph AG37 describes a fact pattern in which the proceeds are allocated to both the liability component and the equity component—whereas the fact pattern described in the submission allocates 100% of the proceeds to the liability component and thus no value is allocated to the equity component.

13. These respondents said that in 2012 and 2013 all of the major commercial banks in Australia issued very similar convertible preference share instruments as part of their preparation for Basel III. Those instruments contain non-viability clauses (the non-viability event being a specific decline in Tier 1 regulatory capital ratios) and all of these banks have classified the instruments entirely as financial liabilities and have treated any interest paid as an expense in profit or loss. These respondents expressed the view that such treatment results in a more representational and faithful outcome in their financial statements. Moreover, they stated that excluding the interest paid on these instruments from profit or loss would change net income margin ('NIM') calculations for statutory purposes. As a result, a bank's true cost of funding would be distorted and net interest income would be considered misleading.

14. These respondents expressed the view that Agenda paper 18 for the July 2013 meeting does not provide a compelling argument as to why the interest paid on the instrument described in the submission must be treated as equity—and encouraged the Interpretations Committee to reconsider its tentative view on that issue. Most of these respondents expressed the view that there is sufficient guidance in IAS 32 to determine the appropriate classification of interest payments — and therefore asked the Interpretation Committee to remove that sentence from the wording of the agenda decision.

The liability component does not necessarily need to be measured at the full amount that the issuer could be required to pay immediately

15. Two respondents (the staff of the Canadian Accounting Standards Board (AcSB) and the Canadian Bankers Association (CBA)) disagreed that the liability component must be measured at the full amount that the issuer could be required to pay immediately. Specifically:

(a) One respondent said that the non-viability condition does not necessarily cause the instrument to be immediately convertible. This respondent expressed the view that most financial institutions have at least partial control over the adequacy of their Tier 1 capital—and disagreed that the full face amount (ie the amount that the issuer must pay upon the occurrence of the non-viability event) necessarily represents fair value of the liability at initial recognition. The respondent also noted concern that the conclusions described in the tentative agenda decision could have repercussions for debt instruments issued with covenants (but did not provide further detail on that concern).

(b) The other respondent agreed with the tentative agenda decision that the instrument described in the submission is a compound instrument and the contingent conversion feature is a liability component because the issuer is obliged to deliver a variable number of its own common shares—but disagreed with the measurement approach described. Specifically, this respondent expressed the view that the issuer should measure the liability component at initial recognition on the basis of its <u>best estimate of the present value</u> of the redemption amount—and allocate the residual to the equity component. This respondent said that expectations about the potential timing of conversion are relevant to measuring the liability component at fair value—and the theoretical possibility for (immediate) conversion does not mean that the entire instrument must be classified as a liability if such conversion is not expected. This respondent said that measuring the liability at the full amount that the issuer could be required to pay immediately is akin to a non-going concern valuation—which would seem reasonable only when the conversion feature is likely to be triggered—and would be inconsistent with the preparation of financial statements under the going concern assumption.

16. Both of these respondents also noted that the specific terms and conditions of these contingently convertible instruments may differ across jurisdictions and such differences may affect the accounting.

IAS 32 is unclear

17. The remaining respondents (BDO; Deloitte Touche Tohmatsu Limited; Ernst & Young Global Limited; KPMG IFRG Limited and PricewaterhouseCoopers) generally expressed the view that the relevant requirements in IAS 32 are unclear. These respondents generally focused on Views 1–3 (as summarized in paragraph 5 in this paper) and commented on one or both of the following items:
    (a) measurement of the liability component (ie the issuer's obligation to deliver a variable number of its own common shares); and/or
    (b) accounting for any interest paid on the instrument.
18. Most of these respondents asked the Interpretations Committee to clarify the requirements for these items—by taking this issue onto its agenda, improving the wording of its agenda decision or referring the issue to the IASB.

Measurement of the liability component

19. Most of these respondents agreed that the issuer's obligation to deliver a variable number of its own common shares meets the definition of a financial liability, but expressed the view that it is unclear how that liability must be measured—specifically, whether it must be measured at the full amount that the issuer could be required to pay immediately or at an amount that reflects the timing and/or probability of the contingent (non-viability) event occurring.
20. Some of these respondents discussed an analogy to a **demand deposit**. They said that the instrument described in the submission is (or may be) different from a demand deposit —and thus it is (or may be) inappropriate to analogize to the measurement requirements in IFRS 13 *Fair Value Measurement* for a demand deposit.[3] That is because the holder of the instrument described in the submission does **not** have the right to demand payment but rather payment is contingent on an uncertain future event that is beyond the control of both the issuer and the holder.
21. At least one respondent noted that, in determining the fair value of the liability described in the submission in accordance with IFRS 13, the issuer must consider

---

[3] Paragraph 47 of IFRS 13 states that '[t]he fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.'

that a market participant would not treat this instrument as if it was 'on demand.' Consequently, the measurement of the liability must reflect a probability-weighted assessment of when the contingent non-viability event might occur; that is, it must be a present value.

22. Similarly, another respondent noted that the issuer of the instrument described in the submission may be able to develop reasonable expectations about the timing of the occurrence of the contingent non-viability event and those expectations should affect the measurement of the liability. That is, the instrument in the submission may be analogous to a written put option that is exercisable only at a particular future date and thus is measured at the present value of the redemption amount.

23. Some of these respondents specifically discussed the **probability versus timing** of the contingent event. One respondent said that paragraph BC12 of IAS 32 is clear that the issuer must assume that the contingent event **will occur** (and thus the probability of the event occurring should not be a factor in the measurement of the liability) but that the paragraph is unclear whether the **expected timing** of that event should be factored into the measurement. Another respondent seemed to imply that the issuer should consider the probability of the event occurring.

24. However, at least one respondent pointed out that measuring the liability based on a probability-weighted assessment of when the contingent non-viability event might occur is (or could be) inconsistent with the measurement requirements in IAS 32 for other instruments that oblige the issuer to deliver cash or a variable number of its own equity instruments; eg written put options on own equity and other instruments with contingent settlement features. Indeed one respondent noted that a probability-weighted measurement approach results in recognizing a residual amount as equity **even though** the issuer does not have an unconditional right to avoid settling those amounts. In other words, such a measurement approach would recognize amounts as equity even though those amounts fail to meet the definition of equity.

25. One respondent did not disagree with the Interpretation Committee's tentative view on the measurement of the liability component in the context of the instrument described in the submission—but was concerned that the view

appeared to extend unnecessarily (and perhaps inappropriately) beyond the particular scenario discussed. This respondent encouraged the Interpretations Committee to avoid making general propositions as to what an entity must do, and instead identify the principles in IAS 32 that are relevant to the **particular scenario** described in the submission.

Accounting for the interest payments

26. Some respondents also expressed the view that the requirements in IAS 32 for the instrument's discretionary distributions are unclear—specifically whether the instrument described in the submission has an equity component, and if so, whether the interest paid on the instrument must be recognized in equity even if the equity component is measured at zero at initial recognition.
27. Similar to the feedback described above in paragraphs 11 and 12 of this paper, some of these respondents questioned whether the guidance in paragraph AG37 of IAS 32 (reproduced in footnote 2 of this paper) is relevant to the scenario described in the submission because 100% of the proceeds have been allocated to the liability component. These respondents noted that **if** paragraph AG37 is relevant to such scenarios, it was difficult to reconcile that paragraph with the requirements in paragraph 36 (reproduced in paragraph 11 of this paper) that dividend payments on shares wholly recognized as liabilities are recognized as expenses.
28. Some of these respondents noted that IAS 32 provides guidance for both (a) measuring instruments with contingent settlement features and (b) separating compound instruments into equity and non-equity components—and expressed the view that IAS 32 does not specify the sequence in which an issuer should apply those requirements; ie which requirements should be applied first if both are relevant. These respondents expressed the view that the accounting result for the discretionary distributions would be different based on which requirements are applied first.
29. Specifically, these respondents stated that the Interpretations Committee's tentative agenda decision seemingly requires the entity to apply the requirements for compound instruments before the requirements for contingent settlement features—ie, first the two components are identified and then the liability

component is measured at the full amount that the issuer could be required to pay immediately. In contrast, these respondents expressed the view that if the requirements for measuring instruments with contingent settlement features were applied first, then the instrument would be recognized entirely as a financial liability and no equity component would exist (and thus the discretionary distributions would necessarily be recognized as interest expense in profit or loss).

30. One respondent expressed the view that the tentative agenda decision was unnecessarily prescriptive regarding the accounting for the discretionary distributions. This respondent said that IAS 32 is not clear how an issuer should account for discretionary distribution when 100% of the instrument's issuance proceeds are allocated to the liability component at initial recognition; specifically whether such discretionary payments must be recognized in:

    (a) equity because they are always an equity feature irrespective of whether any portion of the instrument's issuance proceeds is allocated to equity at initial recognition. This would appear consistent with paragraph AG37 of IAS 32. (Paragraph AG37 is discussed in paragraph 12 of this paper and is reproduced in footnote 2.)

    (b) profit or loss because they relate to an instrument that is 'wholly recognized' as a financial liability. This would appear consistent with paragraph 36 of IAS 32. (Paragraph 36 of IAS 32 is reproduced in paragraph 11 of this paper.)

31. This respondent suggested that an entity should choose an accounting policy—to be applied consistently—to recognize discretionary distributions in profit or loss or equity when 100% of the instrument's proceeds (the fair value of the consideration received) is allocated to the liability at initial recognition. The respondent also noted that this issue is relevant to (and may affect) the ongoing discussion of puts written on non-controlling interests (NCI puts)—specifically whether any discretionary dividends paid to non-controlling interest holders should be recognized as expenses or equity distributions when such interests are subject to a written put (and a 'gross' liability has been recognized and the entire non-controlling interest (equity) balance may have been derecognized). Furthermore, the respondent noted that the submission was focused on the

classification and measurement of the financial instrument, **not** the accounting for the discretionary interest payments. Therefore this respondent suggested that the Interpretations Committee remain silent on whether an equity component exists (and thus the accounting for any discretionary interest payments).

Other items

32. While most respondents focused on Views 1–3 (as summarized in paragraph 5 of this paper), one respondent expressed the view that it may be appropriate to account for the instrument described in the submission as an equity host contract with an embedded derivative liability (that is, an embedded derivative to exchange a fixed number of equity host contracts for a variable number of common shares if a future event occurs).[4]

33. One respondent highlighted principle-level issues that it believes are relevant to the submission but acknowledged that these issues are broader than addressing only the accounting for the contingently convertible instrument described in the submission. The respondent noted that addressing these principle-level issues would require a project to consider (limited) amendments to IFRSs.

Staff analysis

34. In this section we have analyzed separately the following two issues:
    (a) the issuer's obligation to deliver a variable number of its own equity shares; and
    (b) the issuer's discretion to pay interest.

35. We think the submission was focused primarily on the accounting for the obligation described above in bullet (a)—and our analysis of that obligation is discrete (ie it does not depend on our analysis of the accounting for the discretionary interest payments described above in bullet (b)).

[4] As discussed more fully in the staff analysis section of this paper, we think identifying an equity host contact would be inconsistent with the fact that the issuer has a contractual obligation to deliver a variable number of its own equity instruments, which is a non-derivative financial liability under paragraph 11 IAS 32.

Accounting for the issuer's contractual obligation to deliver a variable number of its own equity shares

Classification of the obligation

36. We think IAS 32—not IAS 39 or IFRS 9— provides the relevant requirements for determining how an issuer should classify a financial instrument. The definition of a financial liability in paragraph 11of IAS 32 states that a financial instrument is a financial liability if the issuer is obliged to deliver a variable number of its own equity instruments.
37. Paragraph 25 in IAS 32 provides guidance on applying the definition of a financial liability to instruments with contingent settlement provisions. That paragraph states (in part) that a financial instrument is a financial liability if it obliges the issuer to deliver cash or another financial asset **—or to otherwise settle the instrument in such a way that it would be a financial liability (eg by delivering a variable number of its own equity instruments)**—upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder.
38. Therefore we think IAS 32 is clear that the issuer's obligation to deliver a variable number of its own equity instruments (upon the occurrence of a contingent non-viability event) meets the definition of a financial liability. We think this is consistent with the Interpretations Committee's discussion at the May 2013 meeting. (This conclusion is not intended to prejudge whether the issuer's discretion to pay interest should be accounted for as an equity component. That issue is discussed later in this agenda paper. Rather, the purpose of this section is only to assess whether a financial liability exists. Correspondingly, the following section discusses only the measurement of that financial liability.)

Measurement of the financial liability

39. We think the issuer must consider the fact that the contingent non-viability event could occur immediately because it is beyond the control of the issuer and there is no contractual minimum time period that must elapse before the contingent non-viability event could occur. For example, an entity could suddenly breach a required Tier 1 Capital ratio as a result of a significant one-off event. Hence the

liability component must be measured at the amount that the issuer could be required to repay immediately (ie par). That is, we think IAS 32 requires the liability component to be measured on the basis of the earliest date that the issuer could be obliged to settle the instrument—which, in the case described in the submission, is immediately. That is because the issuer does **not** have an unconditional right to avoid settling the obligation at that date. We think this is consistent with the Interpretations Committee's discussion at the May 2013 meeting.

40. Furthermore, we think that measuring the liability component at a present value, which considers the expected timing of the contingent non-viability event occurring, would result in the recognition of an equity component that does not meet the definition of equity in paragraph 16 of IAS 32. That is because the issuer cannot avoid settling the full amount immediately—**and therefore, no portion of that full amount meets the definition of equity**. In other words, paragraph 25 of IAS 32 is clear that a financial instrument is a financial liability (ie it is not equity) if the issuer does not have the unconditional right to avoid settling it in such a way that it would be a financial liability; eg delivering a variable number of its own shares. Therefore it would be inappropriate for the issuer to recognize as equity any amounts that it cannot avoid settling.

Accounting for the issuer's discretion to pay interest

41. As noted in paragraphs 6(b)(ii) of this paper, the Interpretations Committee's tentative agenda decision expressed the view that the instrument described in the submission had an equity component, which reflects the issuer's discretion to pay interest. Paragraph 6(e) of the tentative agenda decision states that the equity component would be measured as a residual and thus would be measured at zero in the fact pattern discussed—but if the issuer pays any interest on the instrument, those payments relate to the equity component and would be recognized in equity.

42. However, we acknowledge the range of the feedback received in the comment letters; specifically:

(a) IAS 32 does not provide clear requirements for discretionary distributions when 100% of the issuance proceeds is allocated to the liability at initial recognition; specifically whether such amounts should be recognized:

  (i) in equity because they are always an equity feature irrespective of whether any portion of the instrument's issuance proceeds is allocated to equity at initial recognition. This would appear consistent with paragraph AG37 of IAS 32; or

  (ii) profit or loss because they relate to an instrument that is 'wholly recognized' as a financial liability. This would appear consistent with paragraph 36 of IAS 32.

(b) This issue is relevant to (and may affect) the ongoing discussion of NCI puts—specifically whether any discretionary dividends paid to non-controlling interest holders should be recognized as expenses or equity distributions when such interests are subject to a written put (and a 'gross' liability has been recognized and the non-controlling interest (equity) balance may have been derecognized).

(c) The submission was focused primarily on the classification and measurement of the financial liability—ie the issue analyzed in paragraphs 36–40 above—rather than the accounting for the discretionary interest payments.

43. We are persuaded by respondents' feedback regarding whether the discretionary interest payments should be accounted for as an equity component and are concerned that the wording in the tentative agenda decision may have unintended consequences on other fact patterns, such as NCI puts. Moreover, we are aware that are other (more detailed) questions about the accounting for discretionary dividends. For example, some have queried whether an issuer should account for such distributions differently on the basis of whether a redeemable liability (eg a puttable share) is redeemable at a fixed amount or a proportionate share of the issuer's net assets since, in the latter case, the fair value (and thus the

remeasurements) of the instrument would be affected by any distributions.[5] We also agree that the primary issue raised in the submission was the accounting for the obligation to deliver a variable number of shares upon the occurrence of the non-viability event.

Staff recommendation

44. After considering the comments received on the tentative agenda decision, we recommend that the Interpretations Committee should finalize its decision not to add this issue to its agenda. Specifically, we think the appropriate classification and measurement of the issuer's obligation to deliver a variable number of its own equity instruments (upon the occurrence of a contingent non-viability event) as a **financial liability** can be derived from IAS 32 without need for further guidance and consequently we do not think that any changes to or formal interpretation of IAS 32 are required.
45. However, we think the agenda decision should not express a view on whether the issuer's discretion to pay interest on the instrument described in the submission should be accounted for as an equity component, for the reasons expressed above in paragraph 42 and 43. Moreover, we believe the accounting for discretionary distributions is a broader issue than what was raised in the fact pattern in the submission—and we are sceptical that the issue can be comprehensively resolved efficiently within the confines of existing IFRSs.
46. The proposed wording of the final agenda decision is included as Appendix A to this paper.

[5] Specifically, some have expressed the view that it would be inappropriate to recognize discretionary dividends paid on a redeemable instrument in equity if such payments cause the redeemable instrument to be remeasured through profit or loss (ie while the amounts would largely offset each other, the distributions would be recognized in equity but the remeasurements would be recognized in profit or loss).

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should finalize its decision not to add this issue to its agenda? 2. Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the final agenda decision?

Appendix A—Proposed wording for the Agenda decision

A1. The proposed wording for the final agenda decision is presented below. New text is underlined and deleted text is struck through.

IAS 32 Financial Instruments: Presentation—Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

The Interpretations Committee discussed how an issuer would classify a particular mandatorily convertible financial instrument in accordance with IAS 32. The financial instrument 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 (ie described as a 'contingent non-viability event'). The financial instrument is issued at par and the value of the equity instruments that will be delivered at conversion is equal to that fixed par amount. Interest payments on the instrument are payable at the discretion of the issuer.

The Interpretations Committee noted that IAS 32 sets out the relevant requirements for classifying financial instruments (or their components), from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments.

~~The Interpretations Committee noted that the instrument is a compound instrument that is composed of the following two components:~~

~~a.~~ ~~a liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and~~

~~b.~~ ~~an equity component, which reflects the issuer's discretion to pay interest.~~

Paragraph 11 of IAS 32 states that a financial instrument meets the definition of a *financial liability* if the issuer is obliged to deliver a variable number of its own equity instruments. Paragraph 25 of that Standard provides guidance on applying that definition to an instrument with a contingent settlement provision and clarifies that a financial liability exists if the settlement of the obligation is contingent upon the occurrence of an

uncertain future event that is beyond the control of both the issuer and the holder (subject to particular limitations, which are not relevant to this instrument). The Interpretations Committee noted that the contingent non-viability event is beyond the control of both the issuer and the holder. Therefore the issuer's contractual obligation to deliver a variable number of its own equity instruments if a contingent non-viability event occurs meets the definition of a financial liability in IAS 32.

To measure that ~~the~~ liability ~~component~~, the Interpretations Committee noted that the issuer must consider the fact that the contingent non-viability event could occur immediately because it is beyond the control of the issuer and there is no contractual minimum time period that must elapse before the contingent non-viability event could occur. Hence the Interpretations Committee noted that the liability ~~component~~ must be measured at the full amount that the issuer could be required to pay immediately. That is because the issuer does not have an unconditional right to avoid delivering that full amount—and thus no portion of it meets the definition of equity. Moreover, the ~~The~~ Interpretations Committee noted that this measurement is consistent with paragraph 23 of IAS 32, which sets out the requirements for an issuer's obligation to purchase its own equity instruments for cash or another financial asset, including those obligations that are conditional on the holder exercising its right; eg particular put options written on the issuer's own equity instruments. The Interpretations Committee noted that paragraph BC12 in the Basis for Conclusions on IAS 32 discusses the IASB's view that a financial liability must be measured at the full amount of the obligation if the occurrence of the contingent event is beyond the control of the issuer, irrespective of whether that event is within the control of the holder.

~~The equity component would be measured as a residual and thus would be measured at zero in the fact pattern discussed, because the instrument is issued at par and the value of the variable number of shares that will be delivered at conversion is equal to that fixed par amount. Nevertheless, the Interpretations Committee noted that the equity component exists and therefore, consistently 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.~~

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, neither an interpretation nor an amendment to a Standard was necessary and consequently ~~[~~decided~~]~~ not to add this ~~the~~ issue to its agenda.

The Interpretations Committee also discussed how to account for the issuer's discretion to pay interest. In particular, the Interpretations Committee discussed whether such discretionary payments give rise to an equity component since that component would be measured at zero in the fact pattern submitted (ie the instrument is issued at par and the value of the variable number of shares that will be delivered at conversion is equal to that fixed par amount). The Interpretations Committee noted that the accounting for discretionary interest payments is a broad issue that likely cannot be resolved efficiently within the confines of existing IFRS. Consequently the Interpretations Committee decided not to add that issue to its agenda.