STAFF PAPER

December 2021

IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Contingent settlement provisions: compound financial instruments

CONTACT(S)
Angie Ah Kun aahkun@ifrs.org
Uni Choi uchoi@ifrs.org
Riana Wiesner rwiesner@ifrs.org

Purpose of this paper

1. This paper asks the International Accounting Standards (IASB) for tentative decisions on proposed clarifications relating to financial instruments with contingent settlement provisions as described in paragraph 25 of IAS 32 Financial Instruments: Presentation.

2. A contingent settlement provision refers to a contractual term that requires the issuer to deliver cash or another financial asset or to settle it in such a way that it would be a financial liability in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument.

Background

3. The objective of the FICE project is to address known practice issues by proposing clarifications to the underlying principles in IAS 32. The intention is not to develop new principles that will result in fundamental changes to the

requirements. However, the staff acknowledge that potential clarifications may in some situations result in changes in application in practice and in different classification outcomes. The staff will consider transition issues related to any potential amendments in the future once the project is at a more advanced stage.

4. Although IAS 32 generally refers to IFRS 9 *Financial Instruments* for measurement requirements, it contains some measurement requirements for example for obligations to buy back own shares. In explaining the rationale for those measurement requirements in the Basis for Conclusions, the same paragraph (paragraph BC12) refers to the measurement of financial instruments with contingent settlement provisions. Hence the staff considered potential clarifications to the measurement of financial instruments with contingent settlement provisions.

5. At the September 2021 IASB meeting (Agenda Paper 5B), the IASB discussed potential clarifications to IAS 32 that could resolve practice problems related to contingent settlement provisions and directed the staff to develop them further. In this paper, the staff will present further analysis to consider the feedback from IASB members and to consider whether the potential clarifications will result in useful information for users of the financial statements about the nature of the obligations an entity is exposed to from its financial instruments.

6. The IASB also discussed questions that arise in practice in classifying other financial instruments with features affected by contingent events (Agenda Paper 5D of the September 2021 IASB meeting). However, the IASB considered that potential clarifications were not necessary to address these questions either because the requirements in IAS 32 were clear or those issues were not widespread or material. We have therefore not provided further analysis on these questions.

7. This paper is structured as follows:

    (a) Summary of staff recommendations;

    (b) staff analysis of the following practice questions:

        (i) Order of applying requirements in IAS 32;

        (ii) Impact of probability in measurement;

(iii) Discretionary payments; and

(c) Question for the IASB.

Summary of staff recommendations

8. The staff recommend that the IASB proposes the following amendments to IAS 32 for financial instruments with contingent settlement provisions as described by paragraph 25 of IAS 32:

(a) to clarify some financial instruments with contingent settlement provisions may be compound instruments:

(i) require the compound instrument requirements in paragraph 28 to be applied before any specific classification requirements in IAS 32;

(ii) add a reference to a ‘liability component’ to paragraph 25 of IAS 32;

(b) to clarify the measurement requirements for the liability component of a compound financial instrument with contingent settlement provisions that could require immediate settlement in a way that it would be a financial liability upon a contingent event occurring:

(i) incorporate the statements about measurement in paragraph BC12 of the Basis for Conclusions on IAS 32 (full amount of the conditional obligation for instruments with contingent settlement provisions) into the requirements in IAS 32;

(ii) require the ‘full amount of the conditional obligation’ to be defined as the amount repayable assuming the earliest possible repayment date, ie immediate repayment for financial instruments where the contingent event could occur immediately;

(iii) require that the financial liability is accounted for consistently both for classification and measurement purposes irrespective of whether settlement depends on the holder of the instrument or an event outside the control of both parties;

(c) to clarify that payments at the discretion of the issuer are recognised in equity even though all the proceeds are initially allocated to the liability component:

(i) clarify that a compound instrument with a zero-value equity component is still a compound instrument with a liability and an equity component; and

(ii) clarify that the requirement on dividends paid on compound instruments in paragraph AG37 of IAS 32 applies even if the equity component is initially measured at zero.

Staff analysis

Order of applying requirements in IAS 32

9. Paragraph 25 of IAS 32 contains requirements for financial instruments with contingent settlement provisions and refers to a financial liability (not a liability component). Paragraphs 28-32 of IAS 32 contain requirements for separating compound instruments into equity and financial liability components. The issue that arose in practice and during past IFRS Interpretations Committee (Committee) discussions was whether there is a required sequence or order in which an issuer should apply the requirements in IAS 32 when a compound financial instrument contains contingent settlement features. This is because the classification outcome could differ depending on which requirements are applied first.

Potential clarifications

10. The potential clarifications would apply to all compound financial instruments containing contingent settlement features. In September 2021, the IASB considered two examples of compound financial instruments that contains contingent settlement features. The table below provides a summary of the key features and the liability and equity components of these instruments.

Instrument A (discussed by the IFRS Interpretations Committee in January 2014)	**Instrument B** (discussed by the IASB when it revised IAS 32 in 2003)
Key features: Contingent convertible instrument with no maturity date convertible into a variable number of own shares if the issuer breaches the Common Equity Tier 1 Capital ratio. The contingent event is outside the control of both the issuer and holder and could potentially occur immediately. Instrument A was issued at par and is convertible into a variable number of shares to the value of the fixed par amount. Dividends are discretionary.	**Key features:** Contingent convertible bond with a fixed maturity date and fixed interest payments. It is convertible into a fixed number of own shares if the issuer's share price reaches a specified amount (the entity's own share price at issuance plus 5%). The contingent event is outside the control of both the issuer and holder.
Liability component: The contractual obligation to settle the instrument in a variable number of issuer's own shares upon a contingent event outside the control of both the issuer and the holder.	**Liability component:** The contractual obligation to make periodic interest payments and principal repayment on maturity.
Equity component: Discretionary dividends.	**Equity component:** The conversion of the bond into a fixed number of the issuer's own shares upon the occurrence of an event beyond the control of both parties.

11. As discussed in September 2021, consistent with the substance of the contractual arrangement, the classification of compound instruments into its component parts is the starting point. Paragraph 15 of IAS 32 already clarifies the order of applying

the requirements in IAS 32 because it says “the issuer of a financial instrument shall classify the instrument, **or its component parts**, on initial recognition…” (**emphasis added**). The requirements in other paragraphs of IAS 32 such as paragraph 25 of IAS 32 can therefore be seen as additional requirements that help to interpret or apply the definitions used in the classification.

12. Paragraph 25 of IAS 32 is therefore applied to identify the liability components of compound instruments with contingent settlement provisions. In the case of Instrument A, there will be settlement in a variable number of own shares if a contingent event beyond the control of both parties occurs. In the case of Instrument B, there will be settlement of the par amount in cash if a contingent event beyond the control of both parties does not occur. In both cases, paragraph 25 of IAS 32 identifies a financial liability that could require settlement whose existence depends on a contingent event.

13. A financial instrument with a contingent settlement provision should therefore be evaluated to determine whether it contains liability and equity components. If so, it should be treated as a compound instrument rather than being classified as a liability in its entirety. Accordingly, both Instruments A and B would be classified as compound instruments because they contain both liability and equity components.

14. Classifying Instrument B as a compound instrument is also consistent with the classification of a bond convertible at the option of the holder. The convertibility of both instruments is beyond the control of the issuer and the issuer does not have an unconditional right to avoid the obligation to settle in cash in both cases if the conversion does not occur.

15. The staff considered whether guidance is needed to determine whether a contingency is associated with a liability or equity component of a compound instrument with a contingent settlement provision. Paragraphs 31-32 of IAS 32 explain that the liability component is identified first. This is consistent with the definition of equity being a residual interest. In addition to being a residual interest, in compound instruments the equity component generally represents either the discretionary dividends or the conversion of the principal amount into a fixed number of ordinary shares so may be easily identifiable.

16. The specific terms of the instrument will affect whether a contingency is associated with the liability or the equity component. For example, in Instrument A, the conversion into a variable number of shares was contingent on an event occurring so the contingency was associated with the liability component. In addition, the staff note that if the issuer has discretion whether to pay dividends, then the payment of dividends is not contingent on any event occurring or not occurring. Said differently, Instrument A would not have a liability component if it was not for the contingency. In Instrument B, the conversion into a fixed number of shares was contingent on an event occurring. Although the settlement of Instrument B in cash is contingent on an event not occurring, Instrument B would have been a liability in its entirety if it was not for the contingency. Therefore, the contingency is associated with the equity component.

17. In light of the above, the staff do not think further guidance is necessary to determine whether a contingency is associated with a liability or equity component because it depends on the particular terms of the contract.

Staff recommendation

18. To clarify the order of applying the requirements in IAS 32 and reduce diversity in practice, the staff recommend the IASB:

   (a) require the compound instrument requirements in paragraph 28 to be applied before any specific classification requirements in IAS 32; and

   (b) add a reference to a 'liability component' to paragraph 25 of IAS 32, which would indicate that some financial instruments with contingent settlement provisions may be compound instruments.

Impact of probability in measurement

19. As discussed at the September 2021 meeting, the probability of a contingent event (which is outside the control of both parties to the contract) occurring is not considered in *classification*. The IASB concluded in paragraph BC17 of the Basis

for Conclusions on IAS 32 that it is not consistent with the definitions of financial liabilities and equity instruments to classify an obligation to deliver cash as a financial liability only when settlement in cash is probable. There is a contractual obligation to transfer economic benefits as a result of past events because the entity is unable to avoid a settlement in cash or another financial asset unless an event occurs or does not occur in the future. An instrument is therefore *classified* as a financial liability even if that obligation is only contingent as long as the entity has no unconditional right to avoid delivering cash or another financial asset or settling it in such a way that it would be a financial liability.

20. As highlighted in Agenda paper 5B for the September 2021 meeting, there has been much discussion in the past about the *measurement* of a financial liability with a contingent settlement provision. This issue was extensively discussed (but not resolved) by the Committee in 2013-2014.

21. For compound instruments, paragraph 32 of IAS 32 contains a clear explanation of how the measurement requirements in IFRS 9 apply to the liability component. The liability component is measured at the fair value of a similar liability that does not have an associated equity component.

22. For Instrument B described in paragraph 10 of this paper, a similar liability without an associated equity component would be a vanilla bond that does not have a conversion feature. Therefore, the liability would be measured at the fair value of the interest and principal payments on maturity and the probability of the contingent event occurring would effectively be ignored. The contingency (the probability of the contingent event occurring) would be part of the equity component (see table in paragraph 10 of this paper).

23. However, stakeholders previously said that it is not entirely clear what 'the fair value of a similar liability' means when the contingency is part of the liability component, such as in Instrument A (see table in paragraph 10 of this paper). This is because the contingent event could in theory occur immediately and require immediate settlement of the liability component. In Instrument A, 'a similar liability without an associated equity component' is an instrument containing an obligation to deliver a variable number of shares equal to the par amount upon the occurrence of a contingent event that could occur immediately but that does not

pay discretionary dividends. In this case, the associated equity component does not involve a conversion of the obligation into ordinary shares and the contingency is part of the liability component.

24. For measurement purposes, if a similar liability is a liability with a demand feature (discussed in paragraph 47 of IFRS 13 *Fair Value Measurement),* the liability would be measured at the full amount that could be required to be repaid. Such measurement considers the fact that the contingent event could occur and require settlement immediately. If such a financial instrument was issued and repayable at par, no value would be allocated to the equity component. However, if a similar liability is a liability without a demand feature, the general principles in IFRS 13 apply. The fair value of the liability is measured from the perspective of a market participant that holds the identical item as an asset. Such measurement factors in the expected probability and timing of the contingent event occurring. The residual value (the fair value of the instrument as a whole minus the fair value of the liability component) would be allocated to the equity component.

25. In Agenda paper 5B for the September 2021 IASB meeting, the staff noted the past Committee discussions, the measurement requirements in IFRS Accounting Standards (Accounting Standards) and stakeholder views on measuring the liability component. The staff also noted that the measurement of financial liabilities with contingent settlement provisions is mentioned in paragraph BC12 of the Basis for Conclusions on IAS 32 in the context of the IASB's discussion on obligations to purchase own shares. Paragraph BC12 refers to '…other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity's control. These include, for example, (a) **the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation…' (emphasis added)**.

Potential clarifications

26. To resolve the practice issues identified with regards to the measurement of a financial instrument with a contingent settlement provision (that could require immediate liability settlement upon a contingent event occurring), the staff are of

the view that this is an area where the IASB could make a useful clarification that would help reduce diversity in accounting practice.

27. In September 2021, the IASB discussed some potential clarifications it could make regarding the initial measurement of the liability component of compound financial instruments with contingent settlement provisions (that could require immediate settlement upon a contingent event occurring). The staff presented the following two views to the IASB:

View A: full amount	View B: probability-weighted amount
• fair value is the full undiscounted amount of the obligation, similar to the fair value of a liability repayable on demand. • the full amount of the obligation could be immediately repayable and the issuer does not have an unconditional right to avoid the obligation. • there is no discount period and the expected timing is not taken into account because the contingent event could occur, in theory, anytime.	• fair value is a probability weighted amount, similar to the fair value of a liability without a demand feature. • the contingent event is outside the control of both parties and is not assumed to occur immediately. • the price that would be paid to transfer an obligation in an orderly transaction between market participants would reflect the expected probability and timing of the contingent event occurring.

28. The staff is of the view that View A is consistent with the underlying principles in IAS 32 and would result in the most useful information to the users of the financial statement in understanding the nature, timing and uncertainty of future

cash flows arising from financial liabilities with contingent settlement provisions. Paragraphs 29–43 below provides the analysis supporting our view.

29. Applying paragraph 32 of IAS 32, under View A a similar liability that does not have an associated equity component, would be a liability with a demand feature where payment could be required immediately.

30. Paragraph 5.1.1. of IFRS 9 requires a financial liability to be recognised at fair value on initial recognition. Measurement at fair value do not always factor in the probability of an external event occurring or the expected timing of settlement. Paragraph 47 of IFRS 13 requires 'the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid'. Therefore, a liability with a demand feature is still measured at fair value despite not factoring in the probability of the liability being demanded or the expecting timing of when the liability will be demanded.

31. The staff is also of the view that View A is consistent with the IASB's conclusion in BC12 of IAS 32 that the entity has an obligation to pay the full redemption amount and cannot avoid settlement in cash or another financial asset for the full redemption amount unless the counterparty decides not to exercise its redemption right or specified future events or circumstances beyond the control of the entity occur or do not occur.

32. In addition, the staff wish to point out that:

(a) measuring the liability at the full amount that the issuer could be required to pay upon the occurrence of a non-viability event is not inconsistent with preparing financial statements on a going concern basis. This is because an entity could be non-viable and still a going concern.

(b) similar to the classification assessment discussed in paragraph 14 of this paper, an instrument that could be repayable immediately should be measured in the same way regardless of whether it is repayable at the option of the holder or upon the occurrence of an event outside the control of both the issuer and holder. Repayment and the timing thereof for both instruments is beyond the control of the issuer. In both cases the probability and the expected timing of the event should not be considered in the measurement. Rather, both liabilities should be measured at the full amount that could be repayable immediately.

33. In contrast, View B could result in a large equity component on initial recognition if the probability of liability settlement is low even though the issuer does not have the unconditional right to avoid liability settlement. For example, if the probability of the contingent event occurring was considered in calculating the liability component of Instrument A and if the issuer is in a strong capital position and is expected to remain so, it is likely that most of the proceeds would be allocated to the equity component. The equity component will not be remeasured—paragraph 36 of IAS 32 says that changes in the fair value of an equity instrument are not recognised in the financial statements.

34. Further, View B would result in more complex calculations when determining the effective interest rate on the financial liability and in updating the subsequent measurement of the financial liability by reassessing the likelihood and expected timing of the contingent event occurring at each reporting date. In addition, the IASB is aware of diversity in practice in this regard and have asked specific questions about the application of the effective interest method and amortised cost in the *Request For Information* on the IFRS 9 Post-implementation Review. View B therefore:

   (a) would add complexity to the measurement calculation and additional costs to preparers. We note that a similar concern was raised when the 2018 Discussion Paper proposed recognising particular obligations that only arise on liquidation as a financial liability; and

   (b) be inconsistent with the measurement approach applied when liability settlement is at the option of the holder eg written put options on own shares puttable at any time are recognised for the full amount that could be called.

35. The staff is of the view that View B is not consistent with the underlying principles in IAS 32 and would therefore result in a more significant change to

IAS 32 than just a clarification to the underlying principles. Pursuing such an approach would therefore extend beyond the scope of this project.

Other considerations

36. Under View A, the fair value of the financial liability is the full amount of the obligation that could be immediately repayable. A related practice question is how to account for the difference if the full amount of the obligation is higher or lower than the proceeds on issue. Consider the following two examples:

Fact pattern 1 A non-derivative instrument is issued for CU100 (fair value of the consideration) but is redeemable at CU120 in the event of a contingency which could occur immediately.	Fact pattern 2 A non-derivative instrument is issued for CU120 (fair value of the consideration includes a premium of CU20 over par of CU100) and repayable at par in the event of a contingency which could occur immediately.
Journal entry Debit Bank 100 Debit ?? 20 Credit Financial liability 120	Journal entry Debit Bank 120 Credit Financial liability 100 Credit ?? 20

37. If the non-derivative instruments are compound instruments (like in the case of Instrument A in this paper), applying IAS 32, the residual amount not recognised as the fair value of the financial liability would be recognised in equity, even if it is a debit to equity. This is because IAS 32 requires the financial liability component to be measured first and the equity component be assigned the residual amount after deducting the financial liability component from the fair value of the instrument as a whole. As discussed in paragraph 33 of this paper, the equity component is not remeasured subsequent to initial recognition. Therefore, the

discount given or premium received on the instrument would not be amortised over the expected life of the instrument.

38. In determining which financial instruments the proposed clarification would apply to, the staff considered other examples of 'contingent features' in practice such as bonds that are commonly issued with covenants. The bond covenants can contain ratios involving liabilities, assets, and equity eg if the equity to assets ratio falls below a specified level, then the bond becomes payable immediately. The contingency in these bonds may be similar to that in contingent convertible bonds with non-viability clauses and could have similar likelihood of occurrence. However, they are different in that they do not affect *whether* liability settlement will occur but rather the 'timing' of settlement of an existing financial liability.

39. Upon further analysis, the staff think these types of purely 'timing' contingencies which can accelerate repayment of an existing financial liability are outside the scope of paragraph 25 of IAS 32. This is because these bonds are already classified as financial liabilities due to the interest payments and principal due on maturity, ie settlement in a way that gives rise to a financial liability is not contingent on an event occurring or not occurring.

40. Also, the contingent event is whether the covenant is met or not and compliance is usually tested on specified dates. In practice, we understand that the issuer of these types of bonds does not account for them as if they have 'demand features' when measuring them. The bonds continue to be measured based on the discounted value of the interest and principal payments based on their contractual payment dates. This is because a market participant would not assume the bond covenant could be breached immediately as the trigger event is beyond the control of both parties and is measured on specified dates. Similarly, bonds often have change in control or material adverse event clauses that require an accelerated repayment but in practice the issuers of these bonds also do not measure them assuming that the events could happen immediately.

41. The IASB currently has a project that addresses the classification of liabilities with covenants as current or non-current applying IAS 1 *Presentation of Financial Statements* which may be applicable to the financial liabilities with 'timing' contingencies described above. That project considers the fact that when

an entity's right to defer settlement is conditional on the entity's compliance with covenants within 12 months after the reporting date, it is difficult to classify the related liability as either current or non-current at the reporting date. The settlement date of a liability could be either within or after twelve months (depending on whether the entity complies with future conditions) but that will be known only in the future.

42. In the staff's view, the application of View A and View B as described in paragraph 27 of this paper, is only relevant to the liability component of compound financial instruments with contingent settlement provisions that could require immediate settlement, and not to existing financial liabilities with a timing contingency.

43. The staff considered whether the potential clarifications to IAS 32 developed in the FICE project result in any inconsistency with the proposed IAS 1 amendments and concluded that they do not. This is because the scope of the projects and the instruments within their scope is different. We understand that the scope of the proposed IAS 1 amendments focuses on liabilities for which an entity's right to defer settlement is subject to compliance with conditions and not to other conditional settlement terms. This understanding is confirmed by the IASB's proposal in Exposure Draft 2021/9 *Non-current Liabilities with Covenants (Proposed amendments to IAS 1), which* clarifies that a company does not have a right to defer settlement—and thus would classify a liability as current—when the liability could become repayable within 12 months:

    (a) at the discretion of the counterparty or a third party—for example, when a loan can be called by the lender at any time without cause.

    (b) depending on an uncertain future event or outcome that is unaffected by the company's future actions—for example, when the liability is a financial guarantee or insurance contract.

    In both situations (a) and (b) above, there are no conditions with which the entity must or could comply in order to avoid settlement of a liability within twelve months after the reporting period. Accordingly, both situations above are not within the scope of the proposed IAS 1 amendments.

Staff recommendation

44. The staff is of the view that View A is consistent with the underlying principles in IAS 32 and the requirements in Accounting Standards and should be applied to measure the liability component of all compound financial instruments with contingent settlement provisions that could require immediate settlement upon a contingent event occurring. The staff recommend that the IASB:

(a) incorporate the statements about measurement in paragraph BC12 of the Basis for Conclusions on IAS 32 (full amount of the conditional obligation for instruments with contingent settlement provisions) into the requirements in IAS 32.

(b) require the 'full amount of the conditional obligation' to be defined as the amount repayable assuming the earliest possible repayment date, ie immediate repayment for financial instruments where the contingent event could occur immediately and require settlement in a way that gives rise to financial liability. The staff note that any such clarification would also apply to other instruments for which paragraph BC 12 mentions are measured at the 'full amount of the conditional obligation' such as:

(i) preference shares that are redeemable at the option of the holder; and

(ii) puttable instruments that give the holder the right to put the instrument back to the issuer for cash or another financial asset, the amount of which is determined by reference to an index, and which therefore has the potential to increase and decrease.

(c) clarify that whether settlement in cash, another financial asset or in such a way that a financial instrument would be a financial liability is dependent on the holder of the instrument or an event outside the control of both parties, it should be accounted for consistently both for classification and measurement purposes.

Discretionary payments

45. Some compound instruments may allocate all of the issuance proceeds to the liability component at initial recognition. For example, applying View A in the previous section to Instrument A described in this paper results in an equity component representing the discretionary dividends that is measured at zero.

46. In September 2021, the IASB discussed the practice question regarding how an entity accounts for any subsequent discretionary distributions on these types of compound instruments. IASB members acknowledged that just because a component has a value of zero does not mean that it does not exist. They noted the difference between recognition and measurement. In other words, a financial instrument that is recognised wholly as a financial liability is different from a compound instrument where all the value is allocated to the liability component. In the latter case, an equity component exists, albeit measured at zero.

Potential clarification

47. If the IASB clarifies that a compound instrument with a zero-value equity component is still a compound instrument, this would eliminate the view that there is an apparent contradiction between paragraph 36 of IAS 32 (dividend payments on shares wholly recognised as liabilities are recognised as expenses in profit or loss in the same way as interest on a bond) and paragraph AG37 of IAS 32 (discretionary dividends paid relate to the equity component and are recognised in equity as a distribution of profit or loss).

48. If some of the issuance proceeds are allocated to the equity component, there is no practice question about where to recognise the discretionary dividends paid (directly in equity in accordance with paragraph AG37 of IAS 32). If all the proceeds are allocated to the liability component (that is if the IASB agrees with View A described in paragraph 27 of this paper), the clarification as described in paragraph 47 of this paper would be helpful. That is because it would clarify that paragraph AG 37 of IAS 32 would naturally apply because the discretionary dividends relate to the equity component and are recognised in equity.

49. Therefore, regardless of the IASB's views on measurement of the liability component, the discretionary dividends on the compound instrument would be recognised in equity. Although some users of financial statements may not like

dividends on these types of financial instruments to be recognised in equity because they believe there is less transparency about the returns to ordinary shareholders, the staff think the outcome is appropriate. This is because the discretionary dividends relate to a component of equity (even if that equity component is initially measured at zero). Recognising dividends subsequently in equity effectively validates the conclusion that the instrument is a compound instrument. To address concerns of users of financial statements, the staff plan to analyse potential presentation and disclosure requirements for these types of distributions along with other presentation and disclosure issues and present our analysis at future IASB meetings.

Staff recommendation

50. The staff think the principle in IAS 32 is clear that the recognition of interest, dividends, losses and gains relating to a financial instrument follows its classification, ie those related to a financial liability (component) are recognised in profit or loss and those related to an equity instrument (component) are recognised directly in equity. However, given the practice question, the staff recommend the IASB clarify in paragraph 28 of IAS 32 that a compound instrument with a zero-value equity component is still a compound instrument with a liability and an equity component. It would clarify that such a compound instrument is different from a financial instrument that is wholly recognised as a financial liability.

51. In addition, to avoid any further perceived inconsistency within IAS 32, the staff recommend the IASB clarify the scope of paragraphs AG37 of IAS 32. It could do this by specifically clarifying that the requirement on dividends paid on compound instruments in paragraph AG37 of IAS 32 applies even if the equity component is initially measured at zero. This clarification would make it clear that paragraphs 36 and AG37 of IAS 32 apply to different fact patterns.

Question for the IASB

52. The staff would like to ask the IASB the following question.

Question for the IASB
Do IASB members agree with the staff's recommendations summarised in paragraph 8 of this paper?