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27 March 2024

Dear Sir

Exposure Draft ED/2023/5: Financial Instruments with Characteristics of Equity

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We support the efforts of the IASB to clarify some of the requirements in IAS 32 *Financial Instruments: Presentation* to reduce diversity in practice and enhance comparability. However, we have concerns about a number of aspects of the proposals, including some of the proposed disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* and the presentation requirements in IAS 1 *Presentation of Financial Statements*.

We also believe that some of the proposals may have unintended consequences, especially where the current practice is well established and the proposed amendments, although intended to clarify the requirements, may instead lead to unforeseen effects on the accounting currently followed.

Our main areas of concern are as below:

- The effects of relevant laws or regulations:

  We acknowledge the IASB's intention to clarify the effects of laws and regulations on the classification of financial instruments. However, we believe that practice has developed such that appropriate accounting outcomes are recognised in financial statements, which reflect the contractual terms of financial instruments in combination with differences in jurisdictional requirements and the appropriate application of judgement. We are concerned that the proposals could give rise to significant unintended consequences and that many new questions would arise about how to apply the revised requirements. Consequently, we consider that the IASB should not proceed with the proposals.
- Settlement in an entity's own equity instruments:

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We believe that the proposed requirements related to the application of the fixed-for-fixed condition are narrow and may lead to a change in practice in some cases. We also believe that the proposed requirements related to the passage-of-time adjustments to fix, on initial recognition, the present value of consideration are highly restrictive and should be reconsidered. Additionally, a possible reading of proposed paragraph 22D may lead to significant change in practice if entities are required to identify embedded derivatives in non-derivative equity host contracts.

- Contingent settlement provisions:

  We disagree with the proposed measurement approach in paragraph 25A to disregard the probability and estimated timing of occurrence or non-occurrence of contingent events. We have concerns about the effect of the proposed approach on the measurement of some financial instruments. We also disagree, in principle, with the application of the proposed measurement approach to liabilities other than the obligations for an entity to purchase its own equity instruments. We strongly recommend that the IASB reconsider these proposals.

- Reclassification of financial liabilities and equity instruments:

  We disagree with the proposal to prohibit reclassification of financial instruments on changes in the substance of the contractual arrangement that occur when contractual terms become, or stop being, effective with the passage of time and strongly recommend that such reclassification be required. We believe that the proposed amendment may affect fair presentation of financial statements in some cases, as appropriate classification of financial instruments as debt or equity is fundamental to the fair presentation of financial statements.

Our detailed responses to the questions in the ED, along with the reasons for our concerns, are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)7875 311782 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Andrew Buchanan

Global Head of IFRS and Corporate Reporting

Appendix

Question 1: The effects of relevant laws or regulations (paragraphs 15A and AG24A–AG24B of IAS 32

The IASB proposes to clarify that:

(a) only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts (paragraph 15A); and

(b) a contractual right or obligation that is not solely created by laws or regulations, but is in addition to a right or obligation created by relevant laws or regulations shall be considered in its entirety in classifying the financial instrument or its component parts (paragraph AG24B).

Paragraphs BC12–BC30 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We understand the IASB's intention to clarify the effects of relevant laws or regulations on the classification of financial instruments. However, although questions have arisen in the past, in our experience there is consistency at least within jurisdictions in this area. Differences among jurisdictions appear to be due more to differences in the legal and regulatory frameworks and the application of judgement in determining the appropriate accounting approach.

We are concerned that, if the IASB proceeds with its proposals, there may be significant unintended consequences and it is likely that a significant number of new questions would arise about the interpretation and application of the new guidance. As a result, and combined with a number of issues we have identified (see below), we strongly recommend that the IASB does not proceed with this part of the proposals.

If, despite our reservations and recommendation, the IASB decides to proceed with this part of the proposals, we have identified some initial concerns related to certain aspects of the proposals as set out below:

1. Clarification required on whether regulatory framework qualifies as relevant laws or regulations:

   In a number of jurisdictions, particularly for the banking sector, the regulator sets out the framework for the entities to operate within. We suggest the IASB clarifies whether such a regulatory framework qualifies as relevant laws or regulations.

   Our concern here is that, if a feature is incorporated in the contractual terms in order for the instrument to be covered by certain provisions of the applicable framework, it is not entirely clear whether such contractual terms would be considered for determining the classification of the instrument. A typical example of this scenario would be financial instruments with 'bail-in' features, such as Additional Tier 1 (AT-1) capital instruments. Banks issue these instruments with specific contractual terms as required by the regulatory framework, with those contractual terms being required in order that the instrument qualifies as an AT-1 capital instrument.

The following are some examples that we noted during our outreach that illustrate our concern:

- Consider a debt instrument issued by a bank that converts into a fixed number of shares in case of a non-viability event. However, the regulator has the authority to mandate conversion into a variable number of shares in case of the non-viability event. The bank is not legally required to issue such a bail-in instrument. However, once the bank elects to issue the instrument, the general bail-in powers of the regulator apply to the instrument. From the Basis for Conclusions to the ED (BC21(a)), it appears that the bail-in powers of the regulator would not be considered for classification of the instrument. Accordingly, it appears that, for the purposes of classification, the instrument would be considered convertible into a fixed number of shares in case of a non-viability event.

- In some jurisdictions, the regulatory framework allows some discretion (e.g. in determining the conversion ratio) to the banks issuing instruments such as the AT-1 instruments. In our view, a possible reading of the proposed requirements would be that if the instrument has contractual terms within the discretionary limits permitted by the regulatory framework, the resulting contractual rights or obligations would be considered to be created by the relevant laws or regulations that would arise regardless of whether the right or obligation is included in the contractual arrangement.

  For instance, if the relevant law or regulation requires payment of dividend on an instrument within a range of 8-10% per annum and the instrument under consideration provides for an annual dividend of 9%, the contractual obligation to pay the dividend would be considered to be arising from the relevant law or regulation and therefore, classified as equity.

- In some jurisdictions, the issuer is required to incorporate certain contractual terms in order for the issuing entity (not the instrument issued) to qualify to be designated as a particular type of entity. For example, in order to qualify as a Real Estate Investment Trust (REIT), an entity is required to issue shares that are puttable with certain conditions. In our view, it appears that such regulatory requirements that apply to the issuer entity, rather than to a specific instrument that the entity issues, are not covered by the relevant laws or regulations referred to in proposed paragraph 15A.

If the IASB decides to proceed with this part of the proposals, we strongly recommend that the IASB clarifies the requirements to address the points noted above. It would also be appropriate for the IASB to conduct extensive outreach before finalising amendments and to include illustrative examples to clarify the applicability of the proposed requirements to commonly encountered instruments.

2. Treatment in case of invalidation of a contractual term by laws or regulations:

   We agree with the initial part of the proposal in paragraph 15A(a) that in classifying a financial instrument, only those contractual rights and obligations shall be considered that are enforceable by laws or regulations. However, when read in conjunction with paragraph 15A(b), it is not entirely clear as to which terms would apply if a contract provided for a term that is invalidated by the relevant laws or regulations.

   For example, consider an instrument where the relevant regulation provides for a cap on the interest rate that can be charged on a certain type of debt instrument and the instrument provides for an interest rate higher than the maximum regulatory interest rate. As the contractual term for the higher interest rate is not enforceable, it will not be considered in classifying the instrument, as required by the proposed paragraph 15A(a). However, proposed paragraph 15A(b) prohibits the entity from considering any right or obligation created by relevant laws or regulations that would arise regardless of whether the right or obligation is included in the contractual arrangement. Therefore, it appears that the entity cannot consider the regulatory maximum interest rate that applies to the financial instrument.

During our outreach, we came across instances where the relevant regulation allows the holder to call back certain type of perpetual instruments after a period 10 years. In such cases, the instrument cannot be considered perpetual, as the term is not enforceable in accordance with proposed paragraph 15A(a). However, it appears that application of proposed paragraph 15A(b) would not permit the entity to consider the instrument callable after 10 years, as this right for the holder arises regardless of whether it is included in the contractual arrangement.

If the IASB decides to proceed with this part of the proposals, we recommend that the further guidance is added to clarify the requirements in such cases.

3. Possibility of structuring opportunities:

   We believe that the proposed requirement in paragraph 15A(b) gives rise to structuring opportunities. For example, if a contract provided for payment of minimum dividend at a rate only marginally higher than the rate required by law, say 0.1% higher than the minimum dividend required by the relevant laws or regulations, the entire contractual dividend would be classified as a financial liability. If the contract had provided for payment of minimum dividend at the same rate as that required by the relevant laws or regulations, the dividend would be classified as equity.

   Therefore, we recommend that the proposals, if finalised in the current form, be subject to some anti-abuse provisions.

Question 2: Settlement in an entity's own equity instruments (paragraphs 16, 22, 22B–22D, AG27A and AG29B of IAS 32)

The IASB proposes to clarify when the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32 is met by specifying that the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency, and either:

(a) fixed (will not vary under any circumstances); or

(b) variable solely because of:

(i) preservation adjustments that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders; and/or

(ii) passage-of-time adjustments that are predetermined, vary with the passage of time only, and have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments (paragraphs 22B–22C).

The IASB also proposes to clarify that if a derivative gives one party a choice of settlement between two or more classes of an entity's own equity instruments, the entity considers whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative is an equity instrument only if all the settlement alternatives meet the fixed-for-fixed condition (paragraph AG27A(b)).

The IASB further proposes to clarify that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument (paragraph 22D).

Paragraphs BC31–BC61 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Currently, there is limited guidance in IAS 32 on the application of the fixed-for-fixed condition leading to diversity in practice in certain aspects. We appreciate the IASB's intention in seeking to bring clarity on the application of the fixed-for-fixed condition and improve consistency. However, we believe that the proposed amendments are narrow in focus and restrictive and would lead to changes in current practice in some cases, which we believe would be inappropriate and may be unintended.

For example, some instruments incorporate a volume weighted average price (VWAP) (or similar) adjustments into the anti-dilution calculation. Under current practice, VWAP mechanism included as part of an anti-dilution or similar calculation may be permitted to meet the fixed-for-fixed condition, if certain criteria are met. This is typically in cases where the underlying shares subject to the VWAP mechanism are very thinly traded at such a low level such that the VWAP mechanism is considered appropriate in approximating the fair value of the entity's shares and the purpose of the VWAP mechanism is to approximate the fair value of the equity instruments used in an anti-dilution calculation. Under the proposed requirements, such VWAP mechanisms incorporated into anti-dilution or similar calculations, will result in the fixed-for-fixed condition not being met, even for thinly traded shares. This may pose a challenge in determining the fair value of the shares subject to the VWAP mechanism if the shares are thinly traded.

Therefore, we strongly recommend that the IASB consider widening the permissibility of variability in the amount of consideration to be exchanged.

Passage-of-time adjustments:

We also have significant concerns about the passage-of-time adjustments proposed, as set out below:

- Proposed paragraph 22C(b)(iii) requires any difference in the amounts of consideration to be exchanged on each possible settlement date to represent compensation proportional to the passage of time. Assessing what is proportional to the passage of time requires judgement. The ED does not include any guidance on this assessment. Currently, in the illustrative examples proposed, there is no example proposed on this assessment, wherein the change in the number of shares to be issued meets the passage-of-time adjustment criterion. We recommend that if this criterion is to be added, the IASB includes more application guidance and illustrative examples on the assessment of whether the compensation is proportional to the passage-of-time. Without additional application guidance, the proposed amendments may lead to significant diversity in practice.

- We believe that the proposed requirement in paragraph 22C(b)(iii) to fix, on initial recognition, the present value of the amount of consideration exchanged for each of the entity's own equity instruments is inappropriately restrictive. We strongly suggest that the IASB consider a requirement whereby the passage-of-time criterion is met if the number of the entity's own equity instruments to be issued on various settlement dates is predetermined and the number of shares is not leveraged. This would be consistent with the existing requirements in IFRS 9 *Financial Instruments* for assessing whether derivatives are closely related to host contracts. This would also be consistent with the current practice followed (BDO's *IFRS Accounting Standards In Practice – Accounting for Convertible Notes* (section 7.1) includes similar guidance).

Proposed requirements in paragraph 22D:

We also have significant concerns about the possible implications of the proposed paragraph 22D for embedded derivatives in non-derivative equity host contracts. Under current practice, an approach to not identify embedded derivatives in non-derivative equity hosts is typically considered permissible. If the proposed requirement in paragraph 22D is read to mean that a contract that will or may be settled by the exchange of a variable number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of the entity's own non-derivative equity instruments is not an equity instrument, this would be a significant change in current practice.

For example, consider a preference share that is convertible into a fixed number of entity's own equity instruments. The conversion feature contains a down-round provision, whereby if the entity issues additional ordinary shares below the conversion price, the conversion ratio is adjusted to the new share issue price. The issuance of new ordinary shares, and therefore the trigger of the down-round feature, is within the control of the entity. Under current requirements, it is acceptable to classify the entire preference share as equity and not separately account for the embedded derivative. The embedded derivative arising from the down round feature is not separately identified because it is part of an equity host contract. Under the proposed requirements, if paragraph 22D is read to mean as stated in the preceding paragraph above, such down round features would be required to be separately identified from the equity host contract.

We understand the IASB's intention in proposing the clarification in paragraph 22D is to address contracts that involve share-for-share exchanges in which both legs of the contract are a fixed number of own equity instruments (BC59). It is not clear whether the IASB's intention is to not permit equity classification for contracts where a fixed number of one class of an entity's own non-derivative equity instruments is exchanged for a variable number of another class of the entity's own non-derivative equity instruments. If that is the intention, we recommend the IASB to reconsider the requirement given that it will result in a significant change in practice which will require identification of embedded derivatives in equity host contracts. If that is not the intention, we recommend the IASB clarifies the requirements.

Question 3: Obligations to purchase an entity's own equity instruments (paragraphs 23 and AG27B–AG27D of IAS 32)

The IASB proposes to clarify that:

(a) the requirements in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instruments also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments (paragraph 23).

(b) on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would, therefore, be removed from a component of equity other than non-controlling interests or issued share capital (paragraph AG27B).

(c) an entity is required to use the same approach for initial and subsequent measurement of the financial liability—measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right (paragraph 23).

(d) any gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraph 23).

(e) if a contract containing an obligation for an entity to purchase its own equity instruments expires without delivery:

(i) the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial liability.

(ii) any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss. However, the entity may transfer the cumulative amount of those gains or losses from retained earnings to another component of equity (paragraph AG27C).

(f) written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled—consideration is exchanged for own equity instruments—are required to be presented on a gross basis (paragraph AG27D).

Paragraphs BC62–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

While we are supportive of amendments which would result in greater consistency in how entities account for obligations to purchase their own equity instruments, we are not convinced that what appears to be a proposed single approach will necessarily provide the most useful information to investors. We suggest that an explicit test is required, which is whether the entity that is obligated to purchase its own equity instruments has present access to the rights and returns of those equity instruments. We further suggest that this assessment be consistent with the requirements of IFRS 10 *Consolidated Financial Statements,* specifically IFRS 10.B90-B91. As noted below, in a business combination in which an acquirer purchases 80% of the equity instruments of the acquiree, with a put option being granted to the legal owners of remaining 20%, it is common for dividend blockers and other contractual terms to be included, such that the acquirer has exposure to 100% of the returns of the acquiree from the date of acquisition of the 80% interest. In such cases, the non-controlling interests (NCI) would be derecognised at that point. In others, where the returns that relate to the 20% subject to the put option remain with the legal owners of those equity instruments, the acquirer would recognise the NCI.

The appropriate accounting treatment for an entity's obligations to purchase its own equity instruments, in particular for changes in the carrying amount of the financial liability arising from that obligation, has been a long standing and controversial issue. We suggest that, in addition to amendments to IAS 32, it would be appropriate to make consequential amendments to certain parts of IFRS 10 (in particular IFRS 10.B96), and to carry out additional outreach with investors as part of a detailed cost/benefit analysis. In case of a change in the proportion of the equity held by NCI, IFRS 10.B96 requires an entity to recognise in equity any difference between the amount by which the NCI are adjusted and the fair value of the consideration paid or received. The proposed amendment to paragraph 23 to recognise any gains or losses on remeasurement of the financial liability for the entity's obligations to purchase its own equity instruments in profit or loss appears to contradict the requirements of IFRS 10.B96. Therefore, for consistent application, we recommend that the IASB consider making consequential amendments, in particular, to IFRS 10.B96.

We have a number of further concerns and suggestions as set out below:

1. Effect on written put options on non-controlling interests (NCI put options) currently accounted using an approach different from the proposed requirements:

   Currently, due to the lack of guidance in IAS 32, there is diversity in practice in accounting for NCI put options. We understand the IASB's intention in proposing these amendments to bring consistency in accounting for these instruments. However, a retrospective application of these amendments will have a significant effect on the NCI put options that were accounted using an approach different from the proposed requirements. Therefore, we suggest that the IASB consider providing a transitional relief for such cases.

2. Applicability of paragraph AG27B in case of NCI put options with dividend blockers or other restrictions:

   Paragraph AG27B states that '*…if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates (the rights and returns have not legally or in substance been transferred to the entity), these equity instruments would continue to be recognised…*'.

   NCI put options often provide for restrictions such as dividend blockers which restrict payment of dividends till the NCI put options are exercised. We recommend the IASB to include further guidance on the assessment of whether the entity has present access to the rights and returns associated with ownership of the equity instruments subject to the NCI put options in such cases of contractual restrictions.

Question 4: Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)

The IASB proposes to clarify that:

(a) some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A);

(b) the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A);

(c) payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37);

(d) the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations (paragraph 11); and

(e) the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring (paragraph AG28).

Paragraphs BC94–BC115 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

General concern with the introduction of a new measurement model:

In principle, we strongly disagree with the proposal as it introduces a new measurement model in IAS 32, under which the probability and estimated timing of the uncertain event is disregarded. This measurement basis is not at fair value. We do support this basis being followed in paragraph 23 for obligations for an entity to purchase its own shares due to the specific nature of the obligation and the fact that the obligation envisaged in paragraph 23 is not arising due to events outside the control of the issuer and the holder of the instrument. However, in our view, this measurement basis should be treated as an exception for an entity's obligation to purchase its own equity instruments, and not applied to other cases.

Apart from the general concern mentioned above, we have some specific concerns about the implications of the proposals in paragraph 25A.

Effect on the measurement of financial instruments (or components thereof):

Proposed paragraph 25A requires an entity to initially and subsequently measure the financial liability arising from a contingent settlement provision at the present value of the settlement amount without considering the probability and estimated timing of occurrence or non-occurrence of uncertain future events. This approach would result in certain derivatives being measured initially at a very large amount. Subsequent remeasurement of these derivatives may lead to significant volatility in profit or loss.

For example, consider a convertible debt instrument that is repayable after five years. It includes an American-style conversion option that gives the holder the right to convert the debt into ordinary shares of the entity any time after two years until maturity. The debt is convertible into a variable number of shares based on the fair value of the shares on the date of conversion. Additionally, the debt is converted into ordinary shares in the event of a change of control of the issuer. A change of control is considered to be an event outside the issuer's control.

The conversion feature, in this case, does not meet the fixed-for-fixed condition and is accounted as a derivative. Proposed paragraph 25A would require the entity to measure the derivative at the present value of the settlement amount without considering the probability and estimated timing of the IPO. The entity would be required to assume that settlement will occur at the earliest possible settlement date. This would result in a very large value being ascribed to the derivative and a minimal amount being ascribed to the liability towards repayment of the principal. The derivative would be required to be remeasured every period-end on similar basis.

It may have been the intention of the proposed amendment that paragraph 25A applies only to instruments (or components thereof) classified as financial liabilities due to the application of paragraph 25 and not otherwise. If this is the case, we recommend that the IASB explicitly clarifies this.

The proposed amendment may also lead to certain anomalous accounting in cases where the amount payable to settle the instrument on the occurrence of the contingent event exceeds the maturity amount of the instrument or the proceeds received on issue of the instrument. For example, consider preference shares that are issued and are redeemable after 3 years for an amount of CU1 million. However, in the event of a successful IPO, the preference shares are convertible into ordinary shares to the value of CU1.5 million. The probability of the entity launching an IPO in the next 3 years is extremely low. If the measurement model proposed in paragraph 25A is applied, the liability for the contingent settlement would be initially measured at an amount close to CU1.5 million. This would result in a day one loss of CU0.5 million, which, if recognised, would be reversed on maturity, if a successful IPO does not take place and the preference shares are redeemed for CU1 million. Accounting for such loss would not provide meaningful information.

Given the above concerns, we strongly recommend the IASB to not proceed with the proposed measurement approach and instead require the measurement of these financial liabilities to be in accordance with IFRS 9.

Definition of liquidation:

We support the addition of a definition of *liquidation* proposed by the amendments.

In principle, the fundamental feature of a liquidation is that it is a one-way process which cannot be reversed. However, in some cases when an entity is going through a liquidation process, some of its operations may continue. We suggest that the definition is amended to focus on liquidation being a process which cannot be reversed, and to eliminate the requirement for an entity to have permanently ceased its operations.

In the financial services sector, an entity facing severe financial distress may go through a recovery and resolution process, rather than a complete winding up of the entity. It is not clear whether a resolution process may be viewed as the entity permanently ceasing its operations. We suggest that the IASB consider clarifying how the definition of liquidation interplays with the recovery and resolution mechanism.

Question 5: Shareholder discretion (paragraphs AG28A–AG28C of IAS 32)

The IASB proposes:

(a) to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way

that it would be a financial liability) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions (paragraph AG28A).

(b) to describe the factors an entity is required to consider in making that assessment, namely whether:

(i) a shareholder decision would be routine in nature—made in the ordinary course of the entity's business activities;

(ii) a shareholder decision relates to an action that would be proposed or a transaction that would be initiated by the entity's management;

(iii) different classes of shareholders would benefit differently from a shareholder decision; and

(iv) the exercise of a shareholder decision-making right would enable a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) (paragraph AG28A(a)–(d)).

(c) to provide guidance on applying those factors (paragraph AG28B).

Paragraphs BC116–BC125 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We generally agree with the proposed amendments. However, we have concerns and suggestions related to certain aspects of the proposals, as set out below:

1. Effect of paragraph AG28A(b) in case of change of control clauses:

   The proposals in paragraph AG28A(b) will result in a change in current practice for the assessment of whether shareholder decisions related to change of control of the entity are treated as entity decisions. Under current practice, if the entity is or may be required to settle an obligation on a change of control and if the change of control is subject to shareholder approval, an assessment is made of whether the shareholders are acting as part of the entity when making that decision (for example, in a shareholder vote in General Meeting). If it is concluded that the shareholders are not acting as part of the entity when making the relevant decision, the decision is not considered to be an entity decision and the instrument (or a component thereof) is classified as a financial liability, even if the transaction for change of control is initiated by the entity's management. If the shareholders are acting as part of the entity when making the decision, then the requirement to settle an obligation on a change of control would not in itself give rise to a financial liability.

   Under the proposed amendments, if the transaction for change of control is initiated by the entity's management, the related shareholder decision would be considered an entity decision and the instrument (or a component thereof) would be classified as equity.

   As a result, we believe that the proposed amendments would affect a number of instruments (or components thereof) previously classified as liability, which would now be classified as equity.

There is also a possibility that transaction could be structured to achieve a desired outcome, as management may include contractual terms that require initiation of transactions by management in order to achieve equity classification.

2. Retrospective application of the requirements related to routine and non-routine shareholder decisions:

   As the Basis for Conclusions (BC120) of the ED notes, the assessment of shareholder decision-making rights as either routine or non-routine could change over time. While applying the proposed amendments retrospectively, determining whether a particular shareholder decision was routine or non-routine at the time a contract was entered into may be onerous. Therefore, we recommend that the IASB consider providing a transitional relief to the retrospective application whereby an entity may be permitted to assess whether a shareholder decision is routine or non-routine based on facts and circumstances at the date of transition.

3. Application of the proposals for entities with venture capital investors:

   Venture capital investors typically invest with a purpose of exit after a certain period of time. Venture capital investors may hold both debt and equity investments. The nature of decision-making by shareholders who are venture capital investors may differ from the nature of decision-making by other shareholders. We suggest that the IASB consider including an example that addresses the assessment of the factors in paragraph AF28A for venture capital investors.

Question 6: Reclassification of financial liabilities and equity instruments (paragraphs 32B-32D and AG35A of IAS 32)

The IASB proposes:

(a) to add a general requirement that prohibits the reclassification of a financial instrument after initial recognition, unless paragraph 16E of IAS 32 applies or the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement (paragraphs 32B–32C).

(b) to specify that if the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement, an entity would:

(i) reclassify the instrument prospectively from the date when that change in circumstances occurred.

(ii) measure a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification would be recognised in equity.

(iii) measure an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification. No gain or loss would be recognised on reclassification (paragraph 32D).

(c) provide examples of changes in circumstances external to the contractual arrangement requiring reclassification (paragraph AG35A).

Paragraphs BC126–BC164 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Would the proposal to reclassify the instrument prospectively from the date when a change in circumstances occurred give rise to any practical difficulties? If so, please describe those practical difficulties and the circumstances in which they would arise

We agree with the IASB's recommendation to require an entity to reclassify any affected financial liability or equity instrument, if the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement.

However, we strongly disagree with the IASB's conclusion to prohibit reclassification of a financial liability or equity instrument on changes in the substance of the contractual arrangement that occur when contractual terms become, or stop being, effective with the passage of time. We note the IASB's basis for rejecting the approach to require reclassifications for all changes in substance of the contractual arrangement (BC139). We also note the IASB's conclusion that such approach would require a fundamental change to the current approach in IAS 32 (BC139) and that the approach proposed in the ED is consistent with that used in IFRS 9 for reclassifying financial assets when there is a change in the business model for managing financial assets.

However, we strongly recommend the IASB to not proceed with the proposed amendment and require reclassification for changes in the substance of the contractual arrangement to include those that occur when contractual terms become, or stop being, effective with the passage of time. Our reasons for the recommendation are set out below:

- Classification of a financial instrument (or a component thereof) as a financial liability or equity is substantially more fundamental than the classification of financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss. Classifying an instrument as a financial liability when the contractual terms that resulted in a liability classification are no longer effective not only may not provide meaningful information to the users but also may be misleading. For example, consider an instrument which has a discretionary coupon payment and gives the holder the right to demand repayment at the end of a specified period of time. If the repayment is not demanded at the end of the specified period of time, the instrument becomes a perpetual instrument. In such case, if the repayment is not demanded at the end of the specified period of time, continuing to classify the instrument as a financial liability does not provide meaningful information to the users. In our view, in such cases, the instrument should be required to be reclassified.
- Prohibiting reclassification of a financial liability to equity when the contractual term that resulted in the liability classification expires would contradict the requirement of IFRS 9.3.3.1 to derecognise a financial liability when the obligation specified in the contract is discharged or is cancelled or expires.
- Due to lack of guidance in IAS 32 currently on reclassification of financial liabilities and equity instruments, there is diversity in practice. One of the approaches currently followed by entities is to reclassify the instrument for changes in substance of the contractual arrangement that occur when contractual terms become, or stop being, effective with the passage of time. Therefore, we believe that requiring such

reclassifications would not be a fundamental change to the current approach as concluded by the IASB (BC139).

- We note that the Board considered that under an approach that requires reclassification for all changes in the substance of the contractual arrangement, an entity would be required to assess at each reporting date, for each financial instrument issued, whether there has been a change in substance that affects whether the instrument meets the definition of a financial liability or an equity instrument at that date. We believe that this would be an appropriate requirement. The appropriate classification of a financial instrument as a financial liability or equity is fundamental to the fair presentation of the financial statements and we consider that the cost of assessing whether a reclassification is required at each reporting date would not outweigh the benefits.

  In any case, to meet the proposed disclosure requirements in paragraph 30D, the entity would be required to monitor and maintain a record of the terms and conditions of the financial instruments that determine their classification as financial liabilities or equity. Therefore, we believe that the assessment of whether a reclassification is required at each reporting date would not significantly add to the cost of compliance.

We also suggest the IASB clarifies whether a reclassification of an instrument would be required if the relevant laws or regulations changed subsequent to the point at which the contract was entered into. For example, on initial recognition a contract provided for the payment of mandatory dividend at the rate of 10%, which was the same as the regulatory minimum rate of dividend. The dividend was, therefore, classified as equity. Subsequently, the mandatory dividend rate was reduced to 8%. It is not clear whether the dividend payment would then be reclassified as a financial liability as the contractual minimum rate of dividend exceeds the regulatory minimum rate of dividend.

Question 7: Disclosure (paragraphs 1, 3, 12E, 17A, 20, 30A–30J and B5A–B5L of IFRS 7)

The IASB proposes:

(a) to expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its ownership structure is, including potential dilution to the ownership structure from financial instruments issued at the reporting date (paragraph 1).

(b) to delete the reference to derivatives that meet the definition of an equity instrument in IAS 32 from paragraph 3(a) of IFRS 7.

(c) to move paragraphs 80A and 136A from IAS 1 to IFRS 7. These paragraphs set out requirements for disclosures relating to financial instruments classified as equity in accordance with paragraphs 16A–16B and/or paragraphs 16C–16D of IAS 32 (paragraphs 12E and 30I). The IASB also proposes to expand paragraph 80A to cover reclassifications if there are changes in the substance of the contractual arrangement from a change in circumstances external to the contractual arrangement.

(d) to amend paragraph 20(a)(i) of IFRS 7 to require an entity to disclose gains or losses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in its net assets, separately from gains or losses on other financial liabilities in each reporting period.

(e) to include disclosure requirements for compound financial instruments in IFRS 7 (paragraph 17A).

The IASB proposes to require an entity to disclose information about:

(a) the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments (paragraphs 30A–30B);

(b) the terms and conditions of financial instruments with both financial liability and equity characteristics (paragraphs 30C–30E and B5B–B5H);

(c) terms and conditions that become, or stop being, effective with the passage of time (paragraph 30F);

(d) the potential dilution of ordinary shares (paragraphs 30G–30H and B5I–B5L); and

(e) instruments that include obligations to purchase the entity's own equity instruments (paragraph 30J).

Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with the proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We understand the IASB's intention in introducing additional disclosure requirements to meet the information needs of users of financial statements. However, we believe that in some cases, the extensive disclosure requirements may be onerous for the preparers of financial statements, without providing sufficiently meaningful information to users of financial statements.

Our responses for each of the proposed disclosure requirements are set out below:

- The nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments:

  We understand the objective behind the proposed disclosure requirements. However, typically, for most entities, liquidation would be a remote possibility. Based on the feedback received during our outreach, in most cases, the proposed disclosure would, on an ongoing basis, be of little relevance to users of financial statements. We also note that for entities with multinational and complex capital structures, the disclosure would be likely to involve significant time and effort. Therefore, in our view, the cost of preparing the disclosure would significantly outweigh the expected benefit.

  We also note that the purpose of some instruments such as AT1 bonds is to prevent liquidation. Such instruments may suffer a significant loss in value prior to liquidation. The proposed disclosure does not bring out this fact appropriately.

  Therefore, we suggest that the IASB reconsider the proposed disclosure. We suggest that the IASB may consider mandating these disclosures in specific situations, such as when there is significant uncertainty about an entity's ability to continue as a going concern. In our view, such requirement would enhance the relevance of the disclosure to the users of financial statements.

- The terms and conditions of financial instruments with both financial liability and equity characteristics:

  We generally agree with the proposed disclosure requirements in paragraph 30D, related to financial instruments with both financial liability and equity characteristics. We believe that the proposed disclosure would help meet the information needs of the users of financial statements related to the nature and characteristics of financial instruments and the reason for the classification of the instruments as financial liabilities or equity.

  Our observations related to the proposed disclosure requirements in paragraph 30E related to priority on liquidation are same as those for the proposed disclosure requirements in paragraph 30A and 30B. We suggest that the IASB reconsider these proposed disclosure requirements or consider mandating these disclosures only in specific situations, such as when there is significant uncertainty about an entity's ability to continue as a going concern.

- Terms and conditions that become, or stop being, effective with the passage of time:

  As noted in our response to Question 6, we strongly recommend the IASB to require reclassification of financial instruments for changes in the substance of the contractual arrangement that occur when contractual terms become, or stop being, effective with the passage of time. If such requirement is introduced, the disclosure requirement in paragraph 30F may need to be reconsidered.

  If the proposals related to reclassification of financial instruments are finalised in their current form, we believe that the disclosure requirements in paragraph 30F would help users understand the correct nature of the financial instruments which, in our view, in some cases, may not be appropriately reflected in their classification in the statement of financial position, given the restriction on reclassification.

- The potential dilution of ordinary shares:

  Although we understand the needs expressed by the users of financial statements for more information on potential dilution of ordinary shares, we have concerns about the proposed disclosure requirements. We believe that the disclosure, as proposed, may not provide meaningful information. The proposed disclosure requires an entity to consider assumptions that maximise the number of additional shares that the entity might be required to deliver. Therefore, the entity is required to consider potential dilution without consideration of factors such as pricing of the shares. For example, written call options that are deeply out of the money are also required to be considered for potential dilution. The requirement to maximise potential dilution does not take into account interaction between different instruments.

  Therefore, in our view, the resulting information may not provide a fair and meaningful representation of the potential dilution of shares that would serve the information needs of the users. Therefore, we recommend the IASB to not proceed with this disclosure requirement.

  We also note that the disclosure requirement, being introduced in IFRS 7, would be mandatory for all entities whereas, IAS 33 *Earnings per Share* applies to only those entities that disclose earnings per share. We suggest that any disclosure requirement related to dilution of ordinary shares be introduced in IAS 33 and not in IFRS 7.

- Puttable financial instruments classified as equity instruments:

  We generally agree with the proposed disclosure requirements. We believe that the proposed disclosure would help users understand the nature, amount, timing and uncertainty of cash flows arising from puttable financial instruments issued by the entity.

- Instruments that include obligations to purchase the entity's own equity instruments:

  We generally agree with the proposed disclosure requirements. We believe that the proposed disclosure would provide useful information to users of financial statements to help them understand the accounting for financial instruments that include an obligation for the entity to purchase its own equity instruments.

Question 8: Presentation of amounts attributable to ordinary shareholders (paragraphs 54, 81B and 107–108 of IAS 1)

The IASB proposes to amend IAS 1 to require an entity to provide additional information about amounts attributable to ordinary shareholders. The proposed amendments are that:

(a) the statement of financial position shows issued share capital and reserves attributable to ordinary shareholders of the parent separately from issued share capital and reserves attributable to other owners of the parent (paragraph 54);

(b) the statement of comprehensive income shows an allocation of profit or loss and other comprehensive income attributable to owners of the parent between ordinary shareholders and other owners of the parent (paragraph 81B);

(c) the components of equity reconciled in the statement of changes in equity include each class of ordinary share capital and each class of other contributed equity (paragraph 108); and

(d) dividend amounts relating to ordinary shareholders are presented separately from amounts relating to other owners of the entity (paragraph 107).

Paragraphs BC246–BC256 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Would the proposed requirement to allocate issued share capital and reserves between ordinary shareholders and other owners of the parent give rise to any practical difficulties in determining the required amounts? If so, please describe the possible difficulties and specify areas in which further guidance would be helpful.

We understand how the proposed disclosure could be useful to meet the information needs of users of the financial statements. However, we believe that there are significant practical challenges that result in us concluding that the cost of providing the information would outweigh the benefits.

Apart from the overall complexity of preparation of the proposed disclosure, we have some specific concerns as set out below:

- There may be different classes of shares that participate differently in profits and capital. The proposed presentation is challenging in such cases.

For example, consider a non-cumulative mandatorily redeemable preference share, with discretionary dividends. The redemption amount of the preference shares is classified as a financial liability and the discretionary dividends are classified as equity. It is not clear as to how the reserves attributable to the owners of the preference shares will be arrived at.

- Complexities in retrospective restatement:
  As the amendments are proposed to be applied retrospectively, for some financial instruments that were issued a number of years ago, entities may need to go back those many years to arrive at the amount of reserves attributable to other owners. In jurisdictions that transitioned to IFRS in the past, arriving at the amount of reserves attributable to other owners may not be possible, due to the transitional requirements of IFRS.

Therefore, we recommend the IASB to not proceed with the proposed disclosure requirement.

If the IASB decides to take the proposal forward in the current form, we have the following recommendations:

- To support implementation, additional guidance and illustrative examples should be included that explain how to allocate the reserves between those attributable to ordinary shareholders and to other owners of the parent. The IASB may consider including an example of preference shares classified as equity, as these instruments are commonly encountered in practice.

- The IASB should consider providing some transitional relief, given the complexity of preparing the proposed disclosure on a fully retrospective basis and the fact that, in jurisdictions that transitioned to IFRS, it may be impracticable to do so.

Question 9: Transition (paragraphs 97U–97Z of IAS 32)

The IASB proposes to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information (a fully retrospective approach). However, to minimise costs, the IASB proposes not to require the restatement of information for more than one comparative period, even if the entity chooses or is required to present more than one comparative period in its financial statements.

For an entity already applying IFRS Accounting Standards, the IASB proposes:

(a) to require the entity to treat the fair value at the transition date as the amortised cost of the financial liability at that date if it is impracticable (as defined in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors) for the entity to apply the effective interest method in IFRS 9 Financial Instruments retrospectively (paragraph 97X);

(b) not to require the entity to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application (paragraph 97W);

(c) to require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments (paragraph 97Z);

(d) to provide transition relief from the quantitative disclosures in paragraph 28(f) of IAS 8 (paragraph 97Y); and

(e) no specific transition requirements in relation to IAS 34 Interim Financial Reporting for interim financial statements issued within the annual period in which the entity first applies the amendments.

For first-time adopters, the IASB proposes to provide no additional transition requirements.

Paragraphs BC262–BC270 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Would the proposal to apply the proposed amendments retrospectively give rise to any other cases in which hindsight would be necessary? If so, please describe those cases and the circumstances in which the need for hindsight would arise.

Although we agree with certain of the proposed transition provisions, we have some significant concerns and suggestions as set out below. In particular, we disagree with the requirement for entities to assess all financial instruments as at their date of initial recognition (see the second bullet point below for our suggested alternative approach).

- Transitional relief proposed in paragraph 97V(b):

  Proposed paragraph 97V(b) provides a transitional relief to not require restatement of comparative information for any periods prior to the beginning of the annual reporting period immediately preceding the date of initial application.

  In our view, this approach will affect the comparability of the information presented, especially if the classification of a financial instrument has changed on the application of the amendments. Therefore, we suggest that the IASB reconsider this transition relief and provide for a requirement to restate all comparative periods presented.

  As proposed in the ED, the amendments are applicable on a fully retrospective basis, meaning that entities would already be in possession of most of the information required to restate all comparative periods presented. Therefore, in our view, additional efforts required to restate all comparative periods presented would not be significant.

- Recommendations for transitional relief:

  - Classification to be based on terms and conditions at the beginning of the earliest period presented:

    Financial instruments often have very long-term maturities. Therefore, for a full retrospective application, entities may have to assess the terms and conditions and other facts and circumstances going back a number of decades. Some changes in circumstances after a financial instrument was issued, such as a change in functional currency, may require entities to reclassify the instrument sometime after the initial recognition of the instrument. Similarly, certain assessments change over time, for example, in the case of shareholder discretion, assessment of whether a shareholder decision is routine or non-routine.

Therefore, we suggest that the IASB consider a transitional relief to require classification to be based on terms and conditions and facts and circumstances at the beginning of the earliest period presented. We acknowledge that with this recommendation, under the proposals in the ED some instruments with similar features may be classified differently based on whether they were issued before or after the transition date, if some contractual terms expire with passage-of-time. However, this issue will not arise, if, as we strongly recommend in our response to question 6, reclassification is required for changes in the substance of the contractual arrangement that occur when contractual terms become, or stop being, effective with the passage of time.

  - Hedge accounting:

    Retrospective application of the amendments may result in discontinuation of some hedging relationships retrospectively, for example, if a financial liability designated in a hedging relationship is reclassified to equity on the application of the amendments. We suggest that the IASB consider providing some transitional relief for requirements related to hedge accounting.

- Applicability of the requirements related to laws or regulations:

  We suggest that, for the initial application of the amendments, the IASB should clarify which laws or regulations should be considered - those applicable at the time of transition or those applicable at the time the relevant contract was entered into. In case of the latter, we suggest the IASB to consider providing a transitional relief whereby entities are required to consider the relevant laws or regulations as applicable at the date of transition.