Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Financial Instruments with Characteristics of Equity** Proposed amendments to IAS 32, IFRS 7 and IAS 1	**Meeting:**	March 2024 (M201)
Topic:	**Stakeholder feedback, staff analysis and recommendations**	**Agenda Item:** **Date:**	9.1 20 February 2024
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Objective of this agenda item

1 The objective of this agenda item:

(a) To inform the Board about the International Accounting Standards Board (IASB) Exposure Draft/2023/5 Financial Instruments with Characteristics of Equity*: Proposed amendments to IAS 32, IFRS 7 and IAS 1*, Basis for Conclusions, and Illustrative Examples and Implementation Guidance.

(b) For the Board to consider the staff analysis of stakeholders' feedback and matters for inclusion in the comment letter.

Background

2 IAS 32 *Financial Instruments: Presentation* sets out requirements for classifying and presenting financial instruments as financial liabilities or equity instruments in the financial statements of the entity that issues those instruments.

3 The IASB published a Discussion Paper, *Financial Instruments with Characteristics of Equity,* in June 2018 to respond to the challenges in applying IAS 32.

4 After considering feedback on the Discussion Paper, the IASB decided not to pursue the classification approach proposed in the Discussion Paper. Instead, the IASB decided to focus on clarifying the classification requirements in IAS 32, including their underlying principles, to address known practice issues that arise in applying IAS 32.

5 In November 2023, the IASB published *Exposure Draft/2023/5 Financial Instruments with Characteristics of Equity: Proposed amendments to IAS 32, IFRS 7 and IAS 1* (ED2023/5). The due date for comments is 29 March 2024.

6 In December 2023, the AASB issued an Australian equivalent Exposure Draft – ED327 Financial Instruments with Characteristics of Equity: *Proposed amendments to AASB 132, AASB 7 and AASB 101* (ED327)—the due date for comments closed on 9 February 2024.

Outreach activities

7 Staff have received two written submissions on ED327 ([BCCM] and [Basford Consulting]). Staff conducted the following outreach activities to gather views from stakeholders:

(a) 13 December 2023– AASB Financial Instruments Project Advisory Panel (FIPAP) meeting. Four FIPAP members provided feedback to AASB staff on the exposure draft;

(b) 12 February 2024 – AASB staff attended a joint meeting arranged by CAANZ and CPA Australia to obtain the views of their members. Seven practitioners provided feedback on the exposure drafts;

(c) other targeted consultations. Ten individuals representing seven organisations (banks, insurers, practitioners and others) have provided feedback to AASB staff.

(d) 29 February 2024 (forthcoming) – AASB User Advisory Committee (UAC) meeting. AASB staff will ask UAC members to provide feedback on the exposure draft.

Feedback from Australian stakeholders, staff analysis and recommendations

8 There are ten topics in the exposure draft, each with explanatory material and corresponding numbered questions. Staff have considered all feedback received in providing their recommendations to the Board.

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.

Stakeholder feedback and staff analysis

9 Stakeholders asked the IASB for guidance on whether and how laws or regulations applicable to a financial instrument affect the classification of the instrument. Specifically, stakeholders asked about bank bail-in laws and the legal requirement in some jurisdictions for issuers to pay minimum dividends on their ordinary share capital.[1]

10 In Australia, most banks (and some insurance companies) issue Additional Tier 1 (AT1) capital notes subject to bail-in laws. Typical AT1 notes are perpetual, subordinated, and unsecured. In liquidation, AT1 notes are senior only to common equity. The notes pay floating rate distributions that are expected to be fully franked. The distributions are discretionary and non-cumulative. The notes have several call dates when the bank may redeem them, subject to approval by the Australian Prudential Regulation Authority (APRA). After the call dates, there is a mandatory exchange date when the notes may be exchanged (subject to conditions) for a variable number of the bank's ordinary shares. The notes automatically exchange if a Capital Trigger Event, Non-Viability Trigger Event, or Change of Control Event occurs. A capital trigger event occurs if the bank's Common Equity Tier 1 Capital Ratio (CET1) falls below a number that must be specified in the contract (e.g., 5.125% of risk-weighted assets). A non-viability trigger event is at the discretion of the regulator. In such exchanges, the holder could receive significantly less than the face value of the notes, and if the exchange is not effective, the notes will be terminated for no compensation.[2]

11 Accounting for AT1 notes in Australia as compound financial instruments seems consistent for similar instruments. That they are perpetual with non-cumulative discretionary distributions, which is an equity characteristics. However, because contingent settlement for a variable number of own shares could occur immediately, the full proceeds of the issue are allocated to the liability component with zero allocated to the equity component. Payments on the notes are expensed as interest to maintain consistency between the balance sheet presentation and profit or loss.

12 The existing paragraph 15 in IAS 32 requires the issuer of a financial instrument to classify an instrument on initial recognition based upon the "substance of the contractual arrangement".

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[1] APRA introduced bail-in requirements for banks' Additional Tier 1 capital (AT1) in Australia in 2013. There has been significant growth in Australian AT1 outstanding over the past ten years, now around A$40 billion (as of June 2023) and representing 14% of banks' Tier 1 capital. This is higher than in other countries, where AT1 averages 11% of Tier 1 capital. The main issuers in Australia are the four major banks and Macquarie Bank, which account for over 85 percent of Australian AT1. Insurance companies may issue similar instruments.

Some countries have included additional design features to enhance the effectiveness of AT1, beyond the Basel standards and beyond the current regulatory requirements that have been implemented in Australia. This includes higher trigger points for conversion and restrictions on the investor base for AT1.

In 2023, APRA issued a discussion paper to consider how the bail-in laws could be made more responsive to early signs of financial distress. Source: https://www.apra.gov.au/discussion-paper-enhancing-bank-resilience-additional-tier-1-capital-australia

[2] The Capital Trigger is required to be specified in the contract, so that the exchange will activate automatically if the ratio is breached. In Australia, this trigger is set by APRA at a CET1 ratio of 5.125 percent of risk weighted assets, in line with the international minimum standard set by the Basel Committee on Banking Supervision. Staff have confirmed that the 5.125 percent is an APRA threshold. There is nothing to preclude a bank negotiating a higher point of viability trigger with another party as part of the contract. Further, if the threshold were to change, transition requirements would need to be determined, but it is possible that the change would apply only to new contract (i.e., any change would not automatically apply to all existing contracts). This is important in the context of the IASB's proposed changes in Question 1.

The clarification by the IASB hinges on whether and how laws and regulations are considered part of the “substance of the contractual arrangement”.

(a) Paragraph 13 states that “'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law".

(b) Guidance paragraph AG12 clarifies that rights and obligations created by government laws and regulations (e.g., income tax) are not contractual arrangements.

13 The IASB proposes the following amendments:

(a) Proposed paragraph 15A(a) brings together the substance of paragraphs 13 and AG12, stating that entities "shall consider only contractual rights and obligations that are enforceable by law (see paragraph 13) or regulations and are in addition to those created by relevant laws or regulations".

(b) Proposed paragraph 15A(b) adds that entities "shall not consider 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".

(c) Proposed guidance paragraph AG24A explains, "A contractual right or obligation typically applies only to the specific instrument and can be negotiated or modified by the parties to the contract. In contrast, a right or obligation solely created by laws or regulations applies to all similar instruments and cannot be modified by the parties to the contract. Therefore, changing relevant laws or regulations would affect all instruments subject to those laws or regulations".

(d) Proposed guidance paragraph AG24B explains that 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: The entity would not disaggregate such a contractual right or obligation into contractual and non-contractual parts.

14 Three stakeholders agreed with the proposals and do not think they will change existing practices.

15 Seven stakeholders thought the proposed approach lacked a conceptual basis, would lead to unintended consequences, and would not solve diversity in practice.

(a) Four stakeholders observed that two identical contracts would be treated differently if a requirement was established through regulation in one jurisdiction and if it was solely a requirement of the contract in the other jurisdiction.

(b) One stakeholder said the proposals seem arbitrary in deciding which laws should apply and when.

(c) One stakeholder suggested the proposals could provide structuring opportunities.

(d) Two stakeholders think transactions should be accounted for according to their substance per the Conceptual Framework or other more recent Standards.

16 Eight stakeholders said they think it might be difficult to apply the proposals.

(a) Three stakeholders said they are unsure whether or when a contractual term that arises from a law or regulation would be considered "in addition to" or more specific. For example, they do not think it is obvious how this would apply to the bail-in laws.

(b) One stakeholder said the proposals could have significant cost implications for financial institutions given that accounting staff would not necessarily know which parts of the contract are in addition to or more specific than regulatory requirements. They may need to obtain legal advice.

(c) One stakeholder asked how it would be possible to read and understand the substance of a contract without considering laws and regulations that are integral to the contract.

17 One stakeholder suggested more outreach to ensure the proposed changes solve the identified problem, supported by more illustrative examples and guidance. Alternatively, if some of the issues cannot be resolved, they suggested the IASB should not make any changes but instead focus on disclosure. Another stakeholder observed that although some of the requirements in IAS 32 can be difficult to follow, practice has already addressed most of these issues.

18 Similar comments from stakeholders (including Australia) were raised with the IASB following outreach in 2022. They were considered at the February 2023 IASB meeting (Agenda Paper 5B), available on the FICE project page). Analysis from this Agenda Paper is referred to in the following paragraphs.

Staff recommendations

19 Staff agree with the approach taken by the IASB.

(a) We agree that financial instruments are concerned with enforceable contractual rights and obligations (para.15A(a)) and that there is a difference between contractual terms that are negotiated between the parties to the contract and those that would apply whether or not they are included in the contract (para.15A(b)).

(b) We accept that excluding from the substance of the contract 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 (para.15A(b)) will mean that although consistency in classification should be improved within a jurisdiction, it may not be improved between jurisdictions (as the same contractual terms could affect the classification differently depending on whether they arise from law or regulation of the jurisdiction).

(c) Staff also support the practical expedient that 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 should be considered in its entirety (paragraph AG24B and BC23-26).

20 However, during outreach, staff found that stakeholders often had difficulty understanding the proposed amendments without further explanation. For example, referring to the Basis for Conclusions and IASB Agenda Papers was often necessary. We suggest that the wording of the proposals is amended and additional examples provided to improve clarity as follows:

(a) The proposed guidance paragraph AG24B should be moved into the Standard (as para.15A(c)) because it is an additional requirement rather than guidance on how to apply a Standard.[3]

(b) Stakeholders asked how the Standard and guidance would apply to bank bail-in laws and have requested examples. Staff have noted examples in the IASB staff papers that could be included as illustrative examples or guidance.[4] The example should also address the interpretation of contractual rights being more specific to laws or regulations.

Question for Board members

Q1 Do Board members agree with the staff recommendations in paragraph 20? If not, what would Board members suggest?

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[3] Proposed paragraph AG24B states:

> An entity shall consider a contractual right or obligation, which is not solely created by laws or regulations but is in addition to a right or obligation created by relevant laws or regulations, in its entirety in classifying that right or obligation. The entity shall not disaggregate such a contractual right or obligation into contractual and non-contractual parts. For example, if the relevant laws require the issuer to pay a minimum dividend on an instrument, but the instrument's contractual terms specify a higher minimum dividend to be paid (more than the minimum dividend requirement established by relevant laws), the issuer classifies the instrument (or its component parts) based on the entire contractual minimum dividend requirement. The entire contractual obligation to pay dividends would, therefore, be classified as a financial liability or liability component.

[4] For example, paragraph 11 of the February 2023 IASB meeting Agenda Paper 5B available on the FICE project page .

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 forthese proposals

Stakeholder feedback and staff analysis

21 For a derivative to be classified as an equity instrument, paragraph 16(b)(ii) of IAS 32 requires that it be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of the issuer's equity instruments (sometimes referred to as the 'fixed-for-fixed' condition). Stakeholders asked the IASB to clarify whether to comply with the fixed-for-fixed condition, variability could sometimes be permitted in the amount of consideration to be exchanged or the number of an entity's equity instruments.

22 The IASB proposes the addition of new paragraphs 22B-22D and guidance paragraphs AG27A and AG29B (as described in Question 2 above). Illustrative examples 13-20 demonstrate the application of the fixed-for-fixed requirements.

23 Six stakeholders welcomed the proposals, thinking they conceptually make sense and are consistent with current practice. Stakeholders provided additional feedback on the proposals for preservation adjustments, passage of time adjustments, and related illustrative examples.

Preservation adjustments

24 The proposed paragraphs 22C(a) and AG27A(c) explain that preservation (or anti-dilution) adjustments require the entity to preserve the relative economic interests of the holders of the right to be future shareholders to an equal or lesser extent than those of the existing shareholders. Preservation adjustments would include adjustments to the terms of the

derivative to reflect, for example, stock splits, bonus issues of shares and abnormal dividends paid on the existing shares. An adjustment to the amount of consideration to be received on the exercise of a warrant, which is more favourable to the derivative holder than changes in the interests of existing shareholders, would prevent the obligation from being classified as equity.

25 Two stakeholders discussed whether the example in paragraph AG27A(c) of a preservation adjustment for ordinary dividends is appropriate, given that ordinary dividends should be priced into the transaction.[5] However, other stakeholders said they had seen preservation adjustments for ordinary dividends and thought they were appropriate.

<u>Staff recommendations</u>

26 Staff agree with the stakeholders who said the proposals appear consistent with existing practice.

Question for Board members
Q2 Do Board members agree with the staff recommendations in paragraph 26? If not, what would Board members suggest?

Passage-of-time adjustments

27 The proposed paragraph 22C(b) states that:

> A passage-of-time adjustment is an adjustment to the amount of consideration exchanged for each of an entity's own equity instruments (made by adjusting either the amount of consideration to be exchanged or the number of the entity's own equity instruments used to settle the derivative) that: (i) is predetermined at the inception of the contract; (ii) varies with the passage of time only; and (iii) has 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—any difference in the amounts of consideration to be exchanged on each possible settlement date represents compensation proportional to the passage of time.

28 One stakeholder said the reason for the conclusion in Example 14 (para. IE60-61) in the Illustrative Examples is unclear.

29 Two stakeholders thought that the distinction between using an interest rate (discount rate) to represent the time value of money versus using a benchmark interest rate is not clear.

<u>Staff recommendations</u>

30 Staff note that a passage of time adjustment only applies when the exercise date of the contract varies. At the contract's inception, the consideration must be fixed for each possible settlement date, and the difference between the dates should reflect only the passage of time. A present value calculation demonstrates that the amounts vary only due to the passage of time (i.e. the difference in the amounts will be proportional to the amount of time that passes

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[5] Guidance paragraph AG27A(c) states:

> An example of a preservation adjustment, as described in paragraph 22C(a), is an adjustment to the amount of consideration to be received on exercise of a warrant over an entity's ordinary shares to compensate the future shareholder fully or partly for dividends paid on ordinary shares while the warrant is outstanding. However, if any such adjustment benefits the future shareholder to a greater extent than a current shareholder, that adjustment is not a preservation adjustment.

between the dates). An interest rate benchmark cannot be used to represent the passage of time because although a formula can be predetermined, (1) the amount of the benchmark at each exercise date is not known at the inception of the contract, and (2) it is unlikely that an interest rate benchmark will solely reflect the passage of time. For example, paragraph B4.1.7A of IFRS 9 describes interest as consideration for the time value of money, credit risk and other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs).

31 Staff agree with stakeholders and suggest the following:

(a) Example 14 (para. IE60-61) in the Illustrative Examples should be clearer. In this example, the entity issues a convertible bond on which interest accrues if not paid. At maturity, the holder can receive cash or equity at a predetermined rate of CU1 per share. Assuming the holder exercises the conversion option (the derivative component of the instrument), the number of shares they receive might vary, but the conversion ratio is fixed at CU1 per share. There is no passage of time adjustment because the timing of the exercise date does not vary. There is no preservation adjustment because there is no capital event that adjusts the conversion option. This is an example of a fixed-for-fixed transaction that does not vary as described in paragraph 22B(a). Staff suggest that the IASB explains this in the example.

(b) It is not fully clear in the documentation why an interest benchmark is not a passage of time adjustment. In the Basis for Conclusions, paragraph BC57 states, "the Board concluded that neither type of adjustment [interest benchmark or inflation benchmark] would be a passage-of-time adjustment because the strike price per share is not calculated using a predetermined formula that only varies with the passage of time. The inputs vary with an interest rate benchmark or an inflation index." Further, in Illustrative Example 20 (para. IE85), the conclusion states that "the adjustment [using an interest rate benchmark] is not a passage-of-time adjustment as described in paragraph 22C(b) of IAS 32. Although the strike price is based on a predetermined formula, the inputs vary not only with the passage of time but also with an interest rate benchmark." Staff ask that the IASB amend the wording in paragraph BC57 and Illustrative Example 20 to clarify that using an interest rate benchmark fails for two reasons. That is, the benchmark (1) does not solely reflect the passage of time per paragraph 22C(b)(i), and (2) although the formula can be predetermined, the present value of the amount of consideration is not fixed on initial recognition in accordance with paragraph 22C(b(iii). Alternatively, if the reasoning is different, please provide the correct explanation more clearly.

Question for Board members

Q2 Do Board members agree with the staff recommendations in paragraph 31? If not, what would Board members suggest?

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.

<u>Stakeholder feedback and staff analysis</u>

32 Paragraph 23 of IAS 32 sets out the accounting requirements for contracts containing an obligation for an entity to purchase its own equity instruments. One example is a contract that gives the holder of a minority interest the right (but not the obligation) to require the entity to purchase its own shares (NCI-put). NCI-puts might arise in a business combination where the original owners retain a minority equity stake that they can sell to the purchaser at some point after the acquisition. The purchase price may be fixed or set by reference to a factor such as a multiple of revenue, profit or the quoted share price of the entity.

33 Current requirements in paragraph 23 for contracts containing an obligation for an entity to purchase its equity require the entity to recognise a financial liability for the present value of the redemption amount, even if the contract itself is an equity instrument. An example in the Standard is an entity's obligation under a forward contract to purchase its equity instruments for cash. The financial liability is recognised initially at the present value of the redemption

amount, and equity is debited. Subsequently, the financial liability is measured under IFRS 9. If the contract expires without delivery, the carrying amount of the financial liability is debited, and equity is credited. Guidance paragraph AG27(a)-(d) provides examples of such transactions.

34 The IASB proposes the following amendments and clarifications:

(a) Paragraph 23 would be amended to add that:

(i) The requirements will also apply to contracts settled by delivering a variable number of another class of the entity's own equity instruments (i.e., in addition to cash or another financial asset).

(ii) Subsequent measurement of the financial liability is at the present value of the redemption amount (the reference to IFRS 9 is removed), with any gains and losses from remeasurement included in profit or loss.

(iii) The redemption amount is discounted, assuming redemption will occur at the earliest possible redemption date specified in the contract. Therefore, the probability and the estimated timing of the counterparty exercising its right to redeem does not affect the initial or subsequent measurement of the financial liability.

(b) Guidance paragraphs AG27B-D are added as follows:

(i) Paragraph AG27B explains that because the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, these equity instruments should continue to be recognised in the entity's balance sheet. That is, the initial amount of the financial liability is removed from a component of equity other than non-controlling interests or issued share capital.

(ii) Paragraph AG27C clarifies that if the contract expires without delivery, the entity should eliminate the liability against the component of equity from which it was initially removed. Further, any gains or losses from remeasuring the financial liability are not reversed through profit or loss (although they can be transferred from retained earnings to another equity account).

(iii) Paragraph AG27D clarifies that these requirements apply if an entity's contractual obligation to purchase its equity instruments is to be gross physically settled. If the obligation can be net-settled, derivative accounting would apply.

35 Most stakeholders agreed with the proposals, think they are broadly consistent with how such transactions are currently treated and provide useful clarifications.

36 Three stakeholders discussed that paragraph AG27B could result in entities having a large negative reserve and asked how this would be treated for prudential purposes. For example, would the debit balance be an asset?

37 One stakeholder said that the clarifications in paragraph 23 have introduced measurement into IAS 32, which is currently under IFRS 9. This could create conflicts around precedent and which Standard to apply. Also, regarding the present value of redemption amounts, the value of an NCI-put can be based on EBITDA multiples, so it is unclear how to apply this requirement in such cases. Further, if the probability and estimated timing of the counterparty exercising their right to redeem is ignored, are they also ignored for other variables?

<u>Staff recommendations</u>

38 Staff agree with stakeholders who said the clarifications on accounting for contracts containing an obligation for an entity to purchase its equity instruments should reduce diversity. We acknowledge that the accounting treatment will likely be a greater issue for other jurisdictions.

39 However, staff are concerned about extending the scope of IAS 32 beyond classification and presentation by creating a new approach for measuring financial liabilities. Staff think IFRS 9 (and IFRS 13) should apply to the recognition and measurement of financial liabilities arising from an obligation for an entity to deliver its own equity. We agree with stakeholders that introducing a new approach will create conflicts around precedent and which Standard to apply. We also think that IFRS 9 is designed to recognise and measure complex financial arrangements, while IAS 32 is not.

40 Staff suggest that rather than extending the scope of IAS 32 and limiting the scope of IFRS 9, the IASB might instead consider that ignoring probability and timing could be consistent with recognising the instrument at fair value under IFRS 9. For example, as explained in the September 2022 IASB meeting (Agenda Paper 5 para.44), the fair value of a financial liability with a demand feature should be measured at not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (paragraph 47 of IFRS 13 *Fair Value Measurement*). This logic could be discussed in IAS 32, leaving recognition and measurement under IFRS 9.[6]

41 However, if the IASB makes no changes following consultations, staff suggest a scope limitation be included in IFRS 9.

42 Staff also suggest that the IASB provides additional guidance on applying the proposed requirements if the present value of the redemption amount involves variables such as EBITDA multiples.

Question for Board members	
Q3	Do Board members agree with the staff recommendations in paragraphs 40-42? If not, what would Board members suggest?

[6] The application of the IASB's proposed approach to initial and subsequent measurement is raised for the first time at the February 2023 IASB meeting in Agenda Paper 5B (para. 31), available on the FICE project page, which states:

> However, the staff recommend clarifying that the same measurement approach would apply initially and subsequently. That is, the probability and estimated timing of the holder exercising the written put option is not considered in its initial and subsequent measurement. This would mean assuming immediate payment for financial instruments where the option could be exercised immediately and discounting to the earliest possible payment date where the exercise date could only occur in the future. Such a clarification would not only reduce diversity in practice but also avoid applying a measurement approach after initial recognition that would negate the measurement the IASB intended for these financial liabilities. The staff note that if the subsequent measurement did not use the same assumptions about timing of exercise as the initial measurement, the measurement objective that the initial measurement achieves would be lost on 'day 2'.

Relatedly, the Basis for Conclusion states that "in general, issues relating to the measurement of financial liabilities are outside the scope of the project" (para. BC82); however, "the Board considered that many questions about subsequent measurement could be resolved if an entity applied the same approach for subsequent measurement as that applied for initial measurement" (para. BC83). Staff note thathere appears to be no analysis for this conclusion, and the only reason provided is as above.

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.

<u>Stakeholder feedback and staff analysis</u>

Question 4(a)

43 The IASB was asked to clarify the order for applying IAS 32 regarding the interaction of the requirements for financial instruments with contingent settlement provisions (para.25) and compound financial instruments (paras. 28-32).

44 The proposed amendments confirm that entities apply paragraph 25 to identify whether a financial instrument with a contingent settlement feature is a compound financial instrument and, if so, the requirements in paragraphs 28-32 for compound financial instruments would also apply.

45 Stakeholders had no comments on this question. Staff agree with this clarification.

Question for Board members
Q4(a) Do Board members have any questions or comments?

Question 4(b)

46 The IASB was asked to clarify whether the probability of a contingent event occurring affects the measurement (at fair value) of the liability component of a compound financial instrument with a contingent settlement provision. In response, the IASB has addressed the initial and

subsequent measurement of all financial instruments with contingent settlement features, including compound financial instruments.

47 Paragraph 25 is concerned with classifying financial instruments with contingent settlement features and currently has no measurement requirements. If, under paragraph 25, the financial instrument is determined to be a compound financial instrument, paragraphs 28-32 require the components to be classified separately. Following paragraph 32, the entity would first determine the fair value of the liability component by reference to a similar financial instrument with no associated equity component. The equity component is then the difference between the fair value of the compound financial instrument (as a whole) and the liability component (para. 31). However, it is unclear what 'the fair value of a similar liability' in paragraph 32 means when the liability component is a contingency.

48 The IASB proposes to add a new paragraph 25A that states:

> The occurrence or non-occurrence of uncertain future events (or the outcome of uncertain circumstances) described in paragraph 25 that would require settlement, are outside the issuer's control. Therefore, the probability and estimated timing of occurrence or non-occurrence of uncertain future events (or the outcome of uncertain circumstances) have no effect on the initial or subsequent measurement of the financial liability arising from the contingent settlement provision. An entity measures the financial liability on initial recognition and subsequently at the present value of the settlement amount. The settlement amount is discounted, assuming settlement will occur at the earliest possible settlement date specified in the contract. Any gains or losses on remeasurement of the financial liability are recognised in profit or loss.

49 Paragraph 31 is amended as follows: "Except as stated in paragraph 25A, IFRS 9 deals with the measurement of financial assets and financial liabilities".[7]

50 Four stakeholders commented that paragraph 25A has introduced measurement into IAS 32, which is currently under IFRS 9. This could create conflicts around precedent and which Standard to apply. For example, changing the measurement approach could change the initial recognition amount of a financial liability because the new para 25A does not appear to be 'fair value' under IFRS 13.

51 Three stakeholders said the discount rate in determining the present value could require significant judgement without an objective measurement basis like fair value underpinning it (i.e., determining the discount rate that does not reflect probability might be challenging).

52 One stakeholder said the requirement to ignore probability and expected timing has no conceptual basis. However, a fifth stakeholder agreed that probability should be ignored due to the contractual nature of financial instruments.

53 Two stakeholders asked how the proposals in paragraphs 25 and 25A would apply when the redemption amount of the contingent liability (ignoring probability and timing) was more (or less) than the consideration received at issue. For example, if a mining company issues a note to fund exploration, they might agree to receive cash now of $70, and if or when they have achieved production and sales, they will pay $100 (which could be tomorrow or in three years). If they don't find anything, they pay back the $70. The journal entry would be DR Cash $70/CR Financial liability $100/DR? $30.

[7] For a discussion of the proposals, see the December 2021 IASB meeting Agenda Paper 5A (paras.19-35) available on the FICE project page.

Staff recommendations

54 Staff support the IASB view that the probability and timing of settlement should not be reflected in the initial carrying amount of a contingent liability or liability component . However, similar to our comments on Question 3 above, we are concerned about extending the scope of IAS 32 beyond classification and presentation by creating a new approach for measuring financial liabilities. Staff think IFRS 9 and IFRS 13 should apply to recognising and measuring financial liabilities. We agree with stakeholders that introducing a new approach will create conflicts around precedent and which Standard to apply. We also think that IFRS 9 is designed to recognise and measure complex financial arrangements, while IAS 32 is not.

55 Similar to our comment for Question 3, staff suggest that rather than extending the scope of IAS 32 and limiting the scope of IFRS 9, the IASB might instead connect their proposal with the existing requirements in IFRS 9 and IFRS 13.

56 However, if the IASB does not make any changes following consultations, staff suggest that a scope limitation be included in IFRS 9.

57 Staff also note that the measurement approach proposed in paragraph 25A (present value of the settlement amount) appears inconsistent with the measurement of a liability component in paragraph 32 (the fair value of a similar liability). We suggest that the inconsistency be resolved by clarifying in paragraph 25A that the proposed measurement approach estimates fair value and updating paragraph 32 to explain that the fair value of liabilities with contingent settlement features are in accordance with paragraph 25A.

58 Staff have some additional comments:

(a) According to the Basis for Conclusions (para. BC98-102), including the subject heading above paragraph BC98, the proposed amendments are in response to stakeholder questions about the initial measurement of the liability component of a compound financial instrument with a contingent settlement provision in paragraph 32. However, paragraph 25A will apply to all financial instruments with contingent settlement provisions. Staff suggest that the IASB amends the wording and discussion in paragraphs BC98-BC102 to clarify that the proposals apply to all financial instruments with contingent settlement features and explain the decision to apply new measurement requirements to such instruments.

(b) Stakeholders asked questions about the accounting treatment of the difference if the full amount of the contingent obligation is higher (or lower) than the cash proceeds at issue. IASB staff partly answer this question in paragraphs 36 and 37 of the December 2021 IASB meeting Agenda Paper 5A. However, paragraph 37 only clarifies the treatment of the difference if the instrument has debt and equity components (i.e., the residual would be allocated to the equity component) and is silent on how to account for the difference when the financial instrument and the contingent settlement provision are both liabilities.

(c) Staff also suggest it would be useful to clarify that paragraphs 25 and 25A do not apply to contingent events that affect the timing but not the settlement amount of the financial instrument, as explained in Agenda Paper 5A (paras. 38-40). For example, bond covenants can contain ratios involving liabilities, assets, and equity (e.g., 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 a 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.

Question for Board members

Q4(b) Do Board members agree with the staff recommendations in paragraphs 55-58? If not, what would Board members suggest?

Question 4(c)

59 The IASB was asked to clarify the treatment of distributions paid at the issuer's discretion if the equity component of a compound financial instrument has an initial carrying amount of zero.

60 Paragraphs 28-32 are concerned with classifying the components of compound financial instruments. The IASB has added proposed paragraph 32A that states:

> Any discretionary dividends or payments are part of the equity component even if, applying paragraph 25A, an entity allocates on initial recognition the carrying amount of the compound instrument entirely to the liability component. An entity, therefore, recognises any dividends paid as a distribution of profit or loss.

61 This proposal would require Australian banks (and insurers) to reclassify the discretionary payments on their AT1 capital notes from interest expense to equity.[8]

62 Most stakeholders said that the proposed treatment seems to make conceptual sense for discretionary payments, although they did not all agree with the proposal.

(a) One stakeholder observed that the proposed reclassification would, in most cases, improve the banks' net interest margin (NIM) and statutory profit.

(b) However, four stakeholders argued that practitioners had settled this matter and that the classification of distributions should not be changed. They question the logic of the proposal to transfer discretionary payments as dividends through equity and the usefulness of creating an accounting mismatch.

(c) The stakeholders discussed the nature of interest payments on the AT1 capital notes. For instance, although payments on the notes are described as discretionary in the prospectus, the interest rate is closely specified in a way that is not the same as for a dividend on ordinary shares, and conditions and penalties that apply can make the payment less discretionary to the issuer. One of the stakeholders pointed out that interest rate risk is associated with these payments. Two stakeholders questioned what a "discretionary" payment means in light of their comments.

(d) One of the stakeholders observed that the proposals could result in banks making non-IFRS adjustments in their investor presentations.

(e) Three stakeholders think the proposals could negatively affect banks' hedging arrangements. For example, hedge accounting would have to be discontinued if the distributions are classified as equity.

Staff recommendations

63 Staff agree with the IASB that the Australian AT1 capital notes are compound financial instruments under paragraphs 25 and 28. The requirement for the bank to exchange the instruments for a variable number of own shares subject to a trigger event represents the

[8] In the January 2014 IFRS Interpretations Committee Meeting Agenda Paper 9 staff analysed this issue with respect to the fact pattern presented by the big four Australian banks and the ABA (para.10). They concluded at that time that the discretionary distributions should be equity, however, any decision was deferred.

liability component (para.25). In contrast, the perpetual nature of the instruments and discretionary distributions represent the equity component. However, staff also agree with stakeholders that measuring the equity component at zero is an artifact of applying IAS 32. Accordingly, requiring the distributions to be treated as dividends creates an accounting mismatch that may not be justifiable on a cost-benefit basis. Further, the economic substance of these distributions is economically different from that of ordinary dividends. Staff suggest that the IASB could permit entities to make a policy choice when the full amount of a compound financial instrument is allocated to debt.

Question for Board members

Q4(c) Do Board members agree with the staff recommendations in paragraph 63? If not, what would Board members suggest?

Question 4(d) and 4(e)

64 The IASB was asked to define the meaning of the term 'liquidation' and provide additional guidance on the assessment of 'not genuine' in paragraph 25.

Liquidation

65 In paragraph 25, financial instruments may contain a requirement for settlement in cash contingent upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument. Such financial instruments are financial liabilities unless the contingent settlement terms that make it a liability are non-genuine (para.25(a)), arise only on liquidation of the issuer (para.25(b)), or the instrument is a puttable instrument per paragraphs 16A and 16B (para.25(c)).

66 The IASB proposes to add a definition of the term 'liquidation' in paragraph 11 (definitions section) as "the process that begins after an entity has permanently ceased its operations".

67 Two stakeholders questioned how the definition of liquidation could be applied in Australia, where there are voluntary and involuntary receiverships, and receivers often keep entities trading until the end of the process, which may or may not result in a winding up of the business. For example, the appointment of a receiver is more likely to trigger changes in the financial instrument. One of the stakeholders suggested the definition of liquidation may not be operational.

Staff recommendations

68 Staff support the IASB's conclusion that a contingent settlement provision that applies only in the event of an entity's liquidation should not influence classification because to do so would be inconsistent with the going concern assumption. Such a provision is similar to an equity instrument that has priority on liquidation and, therefore, would be ignored when classifying the instrument (para. BC112). Further, the proposed definition is consistent with common usage in Australia.[9] Although we acknowledge alternative views about whether the liquidation process should begin earlier, the IASB's conclusion and reasoning are consistent with the intention in IAS 32 and other parts of the Standard that refer to liquidation.

[9] For example, APRA defines liquidation as “The process of winding up a company by selling its assets and paying its debts, in full or in part, from the proceeds of the sale.” Source: https://www.apra.gov.au/glossary

Question for Board members

Q4(d) Do Board members agree with the staff recommendations in paragraph 68? If not, what would Board members suggest?

Non-genuine

69 Concerning 'non-genuine' the IASB proposes to amend guidance paragraph AG28 to clarify that an assessment of whether a contingent feature should be considered non-genuine under paragraph 25(a) "requires judgement based on the specific facts and circumstances (including the terms and conditions of the instrument) and is not based solely on the probability or likelihood of the contingent event occurring". However, like the existing paragraph AG28, it then adds that "a settlement provision based on a contingent event that might be very unlikely to occur could be genuine if the nature of the contingent event is neither extremely rare nor highly abnormal".

70 Seven stakeholders discussed the non-genuine guidance. Two stakeholders said that there seems to be a lot of time spent on non-genuine, and four think that clauses in Australia are usually genuine even if they are never expected to be used (e.g., non-viability clauses). One stakeholder offered examples of when clauses have not always been genuine. Three stakeholders said the wording in paragraph AG28 should be clearer because even though the probability might be remote, if something is there for a commercial reason, it is still genuine.

Staff recommendations

71 Staff agree with the IASB that judgement should be applied when assessing whether a contractual term is genuine; However, we agree with stakeholders that it should be clearer in paragraph AG28 that if something is in the contract for a commercial reason, it is genuine. For example, non-viability clauses are usually genuine, even though they may never be used.

Question for Board members

Q4(e) Do Board members agree with the staff recommendations in paragraph 71? If not, what would Board members suggest?

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.

<u>Stakeholder feedback and staff analysis</u>

72 For an issued financial instrument to be equity, the entity must have an unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation (para. 19). Where issued financial instruments have discretionary payments, to demonstrate this right, the decision about whether to make the payment must reside with the entity. However, in some cases, the discretionary payment must be approved by the entity's shareholders, and the question arises as to whether the entity has an unconditional right to avoid delivering cash.

73 Put another way, if a shareholder's decision about making a discretionary payment is considered an entity decision, all other things being equal, the entity would have an unconditional right to avoid delivering cash and the instrument would be classified as equity.

74 The IASB proposes to clarify in guidance paragraphs AG28A-AG28C whether and when a shareholder decision is an entity decision for paragraph 19. To summarise the proposals, matters initiated by management in the ordinary course of business and requiring only routine shareholder approval are more likely to be entity decisions. Consideration should also be given as to whether shareholders would be acting as individual investors (such as when different classes of shareholders have different rights and payoffs), in which case their decision-making is less likely to be an entity decision. The guidance provides for applying judgement based on the facts and circumstances and could vary across jurisdictions.

75 Most stakeholders said the guidance should be useful, provided the matters required to be considered are not intended to be exhaustive. Staff confirm the guidance is not exhaustive.

76 One stakeholder did not agree with the first two factors proposed to describe whether shareholder decisions are treated as entity decisions. Specifically:

(a) The term “routine in nature” (para. AG28A(a)) is not sufficiently clear and may lead to different interpretations.

(b) Further, according to paragraph BC119, decisions requiring a special majority are more likely to be non-routine. However, this might not necessarily be the case. For example, it is not uncommon for some company constitutions to require a special majority, such as when entering into a new significant customer contract or incurring expenses over a certain threshold amount.

(c) In addition, requiring a 75 percent majority might indicate that more shareholders must act in concert, providing more evidence that the decision is an entity decision.

(d) The stakeholder thinks most shareholder decisions around funding arrangements will relate to an action that would be proposed or a transaction initiated by the entity's management (para. AG28A(b)) because it is management's role to plan and direct the activities of the entity.

<u>Staff recommendations</u>

77 Staff agree that most decisions of ordinary shareholders at a general meeting are the entity's decisions. However, acknowledging different circumstances and viewpoints, particularly across jurisdictions, we think the IASB has struck the right balance of providing non-prescriptive guidance while observing that outcomes could differ across jurisdictions.

78 Staff also note that the IASB has decided that because the proposed approach could differ from other Standards itcannot be applied by analogy when applying the requirements in other IFRS Accounting Standards to transactions involving shareholders or management (para. BC125). Staff are uncertain of this decision and suggest that the IASB reconsiders the possible implications of conflicting definitions or guidance.

Question for Board members

Q5 Do Board members agree with the staff recommendations in paragraphs 77-78? If not, what would Board members suggest?

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.

<u>Stakeholder feedback and staff analysis</u>

79 Paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument on initial recognition as a financial liability or an equity instrument. However, the Standard contains no general requirements on whether or when to reclassify the instrument after initial recognition.

80 The IASB proposes to clarify when instruments can be reclassified if the substance of the contractual arrangement changes without any modification to its contractual terms by adding a new chapter in IAS 32 titled: Reclassification of financial liabilities and equity instruments.

   (a) Proposed paragraph 32B sets out that an entity shall not reclassify a financial liability or an equity instrument after initial recognition unless paragraph 16E (reclassification of puttable instruments) applies or "the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement".

(b) Proposed paragraph 32C states that such external events arise from "events not specified in the contract that have not been considered in classifying the financial instrument on initial recognition. Such events are not specific to a particular instrument; however, they would affect an entity's business activities and operations, for example, a change in an entity's functional currency or a change in an entity's group structure."

(c) Proposed paragraph 32D requires that the reclassification be made prospectively and that amounts previously put to profit or loss would not be reversed. An entity shall measure a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification with differences put through equity, and an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification with no differences recognised.

(d) Proposed guidance paragraph AG35A provides examples of changes in circumstances external to a contractual arrangement that could change the substance of the contractual arrangement (examples are from para. 32C).

81 Most stakeholders agreed with the proposals and confirmed they are consistent with current practice.

82 Two stakeholders discussed how the proposals would apply to an instrument where laws and regulations that were not considered for classification at issuance change during its life such that the terms of the instrument become 'in addition to' the laws and regulations. For example, consider an entity required by law to pay a minimum dividend of (say) 15 percent, and that is written into the contract. The law then changes so that the minimum dividend is now 5 percent. The 15 percent was initially disregarded for classification purposes. The stakeholders have asked whether this would be an example of a 'change in circumstances external to the contractual arrangement' that would give rise to a reclassification. If so, given the inclusion of the statutory minimum dividend requirement example in new paragraph AG24B, perhaps also include a change in laws and regulations as an example in new paragraphs 32C and AG35A.

83 One stakeholder suggested that reclassification should also apply when the conversion price of a financial instrument changes from variable to fixed. For example, where a convertible note matures in ten years and converts into a variable number of shares until year 3, and then from years 4-10, will convert into a fixed number of shares. The stakeholder thinks that from year four, it is appropriate for the conversion feature to be classified as equity because, consistent with IFRS 9 paragraph 3.3.1 (derecognition of financial liabilities), the obligation to deliver a variable number of shares has expired at the end of year 3. From year 4, the conversion feature will only convert into a fixed number of shares. The stakeholder thinks this is a better alternative than requiring additional disclosure in IFRS 7 paragraph 30F and is more consistent with IAS 1 *Presentation of Financial Statements* in terms of providing relevant information to users of financial statements.

Staff recommendations

84 Staff acknowledge the stakeholder's view that reclassification should be permitted if a financial liability changes in nature due to the passage of time. Such a reclassification would more faithfully represent the substance of the contractual arrangement at each reporting date. However, others think reclassifications should be prohibited or greatly restricted to reduce the burden on preparers and improve the year-on-year comparability of financial statements for users. Recognising the different views, staff agree with the IASB's decision to permit reclassification in limited circumstances such that preparers would not need to make annual evaluations of their financial instruments (para. BC144-49).

85 Staff make the following analysis of the stakeholders' question about whether a change in laws and regulations not considered on the initial classification of the contract could result in a

reclassification event. Based on the analysis,we request that the IASB clarifies in the Basis for Conclusions that changes in general laws and regulations not considered part of the contract for initial classification per paragraph 15A(b) would not result in a reclassification because they will not affect an entity's business activities overall:

(a) Following paragraph 32C, relevant external events are "changes in circumstances external to the contractual arrangement [that] arise from events not specified in the contract that have not been considered in classifying the financial instrument on initial recognition."

(b) Therefore, a change in general laws and regulations that meet the definition in 15A(b) and is not considered in classifying the financial instrument on initial recognition could meet this first condition in paragraph 32C if the laws are not written into the contract.

(c) Paragraph 32C also requires that relevant external events "would affect an entity's business activities and operations". Paragraph BC133 describes events that affect "an entity's business activities overall." Staff are not certain whether a change in laws and regulations that do not form part of the substance of a contract could affect an entity's overall business activity. Perhaps a change in mandatory dividends in some jurisdictions could be thought to do so.

Question for Board members

Q6 Do Board members agree with the staff recommendations in paragraphs 84-85? If not, what would Board members suggest?

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.

<u>Stakeholder feedback and staff analysis</u>

86 The IASB proposes extending the scope and objective of IFRS 7 to include equity and has also proposed additional disclosure requirements based on its deliberations on the classification and presentation topics.

87 Six stakeholders agreed with the disclosures overall and think they will be useful to help users understand the nature and priority of claims. There were some specific comments:

(a) Two stakeholders said that some companies with complex capital structures are reluctant to disclose appropriately, or their disclosures can be insufficient, so the additional disclosure requirements should be helpful.

(b) Proposed paragraph 17A requires that for compound financial instruments, with both a liability and an equity component, an entity shall disclose (a) the terms and conditions of the instrument that determine its classification on initial recognition and (b) the amounts allocated on initial recognition to the liability and equity components in the reporting period in which the financial instrument is initially recognised. One stakeholder suggested paragraph 17A(b) seems unnecessary as the requirements would be covered by the statement of changes in equity and the requirements of IAS 7 *Statement of Cash Flows* paragraphs 44A-44B (changes in liabilities arising from financing activities). The stakeholder suggested that rather than add paragraph 17A(b), there should be an amendment to IAS 7 paragraph 44B to add 'compound financial liabilities' as an example of a financing activity that should be disclosed.

(c) Proposed paragraph 20 requires that an entity disclose certain items of income, expense, gains or losses in the statement of comprehensive income or in the notes. The proposed addition to paragraph 20(a)(i) states that "for financial liabilities that include contractual obligations to pay amounts that vary with the issuing entity's performance or changes in its net assets, the entity shall disclose the gains or losses recognised on these financial liabilities in each reporting period separately from the gains or losses on other financial liabilities." The IASB concluded that such financial liabilities would generally be measured at fair value through profit or loss because the financial liability would typically be an embedded derivative (para. BC183). One stakeholder thinks this is inconsistent with advice from professional services firms who say the feature is not a derivative, as it contains a non-financial variable specific to a party to the contract.

(d) Proposed paragraphs 30A and30B require entities to disclose information that enables users of financial statements to understand the nature and priority of claims against the entity on liquidation arising from all of its financial liabilities and equity instruments within the scope of IAS 32. Two stakeholders discussed that it might be better to use the country of jurisdiction or entity-specific definitions that trigger changes in the contract to provide the order of disclosures (rather than liquidation).

(e) Proposed paragraph 30B(a) requires entities to disclose the carrying amounts of each class of claims arising from financial instruments based on their contractual nature and priority on liquidation and distinguish between (i) secured and unsecured claims and (ii) subordinated and unsubordinated claims. One stakeholder thought that the meaning of 'subordinated' is not always straightforward and can be context-specific.

(f) Implementation Guidance paragraph IG14F shows in tabular format the requirements of proposed paragraph 30H to present the maximum potential dilution to the entity's ownership structure resulting from financial instruments issued at the reporting date. One stakeholder suggested that the tabular disclosure might be more useful if entities disclosed the maximum number of ordinary shares (para. 30H(a)) and the net maximum number of ordinary shares (para. 30H(b)) *if conversion occurred at the reporting date*. The stakeholder observed that, in practice, most convertible notes convert into a variable number of shares; therefore, disclosing the information as "unknown" in such cases (as in the example) is not useful.

(g) One stakeholder thought the potential dilution of ordinary share disclosure requirements (para. 30G-H) could require substantial work. Another stakeholder asked whether there is any overlap with IAS 33 *Earnings Per Share*.

<u>Staff recommendations</u>

88 Staff agree with stakeholders that the proposals should provide useful information to users. We do not recommend any changes at this time. However, staff will discuss the proposed disclosures with the users of financial statements at the UAC meeting on 29 February 2024. Staff will reflect any significant feedback from the users in the submission letter.

Question for Board members

Q7 Do Board members agree with the staff recommendations in paragraph 88? If not, what would Board members suggest?

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.

<u>Stakeholder feedback and staff analysis</u>

89 The proposed amendments to IAS 1 require an entity to present amounts attributable to ordinary shareholders separately from those attributable to other holders of the entity's equity instruments.

90 Five stakeholders agreed with the proposal to separate amounts relating to ordinary shareholders from other owners of the parent in the financial statements. Most stakeholders said it would be useful to users. Some of them made general comments:

(a) One stakeholder observed the proposals are similar to USGAAP. The stakeholder suggested that the IASB could allow some flexibility on presentation (i.e., in the notes), although the requirements should be helpful overall.

(b) One stakeholder agreed with the proposals but observed that as there can be different classes of equity holders, it could be useful to include a table in the notes by class of shareholder.

(c) Two stakeholders thought the presentation proposals could add a lot of detail.

(d) One stakeholder asked if there might be any follow-on effects to the disclosure requirements of IAS 33 *Earnings per Share* that apply when an entity has more than one class of equity instrument outstanding.

(e) One stakeholder was uncertain about how to split a hedge reserve between ordinary and preference shareholders.

<u>Staff recommendations</u>

91 Staff agree with stakeholders that the proposals should provide useful information to users. We do not recommend any changes.

Question for Board members
Q8 Do Board members agree with the staff recommendations in paragraph 91? If not, what would Board members suggest?

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.

Stakeholder feedback and staff analysis

92 The IASB proposes to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information and some modifications to reduce costs.

93 One stakeholder agreed that the changes should be retrospective.

94 Seven stakeholders raised concerns about the proposed retrospective application:

(a) Two stakeholders said they would prefer the transition to be made prospectively because some transactions could change significantly. One of the stakeholders said retrospective application might impact prior period acquisitions, especially if the NCI-put requirements were different under the proposed changes. For example, under IFRS 3, changes are usually made prospectively.

(b) Three stakeholders asked how long the expected transition period would be. If it is a longer period, they will have more time to make the necessary remeasurements.

(c) Two stakeholders said that the changes could represent a great deal of work for some entities and involve significant judgement.

Staff recommendations

95 Staff note the IASB view is that "the benefits of retrospective application would outweigh the costs because the proposals relating to classification are not very different from the requirements in the issued Standards because the objective of the project is to make clarifying amendments to the underlying principles in IAS 32 instead of fundamentally changing any requirements" (para. BC263(a)).

96 However, staff agree with the stakeholders that some clarifications will require significant work and judgement, particularly for a financial institution. If the IASB does not agree to make the transition prospective, we suggest there should be a substantial period between the Standard being issued and its mandatory application.

Question for Board members
Q9 Do Board members agree with the staff recommendations in paragraph 96? If not, what would Board members suggest?

Question 10—Disclosure requirements for eligible subsidiaries (paragraphs 54, 61A–61E and 124 of [IFRS XX])
The IASB proposes amendments to the draft Accounting Standard [IFRS XX *Subsidiaries without Public Accountability: Disclosures*], which will be issued before the proposals in the Exposure Draft are finalised. [IFRS XX] will permit eligible subsidiaries to apply the recognition, measurement and presentation requirements in IFRS Accounting Standards with reduced disclosures. The IASB's proposals select appropriate disclosure requirements from those proposed for IFRS 7, based on the IASB's agreed principles for reducing disclosures. Paragraphs BC257–BC261 explain the IASB's rationale for the selected disclosures. 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, taking into consideration the reduced disclosure principles described in BC258.

Stakeholder feedback and staff analysis

97 The IASB proposes amendments to the draft Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures].

98 Stakeholders had no comment.

Staff recommendations

99 Staff have no further comments.

Question for Board members

Q10 Do Board members have any questions or comments?

Next steps

100 The comment period to IASB ED/2023/5 closes on 29 March 2024. As there is no further AASB meeting before the comment period close date, staff suggest a comment letter reflecting the Board's decisions from this meeting will be finalised out-of-session by the Chair.

101 The proposed timing is as follows:

During week beginning	Deliverable
12-20 March 2024	Staff will draft the comment letter reflecting the Board’s comments.
20 March 2024	Staff circulate a draft comment letter to the Chair for final comments.
25 March 2024	The Chair reviews the comment letter and provides comments.
25-26 March 2024	Staff update the comment letter.
28 March 2024	The comment letter is signed by the AASB Chair and submitted to the IASB.

Questions for Board members

Q11 Do Board members agree with the staff recommendation that the AASB submission is finalised out-of-session by the Chair?

Q12 Do Board members have any comments or concerns about the proposed timing of the finalisation of the AASB comment letter?