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12 Truro Place City Beach WA 6015

12 February 2024

Dr Keith Kendall
Chair
Australian Accounting Standards Board
PO Box 204
Collins St West
VIC 8007

Dear Keith,

AASB Exposure Draft ED 327 *Financial Instruments with Characteristics of Equity*

We are pleased to respond to the above Exposure Draft (the ED).

We support the International Accounting Standards Board (IASB)'s approach in the ED to focus on clarifying the classification requirements in IAS 32 and to address known practice issues that arise in applying IAS 32.

We note that in practice the following underpinning requirements in IAS 32 are well understood:

- A contractual obligation to deliver cash or another financial asset that it cannot avoid results in financial liability classification.
- The 'fixed for fixed' criterion for equity classification.

We also support the IASB's efforts to improve the presentation and disclosure of information about financial liabilities and equity instruments. We think this information is important because, we are aware of various alternative source of complex funding arrangements that have various combination of both debt and equity features in practice, as entities, especially early start-up companies, seek finance to fund their activities. It is important for users of financial statements to understand the potential dilutive effects and priority of claims of various type of instruments.

Our responses to the questions in the ED are set out in the attached Appendix.

We hope that you will find our comments and observables helpful. If you would like to discuss any of them further, please contact Judith Leung at 0416 176 262 or by email at judith@basfordconsulting.com.

Yours sincerely
Basford Consulting Pty Ltd

Wayne Basford
Managing Director

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 disagree with the proposals and instead we support an 'all-inclusive' classification approach. This is because as set out in BC 14 of the ED, an 'all-inclusive' classification approach would be consistent with:

- paragraph 4.60 of the Conceptual Framework;
- other IFRS Accounting Standards that address similar issues such as IFRS 15 *Revenue from Contracts with Customers*; and
- how contracts are viewed from a legal perspective.

In addition, we think an 'all inclusive' approach would be consistent with the requirement in paragraph 18 of AASB 132, which states that "the substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position."

We note one of the arguments against an 'all-inclusive' classification approach is that it would be in be inconsistent with the approach in IFRS 9 *Financial Instruments* for assessing the contractual cash flow characteristics of financial assets. However, we note that the contractual cash flows characteristics test serves different purpose, in that, it is a test that serves to determine the subsequent measurement category of a financial asset, so it is a different type of classification test.

We therefore, think that classifying a financial instrument without an "all inclusive" approach would not faithfully depict all the obligations that has arisen as a result of the entity issuing the financial instrument.

In addition, it is also not clear how the IASB's proposed requirements are to be applied. For example, for a bail-in instrument, if it converts into a fixed number of shares based on the issuer's discretion but under the relevant laws and regulations it must convert into a number converts into a variable number of shares based on a non-viability event. Under the proposal, it seems to imply that conversion feature would be classified as equity since prudential regulation is required to be ignored. If this is the case, we think that is an odd outcome, as set out above, we think it does not faithfully depict and capture all the obligations that the entity has as result of issuing the financial instrument.

Question 2—Settlement in an entity's own equity instruments

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.

We generally agree with the proposals in principle, to clarify the fixed-for-fixed criterion and think the clarifications are helpful.

However, we think the wording and drafting in Example 14 in the draft Illustrative Examples needs to be clarified. We think in order for the conversion feature to qualify for fixed-for-fixed the predetermined passage of time adjustment should only apply:

- Where accrued interest is fixed (this was not specified in the Example 14); and
- There is only one pre-determined outcome at any one time. In Example 14, it could be read to imply that there could be two possible outcomes CU110 or CU150 i.e. it could either convert into 110 shares or 150 share at conversion.

Question 3—Obligations to purchase an entity's own equity instruments

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.

We agree with the IASB's proposals.

We understand that there has been diversity in practice across different jurisdictions and we think the proposals would provide clarification and improve consistency in application.

Question 4—Obligations to purchase an entity's own equity instruments

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.

We agree with the IASB's proposals. We think the proposals would provide clarification and improve consistency in application.

However, we note that in some circumstances, a financial liability could contain a contingent settlement feature, where the undiscounted full amount payable under the contingent settlement feature is a greater value than the cash or consideration received. In some standby funding arrangements / cash facilities, the liability exists before the cash is drawn. It is not clear how the standard would be applied in these circumstances where the full obligation of the financial liability is recognised but cash or consideration received is less than that amount.

Question 5—Shareholder discretion

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 do not agree with the first two factors that are proposed to describe whether shareholders decisions are treated as entity decisions.

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

- We are not sure what "routine in nature" means and how it is to be applied and interpreted in practice. For example, Entity A might issue a particular convertible note that will convert into shares subject to shareholder discretion in 3 years' time. The decision to convert or not would not be a recurring decision that would be made at the annual general meeting on a year-on-year basis. However, compare with Entity B, that might issue the same convertible note with the same terms, but has larger funding needs so might issue one note every year, and therefore similar decisions would be tabled at Entity B's annual general meeting on a year-on-year basis.
- Furthermore, according to BC 119, investment decision that require special majority are viewed as making investment decisions. However, we think this might not necessarily always be the case. It is not uncommon for some company constitutions to require special majority for example entering into a new significant customer contract or incurring expenses over a certain threshold amount. In addition, we think the fact that requiring 75% majority point to the fact that more shareholders have to act in concert and therefore provides more evidence that it represents an entity decision.

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

- Most shareholder discretion decisions relating to funding arrangements would generally meet this criterion, as outlined in BC121 it is management's role to plan and direct the activities of the entity.

Whilst we understand that in practice if a decision is to be made at a general meeting by shareholder vote, this is viewed as an entity decision. An alternative approach, which is contrary to current practice, is to always view with a rebuttable presumption that shareholders will always vote for its own benefit and therefore any decisions subject shareholder approval would not be seen as entity decisions.

Question 6—Reclassification of financial liabilities and equity instruments

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 generally agree with the proposals.

However, we think reclassification should also apply to a situation where the conversion price changes from variable to fixed. For example, where a convertible note matures in 10 years times. The note converts into a variable number of shares until year 3, and then from year 4 – year 10 it will convert into a fixed number of shares e.g. 100 shares. We think that from year 4 it is appropriate for the conversion feature to be classified as equity because, consistent with AASB 9.3.3.1, 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.

In our view, this is a better alternative then requiring further additional disclosure in AASB 7.30F under this situation.

This is also consistent with AASB 101 *Presentation of Financial Statements* in terms of providing relevant information to users of financial statements. We do not think classifying a conversion feature as liability would be useful information if the variability has already lapsed.

Question 7— Disclosure

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 agree with the disclosures proposed. We think it is important that users understand the nature and priority of claims.

For the disclosure proposed in AASB 7.30H to be more useful, we suggest requiring entities to disclose the maximum number of ordinary shares (AASB 7.30H(a)) and the net maximum number of ordinary shares (AASB 7.30H(b)) if conversion occurred at reporting date. We note that a majority of convertible notes in practice converts into a variable number of shares, disclosing "UNKNOWN" is not very useful information.

Question 8—Presentation of amounts attributable to ordinary shareholders

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 agree with the proposal to separate out amounts relating to ordinary shareholders and from other owners of the parent in the statement of financial position, statement of comprehensive income and statement of changes in equity.

This is because we think it is important for the ordinary shareholders to understand the amounts that relates to them and the amount that belongs to other equity holders. If ordinary shareholders are diluted from the issue of other equity instruments, the ordinary shareholders can see the effect of the dilution on their share from the proposed disclosure.

In addition, if there are different classes of other equity holders, we think a table disclosing separately the amounts that relates to different classes of equity holders in the notes, would be useful. The amounts that are attributable to each class of equity holders is then apparent from the notes in the financial statements, and each class of equity holders would be able to obtain an understanding of the amounts attributable to their investments. Ordinary shareholders would also be able to obtain a more detailed understanding of the amounts that are attributable to each of the other classes of equity holders and the extent of dilution, if any, on their ordinary shares.