UKEB
UK Endorsement Board

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3 April 2024

Dear Dr Barckow

Exposure Draft IASB/ED/2023/5 Financial Instruments with Characteristics of Equity: Proposed amendments to IAS 32, IFRS 7 and IAS 1

1. The UK Endorsement Board (UKEB) is responsible for endorsement and adoption of IFRS Accounting Standards for use in the UK and therefore is the UK's National Standard Setter for IFRS Accounting Standards. The UKEB also leads the UK's engagement with the IFRS Foundation on the development of new standards, amendments and interpretations. This letter is intended to contribute to the Foundation's due process. The views expressed by the UKEB in this letter are separate from, and will not necessarily affect the conclusions in, any endorsement and adoption assessment on new or amended international accounting standards undertaken by the UKEB.

2. There are currently approximately 1,500 entities with equity listed on the London Stock Exchange that prepare their financial statements in accordance with IFRS.[1] In addition, UK law allows unlisted companies the option to use IFRS and approximately 14,000 such companies currently take up this option.[2]

3. We welcome the opportunity to provide comment on the International Accounting Standards Board (IASB) Exposure Draft (ED) *Financial Instruments with Characteristics of Equity: Proposed amendments to IAS 32, IFRS 7 and IAS 1* (the Amendments). In developing this letter, we have consulted with stakeholders in the UK, including preparers, accounting firms and institutes, and users of accounts.

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[1] UKEB calculation based on LSEG and Eikon data, May 2023. This calculation includes companies listed on the Main market as well as on the Alternative Investment Market (AIM).

[2] UKEB estimate based on FAME (company information in the UK and Ireland produced by the Bureau Van Dijk, a Moody's analytics company), Company Watch financial analytics and other proprietary data.

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4. We support the IASB's objectives in developing the Amendments, and we are broadly supportive of the proposals. We consider it important to provide clarity and minimise the risk of diversity in accounting practice in this complex area. Our main observations and recommendations are set out in the paragraphs that follow. Responses to the IASB's specific questions about the ED are included in the Appendix to this letter.

Measurement – obligations to redeem own equity and contingent settlement provisions

5. The measurement of financial liabilities is addressed by IFRS 9 *Financial Instruments*. We are concerned that introducing measurement provisions into a presentation standard goes beyond the objective of IAS 32, set out in paragraph 2 of the standard, and risks confusion for stakeholders. We consider that there are significant challenges in introducing what is in effect a new measurement basis for obligations to redeem own equity and contingent settlement provisions, and recommend the IASB consider addressing any measurement concerns arising in this context within its *Amortised Cost Measurement* project.

6. We consider that the proposals could lead to a change in measurement for some instruments, could lead to unintended consequences and may reduce the relevance of information provided to users.

7. In relation to obligations to redeem own equity, the addition in paragraph 23 of the ED "*The redemption amount is discounted, assuming redemption will occur at the earliest possible redemption date specified in the contract*" could lead to a change in measurement of some relatively common instruments in the UK, such as NCI put options with redemption amounts linked to EBITDA. We recommend retaining the existing reference to IFRS 9 *Financial Instruments* within paragraph 23 and removing the final two sentences of ED paragraph 23.

8. In relation to contingent settlement provisions, the introduction of initial and subsequent measurement requirements as proposed in ED paragraph 25A similarly appears to go beyond the scope of this project and could lead to unintended consequences. We understand that, in the absence of guidance, preparers and auditors currently use their judgement in measuring contingent settlement provisions. We therefore recommend removing paragraph 25A.

9. Our detailed comments on obligations to redeem own equity are in paragraphs A14 to A25 of the appendix and on measuring contingent settlement provisions in paragraphs A26 to A29 of the appendix.

Reclassification

10. We welcome the IASB's efforts to clarify this important area. However, we are concerned that the proposals in their current form could have the following unintended consequences: the classification of financial instruments diverging from their substance; inconsistencies between financial liabilities that result from obligations to redeem own equity and other financial liabilities; and an inappropriate change to established practice.

11. The prohibition of reclassification in respect of contractual terms that become, or stop being, effective with the passage of time could result in misleading information. This is because the continuing recognition of a financial liability in such circumstances may no longer faithfully represent the substance of the financial instrument. Example circumstances include the expiry of a contingent settlement provision and a change in terms with the passage of time that results in the instrument meeting the criteria for equity classification.

12. We recommend that the IASB consider requiring reclassification of instruments where contractual terms become, or stop being, effective with the passage of time. This would allow consistency with the current application of IAS 32 and avoid some of the potentially unintended outcomes highlighted by stakeholders. We do not consider that such a requirement would significantly increase costs or complexity for most preparers.

13. However, whether the IASB decides to proceed with the proposals in the ED or to adopt a different approach, we recommend enhancing the Application Guidance on the distinction between reclassification and derecognition, for example in relation to the exercise of an issuer call option in an equity instrument. We believe that in some of the examples raised with us, and in the circumstances set out in paragraph BC143, derecognition of a liability component may be the appropriate outcome, thus resolving the problem.

14. Our detailed comments on reclassification are in paragraphs A33 to A47 of the appendix.

Scope of requirements relating to contingent settlement provisions

15. We understand the IASB considers paragraphs 25 and 25A to apply only in scenarios where the classification of an instrument is determined by a contingent settlement provision. However, we believe the scope is not clear, and that the new measurement guidance in paragraph 25A can be read as applying not only to features of a compound instrument, but to any contingent settlement feature in debt instruments. This additional application to common features within debt instruments such as tax or law change clauses or loan covenants appears to be an unintended consequence.

16. We recommend that the IASB clarify the scope of paragraph 25 as follows: "*A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that the instrument (or a component of it (see paragraph 28)) would be a financial liability,* ***only*** *in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder of the instrument.*"

17. Our detailed comments on the scope of paragraph 25 are in paragraphs A30 to A31 of the appendix.

Fixed-for-fixed

18. We broadly welcome the IASB's proposals in this area. However, the wording of ED paragraph 22C(b)(iii) has caused some confusion as to whether a passage-of-time adjustment could be derived only from a fixed rate, and whether there was any requirement for the rate to be reasonable.

19. ED illustrative example 20 appears to rule out the use of a benchmark rate of interest from meeting the definition of a passage-of-time adjustment. This would depart from current UK practice and appears overly restrictive since reference to a benchmark rate is an established way of reflecting the passage of time. We therefore recommend that the IASB include specific acknowledgement in the Standard that financial instruments that are linked to determinable benchmark rates meet the fixed-for-fixed condition.

20. Further, we consider that providing additional explanation of the meaning of 'proportional', together with further examples of successful and unsuccessful passage-of-time adjustments, should help avoid diversity in practice.

21. Our detailed comments on settlement in an entity's own equity instruments are in paragraphs A9 to A13 of the appendix.

Disclosures

22. We welcome these proposals. However, we consider that the potential volume and cost of the additional disclosures relative to the benefits to investors needs further investigation. We recommend the IASB consider undertaking field testing before finalising the disclosure requirements, targeted at those preparers who will be affected most.

23. Stakeholders have indicated that ED IFRS 7 paragraph 30B may be difficult to apply in groups, where establishing the priority of instruments on liquidation may not be possible when the instruments are held in different legal entities. Further, as claims within one legal entity are not subordinated to those in any other, a consolidated disclosure could be misleading. We recommend that the IASB remove paragraphs 30A and 30B, as the broad disclosure objectives set out in IFRS 7 paragraph 1 may be met more effectively by the requirement to disclose

the terms and conditions of compound financial instruments in paragraph 17A, and the terms and conditions of financial instruments with financial liability and equity characteristics in paragraphs 30C to 30E.

24. Our detailed comments on disclosures are in paragraphs A48 to A54 of the appendix.

Transition

25. We are supportive of the principle of full retrospective adoption, as we recognise this leads to greater comparability across different reporting periods.

26. However, stakeholders have raised concerns about the complexities of retrospective adoption of the amendments in relation to obligations to redeem own equity associated with previous business combinations.

27. Further concerns have been raised by representatives of small- and medium-sized accounting firms, and private equity investors. These stakeholders tell us that, for such entities, complex financial instruments are relatively commonplace, and that full retrospective restatement could lead to significant additional costs of transition with no clear benefit.

28. We therefore recommend that consideration be given to providing transitional relief from full retrospective application where this would require undue cost or effort, as permitted under IFRS 9 in relation to impairment. We further recommend that if financial instruments have been extinguished at the date of initial application, they should not be required to be restated.

29. We also recommend that the IASB consider an across-the-board transition relief from restating comparatives, which would permit entities to assess classification at the date of initial application, similar to the proposals in the *Classification and Measurement of Financial Instruments* ED paragraph 7.2.48. We suggest this is done on the basis of the facts and circumstances at that date, including an assessment of only features that have not expired at that date.

30. Our detailed comments on transition are in paragraphs A56 to A65 of the appendix.

Laws and regulations

31. As drafted, it is currently not clear how these provisions would apply to Additional Tier 1 and Restricted Tier 1 capital instruments issued in the UK by banks and insurers respectively. We recommend providing further clarity on how these provisions apply in scenarios where regulations require the inclusion of a loss absorption feature, but the issuer has some discretion over the form of that feature.

32. Our detailed comments on laws and regulations are in paragraphs A1 to A8 of the appendix.

33. If you have any questions about this response, please contact the project team at UKEndorsementBoard@endorsement-board.uk.

Yours sincerely

Pauline Wallace
Chair
UK Endorsement Board

Appendix A: Questions on ED *Financial Instruments with Characteristics of Equity – Proposed amendments to IAS 32, IFRS 7 and IAS 1*

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.

A1. We welcome the proposals as a pragmatic solution to questions that arise around the extent to which a legal requirement is part of the contractual terms.

A2. Paragraph 15A(b) has created some confusion, as it appears to duplicate aspects of paragraph 15A(a) without enhancing the clarity of the requirement. We recommend that the IASB clarify how paragraph 15A(b) differs from 15A(a) or considers removing it.

A3. The IASB has set out two examples of how these proposals may affect financial instruments: accounting for a financial instrument in a jurisdiction with a legal minimum dividend and accounting for a financial instrument with a bail-in feature.

A4. As the UK does not have a legal minimum dividend, the first example may affect foreign subsidiaries of UK groups but is not expected to affect UK practice.

Additional Tier 1 (AT1) and Restricted Tier 1 (RT1) Instruments

A5. Paragraph BC13 contains guidance on accounting for AT1 instruments. We recommend it be moved to the IAS 32 Application Guidance. As a matter of principle, we consider that guidance on the required accounting should be contained within the Standard rather than within the Basis of Conclusions.

A6. In the UK, in order to qualify as regulatory capital, an AT1 or RT1 instrument must have a loss absorption feature. However, this could take the form of a conversion feature or a write down feature, neither of which are specified in law, but which would be specified in the contract. Stakeholders have noted that, as drafted, it is not clear how these provisions would apply to AT1 and RT1 instruments issued in the UK by banks and insurers respectively. Given the specific terms of the instruments issued in the UK, it is not anticipated that the proposals would be likely to lead to any change in classification for UK-issued instruments. However, it is unclear how the proposals would apply in other situations in which a legal or regulatory requirement could be satisfied in several ways. It would be helpful if the IASB clarified how this scenario should be taken into account in classification.

A7. We recommend that the IASB also include an illustrative example, with supporting analysis and conclusion, based on paragraph BC13 in order to clarify how laws and regulations might apply to AT1 and RT1 instruments, and which could usefully address the following fact pattern:

> "*Consider an AT1 instrument issued by an entity to meet regulatory requirements. It is a perpetual instrument with obligations that arise only on liquidation of the issuer.*
>
> *The regulations require the instrument to have a loss absorption feature which operates either through conversion to common shares at a trigger point of at least a set percentage of the entity's Common Equity Tier 1 capital, or through a write-down mechanism which comes into force at a trigger point of at least a set percentage of the entity's Common Equity Tier 1 capital.*
>
> *The regulations therefore require a loss absorption feature but provide choices for how the requirement might be satisfied.*"

A8. In addition, stakeholders have observed that the explanations in the Basis for Conclusions supporting the changes in relation to financial instruments with bail-in features could be enhanced, to avoid the risk of confusion. The IASB refers to 'bail-in' provisions in AT1 instruments in paragraph BC13. The description appears to conflate loss absorption features, which may be required by regulation for an instrument to qualify as regulatory capital, with bail-in, which is a resolution tool available to the regulator under legislation, as observed in paragraph BC21(a).

Question 2—Settlement in an entity's own equity instruments (paragraphs 16, 22, 22B–22D, AG27A and AG29B of IAS 32)
The IASB proposes to clarify when the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32 is met by specifying that the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency, and either: a) fixed (will not vary under any circumstances); or b) variable solely because of: i. preservation adjustments that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders; and/or ii. passage-of-time adjustments that are predetermined, vary with the passage of time only, and have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments (paragraphs 22B–22C). The IASB also proposes to clarify that if a derivative gives one party a choice of settlement between two or more classes of an entity's own equity instruments, the entity considers whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative is an equity instrument only if all the settlement alternatives meet the fixed-for-fixed condition (paragraph AG27A(b)). The IASB further proposes to clarify that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument (paragraph 22D). Paragraphs BC31–BC61 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

A9. We welcome the proposed clarifications and consider that they will reduce diversity in practice.

Preservation adjustments

A10. We consider the wording of the requirement at 22C(a)(ii) could be enhanced to provide greater clarity. Future equity holders have no current interest in the entity's own equity instruments, so it is not clear how their interest can be 'preserved'. We consider that it would be helpful to include an illustrative example of a successful preservation adjustment.

Passage-of-time adjustments

A11. The wording of ED paragraph 22C(b)(iii) has caused some confusion among stakeholders. Some understood the term "*a present value*" to mean that only adjustments set at variable rates could meet the definition of a passage-of-time adjustment; others thought that both fixed and variable rates could do so.

A12. ED illustrative example 20 appears to rule out the use of a benchmark rate of interest from meeting the definition of a passage-of-time adjustment. This would depart from current UK practice and appears overly restrictive since reference to a benchmark rate is an established way of reflecting the passage of time. We therefore recommend that the IASB include specific acknowledgement in the Standard that financial instruments that are linked to determinable benchmark rates meet the fixed-for-fixed condition.

A13. Further, some understood "*any difference in the amounts of consideration to be exchanged on each possible settlement date represents compensation **proportional** to the passage of time*" to imply that compensation should be reasonable; others thought it simply meant that the return would vary as time passes, irrespective of reasonableness. We consider that providing additional explanation of the meaning of 'proportional', together with further examples of successful and unsuccessful passage-of-time adjustments, should help avoid diversity in practice. In particular, a number of stakeholders indicated they would welcome examples of features that applied over a period of time, not just at maturity, with clear guidance on whether they would qualify as passage-of-time adjustments. We would be happy to share our ideas for explanation and potential examples, should you wish to pursue this recommendation.

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.

A14. We agree with the IASB that the clarifications listed above at questions 3(a), 3(b), 3(d), 3(e) and 3(f) in this complex area should reduce diversity of practice.

A15. However, we are concerned that the proposal at 3(c) introduces a new measurement basis, which goes beyond the objective of IAS 32, set out in paragraph 2 of the standard, and risks confusion for users. The proposal also goes beyond the proposed clarification of classification outcomes (ED paragraphs IN4 to IN6) and may have unintended consequences.

A16. We consider that the addition in paragraph 23 of the ED of "*The redemption amount is discounted, assuming redemption will occur at the earliest possible redemption date specified in the contract*" could lead to a change in measurement basis that may potentially limit the relevance of information provided to users. Our comments in paragraphs A17 to A21 below apply equally to the proposed new measurement basis for contingent settlement provisions referred to in question 4(b) below.

A17. Measuring the financial liability at the earliest possible date of redemption may not provide useful information, for example, if that resulted in the liability being measured at an amount at which a holder was extremely unlikely to redeem and which was below the most likely redemption amount. In particular, disregarding expectations of timing could potentially produce misleading outcomes. Consider the following scenarios:

a) Put options containing a stepped level of payments depending on the timing of exercise e.g. exercisable for £1 in first 12 months, £1m thereafter.

b) Put options with variable payments, depending on time of exercise, e.g. redemption at a multiple of EBITDA at different points in time.

A18. The current proposal could not reasonably accommodate the variability that is a common feature of obligations to redeem own equity. For example, if an instrument can be redeemed for a multiple of EBITDA at several points in time, measuring it at the earliest possible payment date could lead to it being measured at a lower amount than the most likely outcome.

A19. As ED IFRS 7 paragraph 30F requires assessment of whether terms and conditions have become, or have stopped being, effective with the passage of time, reassessing the timing and probability of redemption at each period end would result in useful information without adding significantly to the operational burden.

A20. Overall, we consider that there are significant challenges in introducing a new measurement basis into IFRS, and especially into a presentation standard. The current proposals would require significant additional application guidance to be clear and effective. It would also be necessary to introduce scope exclusions from the measurement provisions of IFRS 9 to those financial instruments for which IAS 32 now provides measurement requirements to minimise the risk of conflict between the two standards. We therefore recommend retaining the existing reference to IFRS 9 within paragraph 23 and removing the final two sentences of ED paragraph 23.

A21. We further recommend the IASB consider addressing any measurement concerns arising in this context within its *Amortised Cost Measurement* project[3].

Net settlement at the election of the issuer

A22. We support the requirement for gross presentation of contractual obligations to purchase own equity as set out in the first sentence of paragraph AG27D. However, our interpretation of the second sentence is that derivative accounting would be required where the holder, but not the issuer, can elect for net settlement

[3] As suggested in paragraph 30 of IASB Staff paper 5B, February 2023, in relation to measurement issues highlighted in this project: https://www.ifrs.org/content/dam/ifrs/meetings/2023/february/iasb/ap5b-fice-classification-and-presentation-sweep-issues-part-b.pdf

of the contract. As net settlement is not within the control of the issuer, it is not clear why gross presentation should not also be required in this example.

A23. The derivative accounting outcome also appears inconsistent with IAS 32 Illustrative Example 6, a written put option which the holder has the right to exercise (IAS 32 paragraph IE27). IAS 32 paragraph IE31 requires that where one of the settlement alternatives results in an exchange of cash for shares, the issuer accounts for the gross liability.

A24. We recommend that paragraph AG27D require gross presentation unless the issuer has the discretion to settle the instrument net, in which case derivative accounting would apply.

Scope

A25. Stakeholders observed that the difficult questions on the interaction between the scope of the guidance on this area within IAS 32, IFRS 2 *Share-based Payments* and IFRS 3 *Business Combinations* remain unaddressed by this ED. We would welcome future efforts by the IASB to clarify these interactions.

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.

A26. We support the IASB proposals in relation to questions 4(a), (c), (d) and (e).

A27. However, as with the proposals regarding obligations to redeem own equity, the introduction of initial and subsequent measurement requirements within IAS 32 in this area appears to go beyond the scope of this project and could lead to unintended consequences.

A28. We understand that, in the absence of guidance, preparers and auditors currently use their judgement in measuring contingent settlement provisions. We therefore refer you to our concerns and recommendations set out at paragraphs A17 to A21 above and recommend removing paragraph 25A.

A29. The proposal may also create inconsistencies within IAS 32. IAS 32 paragraph 31 requires that "*[…] The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.*" IAS 32 paragraph 32 refers to determining the carrying amount of the liability component "*by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component*". Applying the current proposals together with these requirements could lead to inconsistent outcomes. The interaction of ED paragraph 25A with paragraph 31 could require a debit entry in equity in some circumstances. If the ED proposals are finalised and this outcome is intended, it would be helpful for this to be addressed in the Application Guidance to IAS 32.

Scope

A30. We understand the IASB considers paragraphs 25 and 25A to apply only in scenarios where the classification of an instrument is determined by a contingent settlement provision. However, we believe that the current scope of paragraph 25 remains ambiguous and the new measurement guidance in paragraph 25A could be read as applying not only to features of a compound instrument but to any contingent settlement feature in debt instruments. This additional application to common features within debt instruments such as tax or law change clauses, or loan covenants, appears to be an unintended consequence.

A31. IAS 32 paragraph 25 has previously been used to determine classification only. It has not previously determined a measurement basis. This proposal may therefore increase uncertainty about which measurement basis to apply to debt instruments with contingent settlement provisions. Therefore, we recommend that the IASB clarify the application of this section by revising the first sentence of paragraph 25

to read "*A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that the instrument (or a component of it (see paragraph 28)) would be a financial liability,* ***only*** *in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder of the instrument.*"

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.

A32. We welcome the IASB's guidance on this complex area. Stakeholders considered that analysis under the proposals would remain an area of judgement. The proposals provide useful additional guardrails to help determine classification.

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.

A33. We welcome the IASB's efforts to clarify this important area. However, we are concerned that the proposals in the current form could have the following

unintended consequences: the classification of financial instruments diverging from their substance; inconsistencies between financial liabilities that result from obligations to redeem own equity and other financial liabilities; and an inappropriate change to established practice.

A34. The lack of guidance on reclassification might imply that IAS 32 prohibits it except where expressly stated, as suggested by ED paragraphs BC136 to BC137. However, the 1995 version of IAS 32 did include such a prohibition at paragraph 19, but this was removed in 2003. We consider it likely that the IASB no longer wished to prohibit this treatment. This is possibly because it was not consistent with IAS 32 paragraph 18, which states that "*The substance of a financial instrument, rather than its legal form, governs its classification […]*" and with the *Framework for the Preparation and Presentation of Financial Statements* paragraph 51, which contains a similar requirement. Indeed, IAS 32 paragraph 23 refers to recognising a financial liability on reclassification from equity, in the context of the purchase of own shares.

A35. Stakeholders' requests for clarification indicate that IAS 32 was not widely understood as prohibiting reclassification, and this has led to the development of diverse practices. Over the years, accounting firms have developed extensive guidance on reclassification to assist entities in providing up-to-date, relevant classification information to users.

A36. The prohibition of reclassification in respect of contractual terms that become, or stop being, effective with the passage of time could result in the provision of misleading information. This is because continuing recognition of a financial liability in such circumstances may no longer faithfully represent the substance of the financial instrument. Example circumstances include the expiry of a contingent settlement provision and a change in terms that results in the instrument meeting the criteria for equity classification:

a) An entity issues preference shares that are redeemable in cash should a contingent event, such as a change of control, occur within a 12-month period. However, if no such event occurs, subsequent dividends are discretionary and redemption is not required until liquidation. Under the ED proposals, reclassification would be prohibited as the expiry of the cash redemption obligation is anticipated within the contract. After the 12-month period the preference shares would be equity in substance but under the proposals they would remain classified as a financial liability.

b) An entity issues a bond with a conversion feature that is variable in the first three years, but which subsequently becomes fixed. The same analysis would apply. After three years, the conversion feature would meet the criteria for classification as equity, as it would meet the fixed-for-fixed condition, but under the proposals it would remain classified as a financial liability.

A37. Contrary to the statement in paragraph BC132, an instrument meeting the criteria for equity classification may subsequently meet the definition of a financial liability. For example, an entity might issue a perpetual instrument with discretionary coupons and an issuer call option exercisable after, say, 5 years. The instrument meets the definition of an equity instrument at issue. However, if the entity exercises the call option, and this cannot be cancelled, the entity has a contractual obligation to repay the instrument in, say, 3 months.

A38. The IASB has drawn an analogy with the IFRS 9 requirements for classification of financial assets. However, those classification requirements are for measurement purposes. Financial liabilities are a separate element of the financial statements from equity. The reclassification proposals therefore relate to a more fundamental distinction within the financial statements (*Conceptual Framework* paragraph 4.1 (a)).

A39. We therefore consider that the IASB proposals represent a potential change in classification outcomes for some instruments, which stakeholders are concerned may reduce the usefulness of the financial statements. ED paragraph BC143 states that "*Reclassification would be prohibited if the substance of the contractual arrangement changes because of a contractual term that becomes, or stops, being effective during the instrument's life, and therefore the instrument would continue to be classified as a financial liability*." A liability could therefore continue to be recognised that no longer meets the definition of a liability provided within the *Conceptual Framework*.

A40. Given the above concerns, we recommend that the IASB consider requiring reclassification of instruments where contractual terms become, or stop being, effective with the passage of time. This treatment would be consistent with the proposal in ED paragraph 23 to require contracts to redeem own equity that expire to be removed from financial liabilities and included in equity.

A41. ED paragraph BC145 states that the requirement to assess whether an instrument should be reclassified at each reporting date would "*increase costs and complexity for preparers*". However, the disclosure requirement at ED IFRS 7.30F requires assessment of whether terms and conditions have become, or have stopped being, effective with the passage of time. Furthermore, stakeholder feedback indicates that many entities are already undertaking such assessments. We therefore do not consider that reassessing instruments for the passage of time at the reporting date would add significant cost or effort.

Interaction with derecognition criteria

A42. It is possible that many of these concerns would be addressed by enhancing the requirements on the interaction between reclassification and derecognition, the IASB's proposed commentary on which is currently located in the Basis for Conclusions for the ED. We consider that guidance on this important area should form part of the IAS 32 Application Guidance.

A43. The example at A37 has clear parallels with the existing example in AG25 of IAS 32. However, we observe that while AG25 identifies that an obligation arises on exercise of an option, it is silent on the required accounting. We understand the IASB considers that in such circumstances the equity instrument would be derecognised, and a financial liability recognised. However, in the absence of clear instruction within IAS 32, or indeed any authoritative guidance on derecognition of equity instruments, we believe that the required accounting is at best unclear in such circumstances. Stakeholders have told us that their understanding is that the ED proposals on reclassification would prohibit their current practice of recognising a financial liability on exercise of the issuer call option.

A44. In all three examples, the dual possibilities of an event taking place (change of control, conversion while variable, or issuer call) or not taking place (no change of control, conversion while fixed, no call) are both present within the contractual terms from day 1. Further, in an example such as the AT1 instrument after exercise of the call option, it is not clear why derecognition is the appropriate outcome when the underlying instrument remains in existence until the redemption of the instrument takes place. Relying on disclosures of whether such events have taken place or not appears a poor substitute for being able to rely on the classification of the instrument providing relevant information.

A45. ED paragraph BC143 also appears at odds with our understanding of current derecognition practices. It indicates that if a contractual clause "*becomes, or stops being, effective*" as a result of the passage of time, the instrument would continue to be recognised as a liability. A number of stakeholders told us that in this situation, they would expect derecognition.

A46. We consider that the IASB should either adopt the term 'expiring', to be consistent with IFRS 9 paragraph 3.3.1, or explain the distinction between 'expiring' and 'ceases to be effective'. If the IASB decides to retain the proposal to prohibit reclassification for contractual terms that become, or stop being, effective with the passage of time, we recommend that application guidance be included to indicate the circumstances in which a derecognition assessment of a liability component of a financial instrument would be applied.

A47. Furthermore, ED paragraphs BC128 and BC129 refer to derecognition of a financial instrument rather than the components described in the definition of a compound instrument (IAS 32 paragraph 28). However, IFRS 9 B3.3.1 refers to "*a financial liability (or part of it)*" in the context of liability derecognition. We recommend adopting that wording.

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.

A48. We welcome these proposals. However, we consider that the potential volume and cost of the additional disclosures relative to the benefits to investors needs further investigation, in addition to the specific issues explained below. We recommend that the IASB consider undertaking field testing before finalising the disclosure requirements, targeted at those preparers who will be affected most.

Priority on liquidation

A49. Stakeholders have indicated that it may be impracticable for groups to establish the priority of instruments on liquidation, as ED IFRS 7 paragraph 30B(a)(ii) requires, as claims are made against individual legal entities. In addition, as claims within one legal entity are not subordinated to those in any other, consolidating such claims could be misleading. For example, although a parent company can call in its debt from a subsidiary, under these proposals, intra-group debt would not be disclosed unless an entity made the disclosure on a disaggregated basis.

A50. For groups including entities based in different countries with different legal frameworks governing liquidation, this may prove even more challenging. Stakeholders have told us that that this information is not currently routinely collected at a group level, and that there could be significant costs associated with collecting and auditing the information required for these disclosures.

A51. Stakeholders have also told us that information on the priority of instruments on liquidation may be of limited relevance in regulated financial sectors, in which regulatory resolution may be a more likely outcome than liquidation. Entities in those sectors would have to highlight that liquidation is one possible outcome among several.

A52. Overall, this feedback suggests that a consolidated disclosure requirement may not provide useful information.

A53. We recommend that the IASB remove paragraphs 30A and 30B, as we believe the disclosure objectives set out in paragraph 1 of IFRS 7 will be more effectively met by the requirement to disclose the terms and conditions of compound financial instruments in paragraph 17A, and the terms and conditions of financial instruments with financial liability and equity characteristics in paragraphs 30C to 30E.

A54. Stakeholders also questioned whether entities would be able to disclose how significant uncertainty about laws or regulations could affect priority on liquidation (ED paragraph 30E(c)) without disclosing sensitive legal advice. We recommend removing this paragraph.

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.

A55. We welcome the proposals in this area, as they increase the visibility of complex capital structures for users.

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.

A56. We are supportive of the principle of full retrospective adoption, as we recognise this leads to greater comparability across different reporting periods.

A57. However, it is important that sufficient lead time is available to entities to prepare for transition, especially if the proposal for full retrospective application is retained. While classification outcomes may not ultimately change in many cases, this will not be clear until entities have been able to assess fully the final amendments. Understanding, preparing for, and communicating the outcome of transition may be challenging and expensive for some entities. Field testing of

disclosure requirements, as recommended at A48, may also help inform the IASB's decision on an effective date.

A58. Stakeholders have raised concerns about the complexities of retrospective adoption of the amendments in relation to obligations to redeem own equity associated with previous business combinations. Full retrospective application could require both remeasurement of those obligations and consequential remeasurement of acquisition-date goodwill arising. In regulated sectors, this could adversely affect regulatory capital ratios.

A59. Concerns have furthermore been raised by representatives of small- and medium-sized accounting firms, and private equity investors, that costs may exceed the benefits. These stakeholders tell us that, for such entities, complex financial instruments are relatively commonplace and that full retrospective restatement could lead to significant additional costs with no clear benefit. Many entities would have to engage professional advisers to assist with application of the new requirements.

A60. Private equity investors, for example, would have to review the accounting for a significant volume of financial instruments with characteristics of equity, typically a number of years old, within investee entities, at significant expense. They expect that such costs would be required to be passed on to investors in their funds. They generally did not consider that there would be any significant benefit to them as users of the financial statements in these cases, as, generally, classification outcomes were not expected to change.

A61. Change in classification as a result of retrospective application of the requirements may present particular challenges in relation to hedge accounting. For entities which have previously applied hedge accounting in respect of a liability which is required to be restated as equity, which cannot be hedged, early termination of hedge accounting may result in additional cost and work. Equally, if entities reclassify an equity instrument as a financial liability, hedge accounting could have been applied in the past and now may need to be applied in the future.

A62. If instruments were required to be retrospectively reclassified from equity to a financial liability, it would be necessary to measure their fair value at inception, which could also prove onerous and difficult to perform without hindsight.

A63. Owing to the possibility that the cost of transition may outweigh the benefits of implementing these proposals for some companies, we recommend that consideration be given to providing transitional relief from full retrospective application where this would require undue cost or effort, as permitted under IFRS 9 paragraph 7.2.18 in relation to impairment.

A64. We recommend that if financial instruments have been extinguished at the date of initial application, they should not be required to be restated. This is especially important for financial instruments including obligations to redeem own equity and contingent settlement provisions measured on the proposed new basis.

A65. We also recommend that the IASB consider an across-the-board transition relief from restating comparatives, which would permit entities to assess classification at the date of initial application, similar to the proposals in the *Classification and Measurement of Financial Instruments* ED paragraph 7.2.48. We suggest this is done on the basis of the facts and circumstances at that date, including an assessment of only features that have not expired at that date. These proposals adopt a proportionate approach that we consider would also be appropriate for these amendments.

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.

A66. The application of the IFRS Accounting Standard *Subsidiaries without Public Accountability: Disclosures* (forthcoming standard) in the UK is conditional on the endorsement of the standard by the UKEB. The UKEB has not yet begun its endorsement assessment and the following comments should be viewed in that context.

A67. We welcome the IASB's identification of consequential amendments to the forthcoming standard in this ED. We think this is an efficient approach that should ensure disclosure requirements for eligible subsidiaries keep pace with the development of IFRS Accounting Standards for the parent entity's consolidated financial statements.

A68. We support the application of the IASB's agreed principles for reducing disclosures for the forthcoming standard to the full set of disclosures proposed in this ED. Consequently, we broadly agree with the proposed reduced disclosures for eligible subsidiaries. However, the concerns raised above on the full set of proposed disclosures apply equally to eligible subsidiaries, where applicable.

A69. We are, however, concerned that the cost-benefit considerations of the proposed reduced disclosures for eligible subsidiaries are not clearly laid out in this ED. We

draw your attention to our recommendation in paragraph A48 that the IASB consider undertaking field testing before finalising the disclosure requirements. We recommend that the IASB reconsider the cost-benefit considerations of the proposed reduced disclosures for eligible subsidiaries arising from this ED in the light of such field testing.