Quoted Companies Alliance

6 Kinghorn Street
London EC1A 7HW

T +44 (0)20 7600 3745
mail@theqca.com

www.theqca.com

International Financial Reporting Standards
Foundation Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD

commentletters@ifrs.org

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Dear IASB colleagues,

Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1

We welcome the opportunity to respond to your consultation on Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1.

The Quoted Companies Alliance *Accounting, Auditing and Financial Reporting Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

We believe that these amendments risk creating added complexity for both users and preparers. Moreover, we request that the IASB consider how these changes, and the approach that underpins them, relate to the application of principles used in other reporting standards. We refer specifically to the principle, as contained in the revenue recognition standard, that a complex transaction should be broken down into its component parts.

Increased complexity

It is our view that these financial instruments should be recognised and measured as financial instruments with any equity characteristics disclosed in the notes. By adopting another approach, the IASB risks overcomplicating reporting in this area. Moreover, this additional complexity could result in loopholes being created inadvertently that could then be exploited to the detriment of users of accounts.

Indeed, while these changes may result in greater theoretical precision, we believe that ultimately, they will create greater complexity and it is questionable as to whether they will be more understandable for preparers and users.

If companies in specific sectors (such as banks or insurers) require different rules, then a standard should be issued applying only to those types of companies, thus avoiding increasing complexity for all companies when it is not appropriate or proportionate to do so.

Such an approach will produce information that is more relevant, more reliable, and more understandable for users, and will improve comparability between different types of financial instruments that may or may not have characteristics of equity.

Reporting consistency

The IASB set out in the revenue recognition standard the principle that a complex transaction should be split into its component parts with recognition provided after. Specifically, that measurement and disclosure requirements should be assessed separately for each component part.

If the IASB is to be consistent, then a similar approach needs to be taken for financial instruments with characteristics of equity ("FICE").

For example, the separate components of a contingent convertible debt instrument issued by a financial institution are a loan to the financial institution, and a requirement for the lender to convert the loan to equity for the borrower if certain circumstances occur. As such, the lender has the loan as an asset and a (probably contingent) liability for the risk that they are required to convert some or all of the loan into equity. The borrower has a loan and a (probably contingent) asset in respect of the conversion to equity.

Using the same principles, a convertible loan which gives the lender the option to subscribe for equity is a loan and a share option, which should be accounted for in the usual way.

To summarise, if the IASB intends to adopt a different approach for FICE, then we believe that it should justify why the principle set in the revenue recognition standard does not apply to FICE. Alternatively, the IASB should undertake a new project to replace the revenue recognition standard in the interests of consistency in reporting principles.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

James Ashton
Chief Executive

Q1 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.

The need to consider whether a particular contractual requirement replicates what is required by law or not for the purposes of determining if a contract is a financial liability or not creates unnecessary complexity. Consistent with other standards (such as IFRS 15 and IFRS 16), it would be more appropriate to adopt an "all-inclusive" approach in which a contractual requirement to pay cash would be considered a financial liability irrespective of whether or not the specified cash flow was required by law.

Q2 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.

It is our view that additional guidance, such as illustrative examples, would be welcome in this area with regards to situations that:

1. would and would not be considered a preservation adjustment that justifies equity classification. This could be based on real-life examples found in complex contractual situations; and
2. would be a passage-of-time adjustment that justifies equity classification, noting that the proposed examples only illustrate when an adjustment is not a passage-of-time adjustment. This is particularly important in light of Example 20, which many of our members from the small and mid-cap community will likely find confusing. For example, that an adjustment based on benchmark interest rates is not a passage-of-time adjustment.

Q3 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.

The proposal to recognise both a liability for an entity's obligation to purchase its own equity instruments as well as a non-controlling interest for the present ownership rights held by the counterparty does not give relevant information because it results in the double recognition of a counterparty's claim to the entity's net assets. If such accounting is the consequence of incompatibility with IFRS 10 then that is an indication IFRS 10 may need to be changed. A reluctance to reconsider IFRS 10 or the requirements of IAS 32 is not a valid reason to propose the recognition of two credits on the balance sheet for mutually exclusive positions, given the proposed accounting will negatively impact the understandability of the accounts to preparers and users.

Q4 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.

It is our view that it is not clear what is meant by a liability with a contingent settlement provision, and hence it is unclear which liabilities will need to be measured at the "present value of the redemption amount". For example, there is a lack of clarity as to why the measurement requirement is introduced into IAS 32 as opposed to IFRS 9, being the standard which otherwise deals with initial and subsequent measurement of financial liabilities. All measurement requirements should be contained in IFRS 9, including obligations to purchase an entity's own equity instruments which also has the same measurement requirement as proposed for liabilities with contingent settlement features.

It is unclear how one would account for any difference between the fair value of such a liability (being the initial measurement requirement in IFRS 9 for in-scope financial liabilities) and the other measurement requirement proposed in IAS 32.

In addition, there is insufficient clarity regarding how contingent consideration payable on, for example, a business combination, would not be a liability with a contingent settlement provision, for which IFRS 9 already sets out the measurement requirements. The potential impact of cash flows as a result of the

occurrence or non-occurrence of contingent events in financial liability contracts such as profit-linked payments are typically dealt with through paragraph B5.4.6. As such, it is not clear why the proposals will not introduce a conflict between the requirements of IFRS 9 and IAS 32 giving rise to confusion as to which measurement requirement applies to which instruments.

Q5 Shareholder discretion (paragraphs AG28A–AG28C of IAS 32) The IASB proposes:

(a) to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions (paragraph AG28A).

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

> **(i) a shareholder decision would be routine in nature—made in the ordinary course of the entity's business activities;**
>
> **(ii) a shareholder decision relates to an action that would be proposed or a transaction that would be initiated by the entity's management;**
>
> **(iii) different classes of shareholders would benefit differently from a shareholder decision; and**
>
> **(iv) the exercise of a shareholder decision-making right would enable a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) (paragraph AG28A(a)–(d)).**

(c) to provide guidance on applying those factors (paragraph AG28B). Paragraphs BC116–BC125 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

We have no comments.

Q6 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.

A prohibition on the ability to reclassify an instrument for contractual terms that become, or stop being, effective with the passage of time (such as a prohibition on reclassifying the conversion option in convertible debt as equity if the fixed-for-fixed criterion is satisfied subsequent to initial recognition) would not provide relevant information for users, and should therefore be reconsidered.

Q7 Disclosure (paragraphs 1, 3, 12E, 17A, 20, 30A–30J and B5A–B5L of IFRS 7) The IASB proposes:

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

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

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

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

(e) to include disclosure requirements for compound financial instruments in IFRS 7 (paragraph 17A). The IASB proposes to require an entity to disclose information about:

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

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

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

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

(e) instruments that include obligations to purchase the entity's own equity instruments (paragraph 30J). Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

We have no comments.

Q8 Presentation of amounts attributable to ordinary shareholders (paragraphs 54, 81B and 107–108 of IAS 1) The IASB proposes to amend IAS 1 to require an entity to provide additional information about amounts attributable to ordinary shareholders.

The proposed amendments are that:

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

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

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

(d) dividend amounts relating to ordinary shareholders are presented separately from amounts relating to other owners of the entity (paragraph 107). Paragraphs BC246–BC256 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why. Would the proposed requirement to allocate issued share capital and reserves between ordinary shareholders and other owners of the parent give rise to any practical difficulties in determining the required amounts? If so, please describe the possible difficulties and specify areas in which further guidance would be helpful.

We have no comments.

Q9 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.

We have no comments.

Q10 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.

We have no comments.

Appendix A

The Quoted Companies Alliance *Accounting, Auditing and Financial Reporting Expert Group*

Rochelle Duffy (Chair)	PKF Littlejohn LLP
Tom Stock (Deputy Chair)	Haysmacintyre
Edward Beale	Western Selection PLC
Matthew Brazier	Invesco Asset Management Limited
Simon Cooper	KPMG LLP
Anna Hicks	Saffery Champness LLP
Mark Hodgkins	Ensilica
Clive Lovett	Kinovo PLC
Sandra McGowan	BDO LLP
Jennifer Ilsley	Grant Thornton UK LLP
James Naylor	Mazars LLP
Emily Rees	Quartix Technologies PLC
Mathew Stallabrass	Crowe UK LLP