IFRS Interpretations Committee

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Comments on IASB/ED/2023/5 Financial Instrument with Characteristics of Equity

FAR, the Institute for the Accountancy Profession in Sweden, is responding to your invitation to comment on the Exposure Draft *2023/5 Financial Instruments with Characteristics of Equity*.

General comments

FAR shares the view on the problem that there currently can be very challenging to distinguish whether a financial instrument is to be classified as a financial asset/liability or as equity. FAR therefore welcomes the efforts made by the IASB to clarify the requirements.

Question 1 – The effects of relevant laws and 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).

Response

FAR believes that paragraph 15A provides an appropriate clarification. However, in FAR's opinion, there may be a risk for unintentional consequences as the legal systems are diverse in the different jurisdictions.

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 that 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 instrument 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)).

Response

FAR welcomes the clarifications in paragraphs 16 and 22 which generally is based on how the fixed-for-fixed requirement is handled in practice and agrees with the clarifications in paragraphs 22B-22D that future shareholders should not obtain a better right than existing shareholders.

However, the proposal appears to be more restrictive than current practice and FAR is concerned about the increased complexity regarding the treatment of passage of time adjustments. For example, can the adjustment for passage of time be based on a fixed interest rate without any acceptance of any floating benchmark interest rate? In FAR´s view, requiring a fixed rate of exchange at each point in time is sufficient.

FAR does not agree with the requirement that the consideration to be exchanged must be denominated in the entity's functional currency. Entities located in jurisdictions with smaller capital markets may need to find financing in larger capital markets to issue instruments denominated in currencies such as USD and EUR. Having the functional currency requirement is a great disadvantage for such entities. FAR suggests that the IASB reconsiders this requirement. Any currency gains or losses are already recorded in profit or loss for the part of a convertible classified as a liability, hence, the effect is already visible.

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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 requirement in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instrument 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 instrument, 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 gain 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).

Response

FAR welcomes the establishment of one single accounting policy to be applied together with the guidance given. However, FAR acknowledges that there is a diversity in practice. One consideration is that many preparers and users regard recording the initial debit entry in equity other that in the non-controlling interest component will result in double-counting of this interest. FAR encourages the

IASB to consider the information value in financial statements of various fact patterns of the NCI options and the context in which they are used.

Concerning measurement, FAR is unsure for example, whether a discount rate is set at initial recognition (like amortised cost measurement) or updated at each reporting date (like fair value measurement).

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).

Response

FAR agrees with the suggested paragraphs 11, 25, 31 and 32A.

The proposed amendment in paragraph 25A that the entity is not able to include an assessment of the probability of occurrence or non-occurrence of uncertain future events will lead to less relevant information. FAR finds that the outcome of this proposal might not be in compliance with the conceptual framework (faithful representation). FAR fears that there is a risk that entities record too large amount of liabilities if the entity is not able to include an assessment of the probability of occurrence or non-occurrence of uncertain future events (paragraph 25A). FAR believes that the IFRS 9 measurement requirements provide more useful information to users of financial statements about the likelihood of redemption and information that is more comparable with other financial liabilities.

It is unclear how to account for the difference between that initial carrying amount and the proceeds, that would usually be equal to the fair value at the issuance – whether they are recognised in profit or loss or in equity.

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).

Response
FAR agrees with the proposed changes.

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 (paragraph 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).

Response
FAR agrees with the proposed changes but suggests that reclassification from a liability to equity is also required when the liability features expire because this will provide the most useful information.

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 form 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 paragraph 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.

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(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 instrument 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).

Response
FAR agrees with IASB's efforts to gather the disclosure requirement in IFRS 7 and agrees with the proposed changes. However, the priority on liquidation is not clear as it only applies to financial liabilities within the scope of IAS 32, i.e. as an integral part of the FICE project. Disclosure can therefore be misleading without disclosing relative priority to other financial instruments not in scope of IAS 32, e.g. lease liabilities and pension obligations and other non-financial liabilities such tax and VAT payables.

FAR also believe that maximum dilution disclosures may go beyond the narrow scope of the FICE project and the interaction with IAS 33 is not clear.

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).

Response
FAR agrees with the proposal. However, FAR believes that it is necessary to provide more guidance on how to attribute amounts between ordinary shareholders of the parent and other owners of the parent.

Question 9 – Transition (paragraphs 97U-97Z of IAS 32)
The IASB proposes to require an entity to apply the proposed amendment retrospectively with the restatement of comparative information (a fully retrospective approach). However, to minimize 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 an 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 change 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 amendment.

Response
FAR would recommend more transition relief for specific areas should the IASB finalise the proposals as is. For example, exempting entities from reversing a prior reclassification for a change in the effective term of a contract and an exemption from restating business combinations that occurred in prior periods involving non-controlling interests puts/forwards.

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 finalized.

[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 in 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.

Response

FAR has chosen not to respond to this question.

Yours sincerely,

Pernilla Lundqvist
Chairman Accounting Practices Committee