27 March 2024

Dr Andreas Barckow
Chair
International Accounting Standards Board
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Via online submission: www.ifrs.org

Dear Andreas

Exposure Draft: Financial Instruments with Characteristics of Equity—Proposed amendments to IAS 32, IFRS 7 and IAS 1

CPA Australia and Chartered Accountants Australia and New Zealand (CA ANZ) represent over 300,000 professional accountants who work in diverse roles across public practice, commerce, industry, government and academia throughout Australia, New Zealand and internationally. We welcome the opportunity to provide feedback on the above Exposure Draft (the ED) and make this submission on behalf of our members and in the public interest.

We commend the International Accounting Standards Board (IASB) for aligning this ED with the recommendations outlined in the CPA Australia submission to the preceding Discussion Paper – *Financial Instruments with Characteristics of Equity* (DP/2018/1). Specifically, we appreciate the decision not to proceed with introducing a new conceptual basis for classifying financial instruments as debt or equity, and instead introducing additional guidance to assist with distinguishing debt from equity. This project is particularly relevant for financial institutions that issue complex financial products, but it is also important for non-financial corporates that are increasingly using hybrid instruments to obtain financing for a variety of reasons.

Overall feedback

We support, in principle, the IASB's decision to focus on targeted improvements to the existing requirements of IAS 32 *Financial Instruments: Presentation* (IAS 32) and related standards that address the identified challenges. However, the feedback we received indicates that some of the proposed amendments could be subject to varying interpretations. Consequently, some proposed amendments may not achieve the IASB's objective of reducing diversity in practice; rather, the increased uncertainty could potentially cause unintended consequences such as further divergence.

Furthermore, the increased uncertainty is likely to require more attention from senior staff, management and boards/audit and risk committees. Hence, there is a risk the proposals have not struck the right balance between principles and prescription to meet the objective of the project in the most cost-effective way.

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There appears to be an increasing need to refer to the Basis for Conclusions to interpret the Application Guidance. Feedback we received indicates that many preparers do not refer to the Basis for Conclusions, so this design approach has practical limitations. We recommend the IASB incorporates the clarifications from the Basis for Conclusions into the relevant paragraphs of the standard.

We have heard mixed views on the expected impact of the proposals. A cohort generally did not expect classification outcomes to change, while others believed that more classification changes would be required than originally envisaged. On this basis we recommend the IASB conducts field testing of the proposals which in our view is critical to assess any operational challenges – not only for preparers but also for auditors and regulators – and whether it leads to more useful financial information for users. The IASB should ensure that entities of diverse nature and size are represented in the field testing, including subsidiaries without public accountability, to provide necessary insights into the practical application of the proposals. We recommend that the IASB reconsiders the cost-benefit equation of the proposed amendments arising from this ED in light of such field testing.

We have not responded to all specific questions raised in the ED. Outlined below is our high-level feedback derived from member and stakeholder outreach activities undertaken as part of developing this submission.

1. The effects of relevant laws or regulations

We agree that clarifying the requirements in IAS 32 to explain how to consider relevant laws or regulations in classifying a financial instrument is essential for reducing current diversity in practice. However, the feedback we received indicates that the application of proposed paragraph 15A is unclear and may lead to different interpretations. In particular, concerns were raised around paragraph 15A(a) '*…. contractual rights and obligations that are enforceable by laws and regulations and are in addition to those created by relevant laws or regulations (such as statutory or regulatory requirements applicable to the instrument)'* as applying this proposal could lead to some practical challenges. For instance it may be costly and complex to assess whether the contractual terms stated in the contracts are in addition to what is imposed by laws and regulations especially when an entity has numerous complex financial instrument contracts.

Additionally, there is a lack of clarity regarding the impact of changes to relevant laws and regulations subsequent to entering into a contract. Differing views emerged during our outreach discussions depending on the approach an entity might take with regards to relevant laws and regulations in respect of a contract. For example, reproducing provisions of relevant laws and regulations, providing references to relevant laws and regulations, or remaining silent about relevant laws and regulations, within a contract. Consequently, we are concerned that these proposals may result in different classification decisions, which is unlikely to reduce diversity in practice. We recommend the IASB provides clearer guidance on these different approaches and their impact on contract modification and classification decisions.

Concerns were also raised about the practical challenges from a cost-benefit perspective. Evaluating a contract to determine which sections of the contract are established by relevant laws and regulations, as opposed to by the contract itself, could be a costly exercise and potentially lead to financial information that is not useful.

Furthermore, to comprehend the requirements in the proposed Application Guidance paragraphs, we heard that reading the Basis for Conclusions paragraphs was often necessary due to their complexity. Consequently, the ability for the standard to operate in a stand-alone manner may be questionable. We recommend the IASB reconsiders the balance of the location of such material, and the way in which it is presented (e.g., diagrammatical as opposed to written).

2. Settlement in an entity's own equity instruments

We welcome the IASB's efforts to clarify the principles in IAS 32 on the fixed-for-fixed condition to particular derivatives on own equity as there is currently limited guidance in IAS 32 on this matter. However, we have heard views that some of the proposed amendments are unclear. In particular:

- Paragraph 22C(a)(ii) – 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.
- Paragraph 22C(b)(iii) – it is unclear whether a passage of time adjustment could only be derived from a fixed rate, and whether there is a requirement for the rate to be reasonable.
- Paragraph BC33 – in the explanation of fixed-for-fixed the meaning of 'predetermined *in some way*' is not clear and potentially contradictory.

We understand that passage of time adjustments are common, and most are accepted under extant IAS 32. However, there are concerns that the amendments as proposed in the ED could be interpreted far narrower. Therefore, we recommend the IASB provides guidance to help preparers assess whether an adjustment is a preservation adjustment or a passage of time adjustment depending on what they are intended to compensate the holder for because such a distinction might not always be clear.

3. Obligations to purchase an entity's own equity instruments

We support the proposed paragraphs that clarify the measurement of financial liabilities in relation to an entity purchasing its own equity instruments. However, we note that the proposed amendments exclude the probability and estimated timing of the counterparty exercising that redemption right. We recommend the IASB clarifies why the measurement of the obligation in this instance differs from other types of financial liabilities under IFRS 9 *Financial Instruments* (IFRS 9) and IFRS 13 *Fair Value Measurements* (IFRS 13).

Additionally, concerns were also raised about the inclusion of initial and subsequent measurement requirements under IAS 32, given its focus on presentation. Hence, we recommend the IASB addresses measurement requirements in IFRS 9 rather than in IAS 32.

4. Contingent settlement provisions

Feedback we received indicates there are mixed views on what 'not genuine' means. Therefore, we recommend the IASB defines the term as this will be helpful for practical application of the proposed amendments.

Consistent with our recommendation in the previous section, we recommend including initial and subsequent measurement requirements for contingent settlement provisions in IFRS 9 rather than in IAS 32 given it is a presentation standard.

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5. Shareholder discretion

We are of the view that the additional guidance proposed is helpful when an objective assessment could determine if shareholder discretion affects the entity's unconditional right to avoid delivering cash or another financial asset to settle in a way that it would be a financial liability. However, in applying a factor-based assessment retrospectively, there is a risk that it will be difficult for entities not to incorporate an element of hindsight into the assessment. We recommend the IASB permits the use of hindsight for the retrospective application of the requirements on shareholder discretion; or introduces an exception to retrospective adoption if it can only be done with hindsight.

6. Reclassification of financial liabilities and equity instruments

There are concerns that the proposals in their current form constitute a change to established practice in that certain instruments previously classified as equity may no longer meet the proposed requirements for equity classification and would need to be reclassified to liability. We recommend the IASB conducts field testing of the proposals which in our view is critical to assess any operational challenges – not only for preparers but also for auditors and regulators – and whether it leads to more useful financial information for users. The IASB should ensure that entities of diverse nature and size are represented in the field testing to provide necessary insights into the practical application of the proposals.

There are also concerns around the prohibition to reclassify 'passage-of-time changes' whereby a financial instrument originally classified as a financial liability cannot be reclassified as equity even if it subsequently meets the fixed-for-fixed condition that is unrelated to changes in external circumstances. We believe this could potentially create an inconsistency with the Conceptual Framework and we recommend the IASB reconsiders whether there are unintended consequences associated with this proposal.

We do not support the proposed requirement to reassess at each reporting date whether a reclassification is triggered due to a change in circumstances external to the contractual arrangement. In addition to potentially introducing a significant change to IAS 32, we are not sure how the costs of monitoring could be justified and do not agree with the Board's position in paragraph BC148 that it 'provides an appropriate balance between the benefits to users of financial statements and the costs to preparers'. We recommend the IASB clarifies the criteria for a change to be considered as a change in external circumstances that alters the substance of a contract.

7. Disclosure

There are currently no specific disclosure requirements in IFRS 7 with regard to an entity's issued equity instruments or equity components of compound instruments, and some related disclosures are currently included in IAS 1. Therefore, we support the expansion of the objective of IFRS 7 and the inclusion of disclosures for these instruments in one place, i.e., in IFRS 7. In particular, we welcome the proposed disclosures on the terms and conditions that determine classification of financial instruments as debt or equity.

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Feedback we received indicates there may be challenges associated with providing disclosures on an entity's contractual nature and priority on liquidation related to distinguishing between subordinated and unsubordinated claims. The priority of liquidation disclosures proposed in paragraph 30B(a)(ii) of IFRS 7 may be operationally difficult to prepare where they are held in different legal entities, as this information is not currently routinely collected at a group level. Therefore, we recommend that the disclosure proposals be included in the field testing.

8. Presentation of amounts attributable to ordinary shareholders

We acknowledge the inherent limitations of any binary debt-equity split and therefore welcome the IASB's efforts to improve the presentation of equity instruments. Therefore, there is support, in principle, for the proposed requirement to separately present issued share capital and reserves between ordinary shareholders and other owners of the parent entity.

However, we have also heard concerns about the usefulness of the split and the practical ability to distinguish reserves attributable to ordinary shareholders from those attributable to other shareholders, especially retrospectively, in certain circumstances (e.g., where profit allocations are made in accordance with a formula). We recommend that where it is impracticable to apply this requirement retrospectively, entities should be permitted to present this information prospectively.

9. Transition

We agree that retrospective application is the right approach as a starting point. However, for cost-benefit reasons full retrospective application of the proposals may not be practical for entities with a significant number of compound financial instruments contracts, especially older ones. Such entities would need to reassess numerous contracts and revisit the classification of all such instruments which may be a significant burden. The benefit for users of the financial statements is questionable if classification outcomes are not expected to change.

In addition, entities applying hedge accounting are concerned that the full retrospective approach could give rise to accounting mismatches, which would not reflect the performance of the entity.

We recommend that the IASB provides some flexibility to permit a modified retrospective approach with the restatement of comparative information. By way of example, transitional relief from full retrospective application along similar lines to the practical expedient provided in paragraphs C3 and C4 of IFRS 16 *Leases*. Alternatively, transitional relief could be by only requiring full retrospective application for instruments issued after a certain date, for example, within five years of the effective date.

In cases where there are reclassifications between financial liabilities and equity, this could have an impact on prior year coefficients linked to debt/equity ratios. So, we recommend entities be given sufficient lead time to prepare for transition.

10. Reduced disclosure requirements

We welcome the IASB's consideration of whether the reduction of the proposed disclosure requirements is warranted for eligible subsidiaries within the scope of the forthcoming IFRS 19 *Subsidiaries without Public Accountability: Disclosures*. 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. We generally agree with the IASB's proposals, which seem to be a fair balance between costs and benefits related to disclosing relevant information. However, we recommend the IASB includes subsidiaries without public accountability in the field testing and reconsiders the cost-benefit of the proposed reduced disclosures for eligible subsidiaries in light of the field testing results.

Should you have any questions about the matters raised in this submission or wish to discuss them further, please contact either Tiffany Tan at tiffany.tan@cpaaustralia.com.au (CPA Australia) or Amir Ghandar (CA ANZ) at amir.ghandar@charteredaccountantsanz.com.

Yours sincerely

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