Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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28 March 2024

Dr Andreas Barckow
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Andreas,

IASB Exposure Draft
Financial Instruments with Characteristics of Equity
(Proposed amendments to IAS 32, IFRS 7 and IAS 1)

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing, ethics and sustainability disclosures for professional accountants in Hong Kong. We are grateful for the opportunity to provide our comments on this Exposure Draft (ED).

The HKICPA appreciates the IASB's endeavours to clarify the classification principles in IAS 32 *Financial Instruments: Presentation* to address known practice issues. The HKICPA also supports the IASB's objective of enhancing the presentation and disclosure of information about financial liabilities and equity instruments to improve transparency and understandability, as well as to meet the information needs of users of financial statements. Nevertheless, we have significant concerns about certain aspects of the proposals. We provide detailed comments in the Appendix and summarise our primary concerns and recommendations below.

<u>Settlement in an entity's own equity instruments</u>

We have significant concerns regarding the application of the proposed preservation adjustments and passage-of-time adjustments to common contractual terms in Hong Kong, which are widely accepted by the market as anti-dilutive and meeting the fixed-for-fixed condition. Firstly, it is common for entities to adjust the conversion ratio of convertible bonds (CB) to compensate CB holders for dilution loss when shares are issued to investors below market price. Secondly, anti-dilutive adjustments are often calculated using the volume weighted average share price over a specified period before the diluting event occurs. Applying the proposals in the ED, these adjustments would not qualify as preservation adjustments and would therefore fail the fixed-for-fixed condition because they could arguably preserve the economic interests of the future equity holders to a larger extent relative to the economic interests of the current equity holders.

The proposed passage-of-time adjustments would also impact the current practice on CBs that carry an interest rate benchmark and those with protective clauses that compensate holders for loss of an option's time value through an enhanced conversion ratio when there is a change of control of the issuer (i.e. change of control provisions). Applying the proposals, these adjustments would fail the fixed-for-fixed condition because they are linked to a variable (e.g. an interest rate benchmark), or include inputs (e.g. share price and volatility in the time value of option) to the predetermined formula

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話：(852) 2287 7228
Fax傳真：(852) 2865 6603
Website網址：www.hkicpa.org.hk
Email電郵：hkicpa@hkicpa.org.hk

that do not vary solely based on passage of time. Furthermore, the adjustments may not represent compensation proportional to the passage of time as stated in the ED, since the adjustments for change of control provisions may not always be linear over time.

Given that the majority of the CBs issued in Hong Kong include the aforementioned adjustments in their contracts, the IASB proposals, if implemented, would result in the retrospective reclassification of the conversion options of these CBs from equity to derivative liabilities. In light of the significance and pervasiveness of this matter, we strongly recommend the IASB carefully consider the implications and the potential impact of the proposals on existing market practices and provide clarification on the application of the preservation adjustments and passage-of-time adjustments to common contractual terms in Hong Kong.

The effects of relevant laws and regulations

We consider that the proposals lack a guiding principle in considering the effects of laws and regulations in the classification of financial instruments. Specifically, we question why a law that prevents enforceability should be considered in the classification, while a law that creates an obligation should be disregarded. Moreover, the proposals require a clear identification of laws and regulations that are relevant to the financial instruments, but the boundaries may not always be clear due to varying legal systems across different jurisdictions, resulting in practical challenges in determining whether particular rights and obligations stem from the contract or from law or regulation. This issue is particularly relevant for multinational groups operating in multiple jurisdictions with different legal requirements.

The effects of laws and regulations are an important yet complex issue that has broad implications. They either interact with or have implications for other existing IFRS Accounting Standards. We also understand that a complete alignment of the accounting classification with the legal view would fundamentally change the existing requirements in IAS 32 and IFRS 9, which is not the objective of this project. In light of these considerations, we recommend the IASB seriously reassess the feasibility of the proposals, conduct field tests to assess the impact and clarity of the proposals on different financial instruments, and evaluate whether the outcomes reflect the substance of the instruments and provide relevant information. If the IASB were to proceed with the proposals, we recommend the IASB clarify the boundaries of laws and regulations for the purpose of determining the classification of financial instruments, and provide supporting guidance, such as illustrative examples of common financial instruments, to ensure consistent application of the proposals.

Contingent settlement provisions

We have concerns about the lack of clarity regarding the scope of financial instruments with contingent settlement provisions that would be subject to the proposed amendments to IAS 32.25 and 25A. The current wording of the proposed amendments seems to imply that the measurement requirements in IAS 32.25A would apply to all financial instruments with contingent settlement provisions, including those that are currently measured solely under IFRS 9 (such as derivatives for written puts other than over own equity instruments, debt instruments with loan covenants). Such an application could result in unexpected outcomes and create unintended consequences.

In addition, our respondents expressed divergent views on the proposed measurement requirements in IAS 32.25A. Some agreed with the proposals to ignore the probability and estimated timing of the contingent events. Others considered that entities should take those two factors into account in measuring the obligations (i.e. the probability-

weighted measurement approach) as this would better reflect the economics of the transaction and provide useful financial information. Moreover, they noted that the probability-weighted measurement approach has worked well when entities measure similar instruments with contingent settlement clauses under other IFRS Accounting Standards.

To address the above concerns, we strongly recommend the IASB clearly define the scope of financial instruments with contingent settlement provisions that are subject to IAS 32.25 and 25A to avoid diversity in practice and unintended consequences. Additionally, we suggest the IASB conduct field tests on a broad range of contingent settlement clauses using both measurement approaches to determine which approach would best provide relevant financial information.

Reclassification of financial liabilities and equity instruments

We disagree with the proposal that prohibits reclassification when there is a change in the substance of the contractual arrangement due to the passage of time. We believe that prohibiting reclassification that would occur as a result of contractual terms that become or stop being effective with the passage of time (such as the expiry of a contingent settlement provision) would misrepresent the substance of the financial instrument and the entity's situation, potentially resulting in misleading information. We are also not convinced by the IASB's view that reclassification would increase costs and complexity for preparers. Preparers already need to monitor whether certain contractual terms have expired or stopped being effective when measuring the instruments and preparing the proposed disclosures in IFRS 7.30F at the reporting date. Furthermore, we consider that addressing the issues arising from the prohibition by introducing additional disclosures in IFRS 7.30F is not the appropriate approach and is inconsistent with IAS 1.18. Given the above concerns, we strongly recommend that the IASB reconsider its reclassification proposal relating to the passage of time and remove the related prohibition.

Another key concern is the lack of clarity in the proposal regarding whether subsequent changes to laws and regulations would constitute a change in the substance of the contractual arrangement due to *'changes in circumstances external to the contractual arrangement'*, in which case reclassification of financial instruments would be required under the proposal. We consider that the associated core questions are whether reclassification would be required: 1) when a change in law creates incremental contractual obligations; and 2) when a change in law prevents the enforceability of the contract. We recommend that the IASB provide clarification on these matters and consider the proposals on reclassification and the effects of laws and regulations together to ensure that their interactions are adequately addressed.

If you have any questions regarding the matters raised in this letter, please contact Kennis Lee (kennislee@hkicpa.org.hk) or Carrie Lau (carrie@hkicpa.org.hk), Associate Directors of the Standard Setting Department.

Sincerely,

Cecilia Kwei

Cecilia Kwei
Director of Standard Setting

Work undertaken by the HKICPA in forming its views:

The HKICPA:

(a) issued an Invitation to Comment on the ED on 30 November 2023 to its members and other stakeholders;
(b) sought input from its Financial Instruments Advisory Panel and Small and Medium Practices Committee and its Technical Issues Working Group, which mainly comprise technical and industry experts from large as well as small and medium accounting firms (collectively, Practitioners);
(c) held a public roundtable discussion for local stakeholders, including Practitioners, preparers and other interested parties on 22 January 2024;
(d) developed its views through its Financial Reporting Standards Committee, having reflected on its respondents' views. The Committee comprises preparer representatives from various industry sectors, regulators, as well as technical and industry experts from small, medium and large accounting firms.

Detailed comments on the IASB ED

Question 1: The effects of relevant laws or regulations (paragraphs 15A and AG24A-AG24B of IAS 32)

1. We appreciate the endeavours undertaken by the IASB in addressing the intricacies surrounding the effects of relevant laws or regulations in classifying financial instruments as financial liabilities or equity instruments. However, our respondents have expressed the following concerns.

A. Lack of a guiding principle in considering the effects of laws or regulations

2. Some respondents were concerned that the proposals lack a guiding principle and primarily focus on accommodating specific practice issues without addressing the core issue of the effects of laws or regulations on the classification of financial instruments. Specifically, they questioned why a law that prevents enforceability of a contractual right or obligation should be considered in the classification, but a law that creates an obligation should be disregarded. They contended that both the legal and contractual obligations should be considered in their entirety by the issuer, as financial instruments are governed by contracts that are entered into within a legal framework. This approach also aligns with paragraph 4.60 of the *Conceptual Framework* and IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*, whereby the relevant laws and regulations are considered in determining the rights and obligations arising from the contracts.

B. Boundaries of relevant laws or regulations for classification purposes

3. Our respondents considered that the proposals require a clear identification of laws or regulations that are relevant to the financial instruments. However, the ED does not provide explicit guidance about the interactions between laws, regulations and contracts, or the extent of how laws and regulations should be considered in the proposals. They highlighted that different jurisdictions have different legal systems, and different laws and regulations may have different legal implications. This presents practical challenges when determining whether particular rights and obligations stem from the contract or from law or regulation. This issue is particularly relevant for multinational groups operating in multiple jurisdictions with varying legal requirements (with some jurisdictions having a legal system based on civil law where the key terms of instruments are already codified in the law, while others

having a legal system based on common law where there are no such provisions in the law and therefore the comparable terms must necessarily be contained in the contractual terms of instruments).

For example, the Real Estate Investment Trusts (REIT) established in Hong Kong are subject to minimum dividend requirements pursuant to the trust deed and REIT Code issued by the Securities and Futures Commission (SFC) of Hong Kong. The REIT Code specifies the minimum dividend payout ratio for all the REITs regulated by the SFC. The REIT Code provides a framework through which the SFC may take actions (e.g. sanctions or penalties) against the REITs, without creating legal enforceability of the minimum dividends. Instead, the trust deed of each REIT sets out the minimum dividend payout ratio, which provides the legal enforceability on the minimum dividends.

Under this situation, our respondents questioned whether the REIT Code should be treated as laws and regulations that create the rights and obligations for the minimum dividends. This question is crucial because it would have a determinative impact on the classification of the units issued by REITs in Hong Kong:

- If the REIT Code is considered as part of laws and regulations under the ED, units issued by REITs could be classified as equity (assuming that the trust deed does not contain any clauses that would classify the units as financial liabilities).

- However, if the REIT Code is not considered as part of laws and regulations, the minimum dividend obligation specified in the trust deed would trigger the classification of the units (or their component part) as financial liabilities.

C. *Recognition and measurement of the rights and obligations disregarded in the classification*

4. Some respondents expressed concerns that the proposals in IAS 32.15A(b) would create ambiguity in the recognition and measurement of the contractual rights and obligations arising from relevant laws and regulations that are proposed to be disregarded in classifying a financial instrument. In the absence of sufficient guidance in the ED, this ambiguity could result in the following application issues and pose challenges in determining the appropriate measurement requirements for these contractual terms.

   For instance, consider the case of ordinary shares that include a contractual provision to mirror the statutory minimum dividend of 10%. Applying the proposals in the ED, these shares would be classified as equity instruments as the contractual dividend is disregarded. However, the following questions arise:

   - Should entities apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to account for the contractual obligation to pay the minimum dividend at initial recognition and for subsequent periods?

   - If the statutory minimum dividend subsequently decreases from 10% to 5% while the contractual dividend remains at 10%, would the change in laws and regulations constitute '*a change in circumstances external to the contractual arrangement*' and trigger reclassification under the proposed requirements in IAS 32.32B? Our respondents are concerned about the potential complexity that may arise if reclassification is required whenever such changes occur, even though they may not be frequent.

D. Classification of an incremental contractual right and obligation in its entirety

5. Some respondents found the proposal in IAS 32.AG24B to be counter-intuitive and difficult to comprehend. Applying the proposal, an ordinary share with statutory minimum dividend of 10% is classified as an equity instrument, while another ordinary share subject to the same statutory requirement but containing a contractual dividend of 10.1% is classified entirely as a financial liability, instead of being classified as an equity instrument of 10% and a financial liability of 0.1%. Our respondents noted that the different classification resulting from such a small but genuine difference in the dividend payout ratio would not provide meaningful information, would impede comparability between different entities, and potentially create structuring opportunities.

   We acknowledge that there are certain situations where separating a contractual obligation and accounting for each element individually might be complex. However, for the reasons stated in BC24 of the ED, we consider that entities should separately account for the regulatory obligation and the incremental contractual obligation, unless it is impracticable to do so, in which cases entities would classify the entire obligation as a financial liability and provide additional disclosures. Such approach would provide useful information to users of financial statements and would be consistent with the concept of bifurcation in IAS 32.

E. Our recommendations

6. Overall, we consider that the effects of laws and regulations are an important yet complex issue that has broad implications. They either interact with or have implications for other existing IFRS Accounting Standards (e.g. IFRS 9 *Financial Instruments*, IAS 37 and IFRIC 2). We also understand that a complete alignment of the accounting classification with the legal view would fundamentally change the existing requirements in IAS 32 and IFRS 9, which is not the objective of this project. In light of this and our respondents' concerns, we recommend the IASB seriously reassess the feasibility of the proposals, conduct field tests to assess the impact and clarity of the proposals on different financial instruments, and evaluate whether the outcomes reflect the substance of the instruments and provide relevant information considering the different legal systems between jurisdictions, particularly between those based on civil law versus common law.

7. If the IASB were to proceed with the proposals, we recommend the IASB undertake the following actions:

   - Clarify the extent of laws and regulations that should be considered in determining the classification of financial instruments;

   - Clarify the initial recognition and subsequent measurement of contractual dividend that would be disregarded in the classification;

   - Consider accounting for regulatory obligation and incremental contractual obligations separately, unless it is impracticable to do so; and

   - Provide supporting guidance (e.g. illustrative examples on common instruments) to avoid potential diversity in application and unintended consequences.

Question 2: Settlement in an entity's own equity instruments (paragraphs 16, 22, 22B-22D, AG27A and AG29B of IAS 32)

8. We generally welcome the proposals to clarify the principles in IAS 32 regarding the fixed-for-fixed condition. However, we have significant concerns about the accounting implications of applying the proposals to certain common contractual terms in Hong Kong. Our concerns and recommendations are summarised as follows.

A. Preservation adjustments for issue of new shares below market price

9. Several respondents from large accounting firms expressed significant concerns that the proposals in IAS 32.22C(a)(ii) would impact the current practice in respect of classification of conversion options in convertible bonds (CBs) whose terms provide for an adjustment to the conversion ratio when an entity issues shares to new investors below market price in order to compensate the CB holders for the dilution loss.

10. Currently, the market widely accepts such adjustment to conversion price as anti-dilutive and meeting the fixed-for-fixed condition because:
    - The adjustment protects the rights of CB holders relative to the *current and future equity holders* taken together. It focuses on preserving the CB holders' interests without regard to whether such a preservation would be to the detriment of *current* equity holders. As such, whether the current shareholders' interests get preserved is not a consideration in the formula.

    - In addition, the current shareholders can exercise their rights to preserve their interests by voting for or against issuing shares at below market price, while CB holders, who cannot vote, are compensated for the potential dilution loss through an enhanced conversion ratio. Also, issuing a large number of shares at a discount to improve liquidity of the shares also makes commercial sense.

11. However, such adjustment may cause the CBs to fail the fixed-for-fixed condition under the proposals in IAS 32.22C(a)(ii) because the CB holders are compensated whereas the current shareholders are not, meaning that the economic interests of the CB holders are preserved to a larger extent relative to the current shareholders (AG27A(c) of the ED).

12. Given that the vast majority of the CBs issued by Hong Kong issuers include such an adjustment in their contracts, the IASB proposals, if implemented, would result in the retrospective reclassification of the conversion options of these CBs from equity to derivative liabilities. Furthermore, we understand that the guidance published by certain large international accounting firms treats such adjustment as anti-dilutive. Hence, the proposals would also affect the current practice in other markets where we understand such instruments are also issued.

13. Considering the significance and pervasiveness of the potential change of the classification of CB's conversion options in Hong Kong, we strongly recommend the IASB carefully consider the implications of the proposals on existing market practices and provide clarification. In order to ensure that such clauses are not an impediment to equity classification of affected CBs, the IASB could consider clarifying the meaning of 'current holders of equity instruments' so as to include all equity instrument holders at the date of, and arising from, the 'contractually specified event'

in proposed paragraph IAS 32.22C(a) which leads to the dilution of future equity instrument holders.

B. *The use of a volume weighted average share price to adjust a conversion ratio*

14. Another concern is related to the accounting implications of the conclusion in Example 17 in the ED on the use of a volume weighted average share price (VWAP) to adjust the conversion ratio in CBs. We noted that, in practice, the share price used to determine the extent of dilution arising from right issues or share issues below market price is often calculated as the VWAP over a specified period before the diluting event occurs, instead of using the share price at a point in time just before that event occurs. For reasons ranging from corporate governance to securities law, this approach is adopted to avoid outliers or price spikes and is generally considered meeting the fixed-for-fixed condition by the market.

15. However, Example 17 states that the use of the average share price to determine the conversion price of a CB does not meet the fixed-for-fixed condition because it would favour the CB holders with additional shares at the expense of the ordinary shareholders if the average share price decreases. Based on the rationale in Example 17, we questioned whether using VWAP as a basis for determining the adjustment to a conversion ratio would no longer be considered a preservation adjustment in the ED. To illustrate our concern, consider an example where new shares are sold to existing shareholders at $5 per share when the last share price before the announcement was $7 per share, resulting in a dilution of $2 per share. According to the ED, a preservation adjustment could be up to $2 to meet the fixed-for-fixed condition. However, if a 20-day VWAP is adopted in the preservation adjustment calculation, the share price used for the adjustment could be $8, resulting in an adjustment of $3 instead of $2. Consequently, the CB holder is arguably favoured with additional shares at an enhanced conversion ratio when a 20-day VWAP is used.

16. Considering the common use of VWAP in Hong Kong as a measure to prevent potential market manipulation and the existence of differing practices in determining the period for a VWAP calculation, we strongly recommend the IASB clarify the application of the proposals to VWAP, particularly whether VWAP clauses can meet the fixed-for-fixed condition. Furthermore, acknowledging the challenges in designing a preservation adjustment that would completely eliminate any possibility of overcompensating CB holders relative to current equity holders, the IASB could consider the relative merits of changing the proposed criteria for preservation adjustments in IAS 32.22C(a)(ii) so it reads:

    - ‘preserves the economic interests of the future holders of the entity’s own equity instruments (the future equity instrument holders) to an **approximately** equal or lesser extent…’ (which would likely require a qualitative test), or

    - ‘**is designed** to preserve the economic interest of the future holders of the entity’s own entity instruments (the future equity holders) to an equal or lesser extent’ (which would amount to a qualitative assessment).

    In addition to its own considerations, the IASB may wish to conduct field test or discuss with preparers or users the proposals and how the market currently considers such adjustments.

C. Passage-of-time adjustments

17. Our respondents raised concerns about the application of the proposed passage-of-time adjustments on the following two common contractual terms:

- **CBs carrying an interest rate benchmark**: Currently, entities generally consider CBs with an interest rate benchmark as meeting the fixed-for-fixed condition because they consider that the '*fixed amount of cash*' requirement in IAS 32.22 is met whenever the contract has a '*fixed stated principal amount*'. In addition, IAS 32.22 further specifies that '*changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received…on settlement of the contract'* do not preclude equity classification. However, Example 20 and BC 57 of the ED state that an adjustment linked to a variable, such as an interest rate benchmark, would not be considered a passage-of-time adjustment because such an adjustment does not solely vary with the passage of time. Consequently, the proposals appear to change the current practice of classifying the conversion options as equity to derivative liabilities. On the other hand, Example 14 in the ED describes a CB with accrued interest where the conversion option passes IAS 32.22B (assuming there are no other features that fail equity classification). Example 14 does not state whether the interest rate that accrues is fixed or floating so it is ambiguous whether a floating rate of interest in this case is a passage-of-time adjustment that passes the criteria in IAS 32.22C(b).

  In any case we believe that the idea of a 'passage-of-time adjustment' for these purposes should extend to either compensation for passage of time based on benchmark interest rates over periods of time (which could change) or a locked-in interest rate over that same period at contract inception.

- **Change of control provisions:** These provisions are common as protective rights for CB or derivative holders, as they allow for adjustments to the conversion ratio to compensate for the loss of time value in the option and the loss of optionality following a change of control event, such as when a listed company is being privatised. The inputs used to estimate an option value could include other parameters, such as share price and share price volatility, which vary based on the remaining option life. These inputs are inter-dependent in calculating the time value of an option. Currently, the market treats many of these provisions as anti-dilutive adjustments.

  However, IE 80 of the ED explicitly states that if the predetermined formula for the adjustment to a conversion ratio includes the share price as an input, such an adjustment would not be a passage-of-time adjustment. Therefore, the proposals could cause some of the cases that currently meet the fixed-for-fixed condition to fail under the proposed passage-of-time requirement in IAS 32.22C(b) because:
  - They may not be predetermined at the inception of the contract (IAS 32.22C(b)(i));
  - They may not vary with the passage of time only (IAS 32.22C(b)(ii)); and
  - They may not always be linear and proportionate over time (IAS 32.22C(b)(iii)) even though the adjustment is anti-dilutive.

18. In light of the above concerns, we recommend the IASB:

    - Clarify and reconsider whether financial instruments linked to interest rate benchmark would still meet the fixed-for-fixed condition under the ED; and

    - Clarify and explain its expectation of the calculation of a passage-of-time adjustment for change of control provisions through illustrative examples.

Question 3: Obligations to purchase an entity's own equity instruments (paragraphs 23 and AG27B-AG27D of IAS 32)

19. We generally agree with the proposed clarifications on the requirements for contracts containing an obligation for an entity to purchase its own equity instruments.

20. Nevertheless, some respondents have expressed concerns about the proposals regarding the initial and subsequent measurement of this obligation in IAS 32.23 of the ED. Given the proposed measurement principles are largely the same as those in IAS 32.25 and 25A for contingent settlement provisions, the comments provided by the respondents are summarised in Part C of Question 4 below (see in particular paragraphs 31 and 33 of our response below).

Question 4: Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)

21. We appreciate the efforts made by the IASB to clarify this important area. However, we have the following concerns about the proposals.

A. *Scope of financial instruments subject to IAS 32.25 and 25A*

22. Our respondents raised concerns about the potential implications of the proposed amendments to IAS 32.25 and 25A. Specifically, the current wording of the amendments seem to imply that the measurement requirements in IAS 32.25A would apply to all financial instruments with contingent settlement provisions, including those that are currently measured solely under IFRS 9, and this could result in unintended consequences.

23. Consider a written put option (other than over own equity instruments) that is contingently exercisable if the stock market index rises by a certain percentage. Applying the proposals, such a written put option would be measured at the full settlement amount instead of at its fair value. This would inadvertently result in a day-1 loss for the option writer whenever the option premium received (which equals the option's fair value on initial recognition) is lower than the full settlement amount. Another example relates to debt instruments with contingent settlement provisions. Consider a three-year fixed rate loan that includes an early redemption option exercisable by the holder at 105% of its par value in the event of a change of control over the issuer. Applying the proposals, the loan would be initially recognised at 105% of par, even if the loan is issued at market rate (and thus has an initial fair value equal to par) and the likelihood of a change of control is low. The accounting outcomes of these two examples would be different from the current practice where IFRS 9 measurement is applied. We believe that the IASB does not intend for such accounting outcomes, but the proposals in the ED are not clear in this regard.

24. We consider that the lack of clarity and guidance on the scope of financial instruments subject to IAS 32.25 and 25A poses a risk of misapplication of the proposed measurement on derivatives for written puts other than over own equity instruments and debt instruments with contingent settlement clauses, leading to unintended outcomes. Hence, we strongly recommend the IASB clearly define the scope to avoid diversity in practice and to minimise the risk of misapplication.

B. Measurement approach in IAS 32.25A

25. Our respondents expressed divergent opinions on the measurement principle proposed in IAS 32.25A. Some respondents agreed with the proposals to measure the financial liability at its full amount without considering the probability and estimated timing of settlement. They formed their views based on BC11-12 of IAS 32 that IAS 32.23 and IAS 32.25 have the sole purpose of creating a gross liability for obligations that are conditional on events or choices that are beyond the control of the issuer. This is different from a typical financial liability, such as a bank loan recognised under IFRS 9, which represents an economic burden for an entity.

26. However, other respondents disagreed with the proposals to ignore the probability and estimated timing of the contingent events in measuring the financial liabilities with contingent settlement provisions. One of these respondents pointed out that the measurement requirements for compound financial instruments in existing IAS 32.30-32 provide a more suitable framework for determining the measurement requirements of compound financial instruments with contingent settlement provisions. Measuring the liability component at fair value is also consistent with the measurement principle for contingent consideration that meets the definition of a financial liability, as required under IFRS 3 *Business Combinations* (IFRS 3.39 and 58). This would better reflect the economics of the transaction and provide useful financial information, for example, in the following cases:

    - Entity X issued redeemable preferred shares that include contingent settlement clauses. In the event that Entity X fails to meet a specific condition, such as achieving a specified level of net income, the preferred shares become immediately payable. In addition, the distribution to preferred shareholders is discretionary. Applying the proposals, Entity X would be required to initially measure the liability component at the full settlement amount, assuming a breach of that condition had occurred. However, this respondent considered that it would be more sensible to assess the likelihood of a condition being breached (a contingent event) and measure the liability component of the preferred shares accordingly. This approach is consistent with the measurement of bank loans that are subject to the same condition applying IFRS 9. In practice, entities consider the probability of a breach of a condition when measuring such loans, rather than assuming an immediate breach of the covenant.

    - Entity Y issued preferred shares with a coupon rate equivalent to that of ordinary shares. These shares would be converted into a fixed number of Entity Y's ordinary shares if Entity Y successfully completes an initial public offering within a 5-year period. Holders of these shares also have the option to redeem them at their principal amount and interest in the 5th year. However, if Entity Y fails to meet the profit targets, the redemption amount would become 120% of the principal amount and interest. Applying the proposals, Entity Y would be required to measure the liability component at the present value of 120% of the principal amount and interest. However, entities generally considered it more reasonable to factor in the likelihood of meeting the profit targets in determining

the liability host contract and then bifurcate the embedded derivatives to be measured at fair value before recognising the equity components.

27. We note the IASB’s intention to align the measurement approach (i.e. full amount payable at the earliest possible date) with the requirements in IAS 32.23. We also note the IASB’s concern about the complexity of the probability-weighted measurement approach (BC101 of the ED). However, some of our respondents believe that the probability-weighted approach has worked well when measuring similar instruments with contingent settlement clauses. In their view, the current practice also provides relevant financial information to users of financial statements.

28. In light of the differing views expressed by our respondents, we recommend the IASB conduct field tests using both measurement approaches on a broad range of contingent settlement clauses. By evaluating the accounting outcomes resulting from these tests, the IASB can make an informed decision on whether a single measurement approach or a combination of approaches would best provide relevant financial information.

C. *Potential practice issues of IAS 32.25A*

29. In relation to the proposals in IAS 32.25A to measure the financial liability at the present value of the settlement amount at the earliest possible settlement date, we have identified a few practice issues that warrant attention and further consideration by the IASB. We recommend the IASB provide guidance or clarifications, should it proceed with the proposals. These issues are summarised as follows.

30. Firstly, making the assumption to settle at the earliest possible date may not always reflect the maximum exposure and depict the liquidity risk of the issuer, for example, in the following cases:

    - A holder of a written put option can exercise his right to redeem at $100 at any time, but the redemption amount increases to $100 million if it is redeemed in the 5th year. The liability of $100 on initial recognition has little substance but represents a clearly genuine clause (something could happen to make it worth exercising, although the likelihood is low). As the issuer would only remeasure the liability to $100 million in the 5th year under the proposals, it has arguably inappropriately benefitted from a higher net asset value for the intervening period.

    - Contracts with multiple settlement provisions may have the highest settlement amount (even on a present value basis) occurring at a later possible settlement date.

    - Contracts with a redemption obligation that is subject to growth at a rate of x%, but the discount rate is lower than x%, assuming settlement at later dates are more likely in this case.

31. Secondly, the ED has not provided any guidance on determining the discount rate for calculating the present value of the settlement amount. Unlike IFRS 9, where the discount rate can be derived from the fair value and undiscounted contractual cash flows of the financial liability at initial recognition, the financial liability for the obligation in question is not initially recognised at fair value under the proposals. Hence, the discount rate is an input instead of an output (as it is in the case of the effective interest method). However, the ED does not provide guidance on how to select or develop the discount rate, and whether it needs to be updated in subsequent reporting periods.

32. Thirdly, the ED lacks clarity on the measurement of the financial liability when the contingent settlement clause is not settled by cash but by another financial instrument that is also subject to contingent settlement provisions. The following example illustrates this issue:

    - A group has two companies that have issued preference shares. Company A issued Type A preference shares that are the same as its ordinary shares except:

        - In case of Event A1, the share is redeemable at $100, which was its issue price.
        - In case of Event A2, the share is convertible into one Type B preference share of Company B.

    - Company B issued Type B preference shares that are the same as its ordinary shares except that in case of Event B, the share is redeemable at $120.

    - All the Events (A1, A2 and B) are beyond the control of the issuer and the holder, and could occur at any time. At the reporting date, the fair value (as defined in IFRS 13 *Fair Value Measurement*) of both Type A and Type B preference shares is $100 per share.

    Questions arise as to how the liability arising from a Type A preference share should be measured in the consolidated financial statements of the group. Should the liability be measured at $100, being the fair value of a Type B preference share, or should it be measured at $120, being the settlement outcome that the issuer 'does not have the unconditional right to avoid'? If Events A2 and B happened in immediate succession, the issuer could not avoid delivering $120.

33. Lastly, the ED lacks clarity on how the remeasurement of financial liability should be conducted for contracts with multiple contingent settlement provisions and the triggers for settlement are mutually exclusive.

    For example, an entity issued a preference share which is the same as an ordinary share except that it is redeemable at $10 in case of a change of control event (Event X), and at $15 if the founders leave the entity within 5 years of issuance of the preference shares (Event Y). Both events can happen at any time. The issuer would initially recognise the gross liability at the higher of the two liabilities, i.e. $15, to depict the liquidity risk of the issuer.

    If the preference share remains unsettled after 5 years, the liability of $15 ceases to exist because Event Y can no longer occur. Since IAS 32.25 and 25A do not provide specific guidance for contracts with multiple contingent settlement provisions, questions arise as to whether the issuer should follow the principle in IAS 32.23 for reason specified in paragraph 25 above. If the principle in IAS 32.23 is applied, the issuer would remove the gross liability of $15 and include the amount in equity when Event Y expires. However, as the gross liability of $10 for Event X still exists, the issuer would reclassify only $5 to equity and retain a liability of $10.

    Some respondents disagreed with presenting the $5 as a remeasurement gain in profit or loss based on the proposals in IAS 32.25A for the following reasons:

    - The $5 arose from the expiry of an obligation that was accounted for as a gross liability (i.e. Event Y), not a normal financial liability; and

    - The gross liability does not represent a present economic burden of the issuer at the date of derecognition and the reduction of $5 in the gross liability does not

represent an economic gain for the issuer (i.e. there was no loss for the other party). This is different from a scenario where an issuer has a bank loan of $10 that 'expires' without having to be repaid, in which case it would be a faithful representation of the event to recognise a gain of $10 upon derecognition because the issuer is relieved from the economic burden of the bank loan 'for free'.

This issue would also occur in conjunction with IAS 32.23 when the written put option is contingently exercisable at different exercise prices for different triggering events.

Question 5: Shareholder discretion
(paragraphs AG28A-A28C of IAS 32)

34. We acknowledge the challenge of providing guidance on determining whether shareholder discretion should be treated as an entity's decision, considering that different jurisdictions have their own laws, regulations and legal frameworks. Consistent with the majority of our respondents' views, we generally support the IASB's approach to establishing several broad factors to assist entities in making this determination. We consider that the proposal provides guidance and an appropriate level of flexibility for entities to exercise judgement when determining the classification based on their specific circumstances, and at the same time, it also helps reduce diversity in practice.

35. Nevertheless, a respondent who disagreed with the proposal questioned the feasibility of using the four proposed factors to determine whether shareholder discretion should be treated as an entity's decision. This respondent illustrated his concerns by explaining how the factors could be applied in an example of a capital reduction of ordinary shares with subsequent pay-outs of the reduced amount:

    - *1st factor:* Capital reduction is not considered a routine decision and occurs only occasionally for certain entities.

    - *2nd factor:* In some major jurisdictions, shareholders can propose capital reduction themselves with management's assistance in enforcing the proposal.

    - *4th factor:* Exercising shareholders' decision-making right would enable the shareholders to require the entity to make the pay-outs.

    Accordingly, depending on how an entity applies the factors, it is possible for an entity to arrive at a conclusion that shareholder decision is unlikely to be treated as an entity's decision, resulting in the classification of ordinary shares as financial liabilities. This outcome apparently contradicts the market practice that ordinary shares are equity instruments.

36. We note that the proposed IAS 32.AG28B explicitly states that the four factors are not exhaustive. It emphasises the importance of exercising judgement in assessing these factors and considering other relevant factors based on the entities' own circumstances. However, in light of the potential issue raised by the respondent (see paragraph 35), we suggest that the IASB explore providing illustrative examples to demonstrate the application of the four factors, identification of other relevant factors, and determination of their weightings in different scenarios. These examples could specifically address the situation of capital reduction of ordinary shares that was previously mentioned. We believe that the IASB could explore the usefulness of developing such illustrative examples, taking into account the benefits of clarifying

the treatment in common scenarios and the risk of needing to illustrate very specific and limited circumstances that may not be suitable for illustrative examples.

Question 6: Reclassification of financial liabilities and equity instruments (paragraphs 32B-32D and AG35A of IAS 32)

37. We welcome the IASB's efforts to address this important area, as currently IAS 32 does not contain any specific requirements on whether and when to reclassify an instrument after initial recognition. However, we have significant concerns about the following two major areas in the proposal.

A. *Prohibition of reclassification of a financial instrument when there is a change in the substance of contractual arrangement due to passage of time*

38. We disagree with the proposal that prohibits reclassification when there is a change in the substance of the contractual arrangement due to the change in the passage of time ('Prohibition') for the following reasons:

    - IAS 32 establishes classification requirements that are definition-driven. Therefore, if a financial instrument no longer meets the definition of a liability or equity, a change in its classification should be warranted. However, the Prohibition would require an entity to retain the classification of the instrument as a financial liability, even though the definition of 'financial liability' under IAS 32 is not met. Accounting for the instrument as such might misrepresent the substance of the financial instrument and the entity's situation, potentially triggering the 'true and fair' override to achieve a fair presentation of the financial statements.

    - The proposal could create potential structuring opportunities for entities to recognise gains in profit or loss without the occurrence of a performance event. Consider the case of a preference share with a contingent settlement provision. Initially, the issuer recognises a gross liability under IAS 32.25A. When the contingent settlement provision stops being effective due to the passage of time, the Prohibition would prevent reclassification of the preference share to equity. The preference share which is still accounted for as a gross liability would be remeasured to nil under IAS 32.25A and BC143. Consequently, a gain equal to the carrying amount of the gross liability would be recognised in profit or loss at the remeasurement date, although there is no performance event.

    - We are not convinced by the IASB's assertion in BC138-139 and 145 of the ED that reclassification would increase cost and complexity for preparers due to the need to assess whether an instrument should be reclassified at each reporting date, and this assessment could be onerous for preparers. Preparers already need to monitor whether certain contractual terms have expired / stopped being effective when remeasuring the instruments and preparing the proposed disclosures under IFRS 7.30F. Furthermore, reclassification is beneficial for users in understanding the financial statements, as it appropriately reflects the change in the substance of the contractual arrangement.

    - We do not support the IASB's approach of requiring entities to disclose the contractual terms and conditions of financial liabilities that become or stop being effective with the passage of time as a means to compensate for the Prohibition. We do not think this is the appropriate approach to address this issue, based on a view similar to the requirement in IAS 1.18, which states that '*[a]n entity cannot*

rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material'.

In view of the above, we strongly recommend the IASB reconsider its reclassification proposal relating to the passage of time, and remove the Prohibition.

39. If the IASB decides to proceed with the proposal of Prohibition, we suggest that the IASB:

    - State explicitly in the body of the standard that the derecognition requirements of IFRS 9 do not apply to situations when the terms and conditions in a contractual arrangement have expired or become ineffective due to the passage of time. This clarification is necessary because several respondents raised this question, despite BC128 of the ED having already set out the IASB's relevant considerations; and

    - Include a reference to the 'gross liability' model under IAS 32.25 and 25A in BC143. This reference is important because the Prohibition would generally apply to obligations that are measured using the 'gross liability' model, and this model differs from the 'amortised cost' and 'fair value' models under IFRS 9, which are currently referred to in BC143.

B. <u>Interactions between the proposals on reclassification and the effects of laws and regulations</u>

40. We consider that the proposal also lacks clarity regarding whether a subsequent change to laws and regulations would constitute a change in the substance of the contractual arrangement due to *'changes in circumstances external to the contractual arrangement'*. As mentioned in paragraph 4 above, the proposal is unclear whether reclassification would be required when there is a change in the law that creates incremental contractual obligations. It is also unclear whether reclassification would be required when a change in law prevents the enforceability of the contractual rights and obligations.

41. Therefore, we are of the view that the proposal on reclassification interacts with the proposal on the effects of laws and regulations. Accordingly, we strongly recommend that the IASB consider the two proposals together and ensure that their interactions are adequately considered and addressed.

Question 7: Disclosure **(paragraphs 1, 3, 12E, 17A, 20, 30A-30J and B5A-B5L of IFRS 7)**

42. We acknowledge the IASB's efforts in responding to the information needs of users and improving the quality of disclosures related to financial instruments with characteristics of equity. Although many of the proposed disclosures individually are beneficial, we consider it crucial to strike a balance between the potential costs and benefits associated with the disclosures as a whole. We are concerned that the expected costs associated with implementing the proposed new disclosures as a whole would outweigh the potential benefits. Accordingly, we recommend the IASB perform field testing of the proposals for entities of different sizes, particularly multinational entities with complex financial instruments, to assess the associated costs and benefits. In addition, we have comments and recommendations on the following specific disclosures proposed by the IASB.

A. *Disclosure on the nature and priority of claims against the entity on liquidation, arising from its financial liabilities and equity instruments [IFRS 7.30A-30B, IG14B-14C]*

43. Our respondents questioned the usefulness and practicability of disclosing the nature and priority of claims in the consolidated financial statements in complex situations, such as in a group where various claims arise from subsidiaries in different jurisdictions with different legal framework on liquidation. Summarising the claims against subsidiaries in a single note to the consolidated financial statements may not provide meaningful information to investors to understand the priority of claims of their investments.

44. In addition, although the ED has provided an illustrative example in IG14C on the application of the proposed disclosure requirement, that example only demonstrates a simple scenario. We anticipate that complexities and operational challenges in practice would exist as mentioned above.

45. In this regard, we suggest the IASB consider adopting a similar approach to that in IFRS 12.12, which would require entities to provide disclosures about the nature and priority of claims for each of their subsidiaries that have financial instruments with characteristics of equity that are material to the reporting entity.

B. *Disclosure on potential dilution of ordinary shares [IFRS 7.30G-3H, B5I-5L, IG14H]*

46. Some respondents considered it more appropriate to propose the disclosure on potential dilution of ordinary shares in IAS 33 *Earnings per Share*, instead of IFRS 7, given that IAS 33 already includes similar disclosures, such as diluted earnings per share (EPS). Others are concerned that the proposed new disclosure, regardless of its location in IAS 33 or IFRS 7, could potentially confuse users, particularly in terms of how it is different from the determination of the denominator in the calculation of diluted EPS in IAS 33. Accordingly, we suggest the IASB consider adding disclosures to reconcile the new disclosure with diluted EPS in order to avoid such confusion, if the IASB decides to proceed with the proposal.

47. In addition, a few respondents questioned the practicability of disclosing a description of contracts or other commitments to repurchase ordinary shares and the minimum number of each class of ordinary shares the entity is required to repurchase as proposed in IFRS 7.30G(b), particularly in the case of 'Share buy-back' as illustrated in Table 1 in IG14H. They explained that in practice, entities do not know the exact number of shares to be repurchased in the future, as share buy-back transactions are usually framed in terms of dollar amount expected to be spent, rather than the number of shares planned to be repurchased. Furthermore, an announced share buy-back only indicates an entity's intent and does not represent a legal commitment. In view of this, we suggest categorising the item of 'Share buy-back' in the illustrative disclosure as 'Unknown number of share buy-back', on the condition that the entity has entered into contracts or commitment to repurchase its ordinary shares.

C. *Disclosure on information about financial instruments that include an obligation for an entity to purchase its own equity instruments [IFRS 7.30J]*

48. Some respondents questioned the usefulness of adding the proposed disclosures in IFRS 7.30J, as IAS 1 already sets out similar requirements to provide the relevant information. Specifically, the proposed disclosure on equity movements for the entity to repurchase its own equity instrument duplicates the information already presented in the statement of changes in equity. Furthermore, the proposed

disclosures on remeasurement gains or losses recognised during the period and gains or losses on settlements should have been presented as separate line items under IAS 1.85 if the amounts are material. Introducing these duplicated disclosure requirements in IFRS 7 would not only result in increased costs for preparers but would also lead to excessive amount of information, potentially obscuring other material information. Given these concerns, we recommend the IASB reassess the costs and benefits associated with adding these disclosure requirements.

D. Disclosure on information about terms and conditions [IFRS 7.30D]

49. We consider that the proposed disclosure in IFRS 7.30D(a) regarding the terms and conditions of financial instruments that determine their classification as financial liabilities or equity instruments, as well as the proposed disclosures in IFRS 7.30D(b)(i) and (ii) regarding the cash flow characteristics that are not representative of the classification of financial liabilities or equity instruments but are relevant to an understanding of the nature of those financial instruments, are particularly useful in helping users gain a better understanding of the nature of 'debt-like' instruments classified as equity instruments and 'equity-like' instruments classified as financial liabilities. These disclosures are especially relevant for significant investments made by pre-IPO investors or other investors with complex arrangements. Accordingly, we recommend the IASB retain these disclosures when reassessing the proposed disclosures in the ED during the finalisation of the proposal.

Question 8: Presentation of amounts attributable to ordinary shareholders (paragraphs 54, 81B and 107-108 of IAS 1)

50. We have concerns about the usefulness and the practicability of implementing the proposed presentation of amounts attributable to ordinary shareholders separately from amounts attributable to other holders of the entity's own equity instruments.

51. From a usefulness perspective, we noted that BC256 of the ED indicates that the presentation of equity attributable to ordinary shareholders and other equity holders is based on the contractual terms applicable at the reporting date. It does not include amounts expected to become attributable to those equity holders upon the occurrence of future events. This means that the allocation is solely determined based on the circumstances at the reporting date, without the need for any forward-looking estimation. However, we question whether the presented amounts can provide useful and meaningful information to users in this case. This is because these amounts can be subject to various future changes in the entity's circumstances, but their determination does not take into account any forward-looking estimation of these changes, which could significantly impact the amounts.

52. From a practical perspective, our respondents emphasised the practical difficulties involved in determining an appropriate allocation of various types of reserves, other than retained earnings, between ordinary shareholders and other owners in the consolidated financial statements. Examples of such reserves include foreign exchange reserve and fair value reserve of financial instruments measured at fair value through other comprehensive income. The respondents did not consider the allocation to be a simple apportionment exercise. They also questioned whether management would need to make assumptions based on the applicable contractual terms in determining the allocation. If so, the process could be difficult and challenging, depending on the circumstances of the entity.

53. In light of the above concerns, we recommend that the IASB reassess the costs and benefits of the proposal and reconsider whether to proceed with the proposal. If the IASB decides to proceed with the proposal, we suggest the IASB:

    - Provide guidance and illustrative examples to explain how the allocation should be performed under different scenarios (e.g. foreign exchange reserve, fair value reserve) based on some common fact patterns in practice; and

    - Clarify in the body of the standard that the proposed allocation of reserves does not require the use of forward-looking information (BC256 of the ED). This clarification is necessary as some respondents have misinterpreted that the allocation involves estimation of occurrence of future events.

Question 9: Transition
(paragraphs 97U-97Z of IAS 32)

54. We support the IASB's proposal of applying a full retrospective approach for the proposed amendments. In particular, we agree that the retrospective application of the proposed amendments would ensure consistency of financial information between periods and facilitate analysis and understanding of comparative information.

55. Considering that the proposed amendments may result in changes to the classification and measurement of certain complex financial instruments, we recommend that the IASB allow sufficient time for entities to implement the proposal when it determines the effective date of the amendments.

Question 10: Disclosure requirements for eligible subsidiaries
(paragraphs 54, 61A-61E and 124 of [IFRS XX])

56. Our respondents consider that the proposal does not provide an appropriate level of relief to eligible subsidiaries without public accountability ('Eligible Subsidiaries'), despite the objective of IFRS XX being to simplify and reduce the cost of financial reporting for these subsidiaries through reduced disclosures. In particular,

    - As explained in paragraph 48 above, certain proposed disclosures in relation to financial instruments that include an obligation for an entity to purchase its own equity instruments appear to duplicate the existing requirements in IAS 1, and therefore are excessive.

    - Some respondents expressed the view that the disclosures concerning the nature and priority of claims on liquidation arising from financial instruments have limited usefulness for Eligible Subsidiaries, especially those that are private, closely-held subsidiaries with sophisticated investors, such as private equity funds. These respondents considered that these investors would have a comprehensive understanding of the contracts when making their investments.

57. We conducted a high-level comparison between the proposals in IFRS 7 and the consequential amendments to IFRS XX. It appears that the main relief provided to Eligible Subsidiaries is the exemption from providing disclosures on the potential dilution of ordinary shares. In light of this, we are concerned that the costs associated with implementing all the proposed additional disclosures for IFRS XX might undermine the objective of simplifying and reducing the cost of financial reporting for Eligible Subsidiaries, and that these costs may outweigh the associated benefits.

58. Considering the nature of Eligible Subsidiaries and the need to balance costs and benefits, we suggest the IASB conduct further analysis or test the proposals on some common types of Eligible Subsidiaries to assess the potential significance and relevance of each proposed disclosure.

~ End ~