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29 March 2024

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Comments on the Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity* (Proposed amendments to IAS 32, IFRS 7 and IAS 1)

1. The Accounting Standards Board of Japan ("we") welcome the opportunity to provide our comments on the International Accounting Standards Board ("the IASB")'s Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity* (Proposed amendments to IAS 32, IFRS 7 and IAS 1) ("the ED"), issued in November 2023.

2. We previously commented that a more fundamental review of the classification of financial liabilities and equity instruments would assist consistency and understandability of the classification. However, if the rationale behind the existing requirements in IAS 32 *Financial Instruments: Presentation* were to remain in place for the foreseeable future, we think that the focused efforts of this project to address practical questions that have accumulated over the years would be beneficial.

3. With respect to the effects of relevant laws or regulations discussed in Question 1, we believe that classification should, in principle, be based on all facts and circumstances, and that the IASB should take steps to reconsider the requirements of IAS 32 to consider only contractual rights and obligations in classification in the long term.

4. Regarding the proposed disclosures discussed in Question 7, we believe that further consideration should be given to measures to reduce the cost of preparing the

disclosures, as such costs may not be proportional to the benefits for some entities, depending on how those entities raise capital.

5. Our responses to each of the questions are set out in the Appendix.

We hope that our comments will contribute to future deliberations at the IASB. Please feel free to contact us if you have any questions.

Yours sincerely,

Y. Kawanishi

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Appendix

Question 1—The effects of relevant laws or regulations (paragraphs 15A and AG24A–AG24B of IAS 32)
The IASB proposes to clarify that: (a) only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts (paragraph 15A); and (b) a contractual right or obligation that is not solely created by laws or regulations, but is in addition to a right or obligation created by relevant laws or regulations shall be considered in its entirety in classifying the financial instrument or its component parts (paragraph AG24B). Paragraphs BC12–BC30 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

(Comments)

1. We do not agree with the proposals.

2. We understand that the proposals are based on the rationale behind the existing requirements in IAS 32, which requires an entity to consider only contractual rights and obligations in classifying financial instruments. The definitions of a financial instrument, a financial asset, a financial liability and an equity instrument in IAS 32 refer to contracts and contractual rights and obligations and we acknowledge that there is an established practice based on those definitions. However, we are concerned that the proposals could result in different classifications of instruments that have no substantive difference in the obligations when laws and regulations are taken into account. In this regard, the proposals differ from the requirements of other IFRS Accounting Standards, including IFRS 15 *Revenue from Contracts with Customers,* which require an entity to consider contractual terms as well as any legislation or legal precedent that could supplement those contractual terms.

3. As a result of the proposals to focus on contractual terms, additional issues arise such as whether the minimum dividend rate established by law should be treated separately or together with the dividend rate established by the contract. Another issue may arise in relation to the so-called bail-in instruments issued by regulated banks. Each jurisdiction has discretion as to whether the conditions to determine whether certain bail-in instruments qualify for Tier 2 status should be prescribed in laws or regulations, or in a contract. As a result, there may be differences in classification depending on the decisions each jurisdiction makes.

4. We believe that classification should essentially reflect all facts and circumstances. We acknowledge that it is difficult to achieve this objective in the short term, but we believe that the IASB should work toward this objective and consider revising the requirements of IAS 32 in the longer term.

5. We would also add that, if the IASB were to proceed with the proposals in the ED, clarification related to the following proposals are warranted:

   (a) In relation to paragraph 15A of IAS 32 and paragraph AG24B of IAS 32, although we acknowledge that an example is provided of a minimum dividend payment under relevant laws and an additional minimum dividend payment under contractual terms, the ED does not necessarily describe the conditions under which an entity should apply the latter, and there is a concern that this may be read as the former and latter being used interchangeably.

   (b) Some of our stakeholders note that the wording of the former and latter in (a) is similar, and that it is difficult to distinguish between the two, and that there is a concern that this may lead to misunderstandings in their application.

Question 2—Settlement in an entity's own equity instruments (paragraphs 16, 22, 22B–22D, AG27A and AG29B of IAS 32)
The IASB proposes to clarify when the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32 is met by specifying that the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency, and either:

(a) fixed (will not vary under any circumstances); or

(b) variable solely because of:

(i) preservation adjustments that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders; and/or

(ii) passage-of-time adjustments that are predetermined, vary with the passage of time only, and have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments (paragraphs 22B–22C).

The IASB also proposes to clarify that if a derivative gives one party a choice of settlement between two or more classes of an entity's own equity instruments, the entity considers whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative is an equity instrument only if all the settlement alternatives meet the fixed-for-fixed condition (paragraph AG27A(b)).

The IASB further proposes to clarify that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument (paragraph 22D).

Paragraphs BC31–BC61 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

(Comments)

6. We basically do not object to the proposals, but comment on the following:

   (a) Paragraph BC47 of the ED describes the arguments for the preservation adjustments as being to ensure that current and future equity instrument holders have the same relative residual interest in the net assets of the entity. In this regard, paragraph BC48 of the ED provides an example of an adjustment that might favour a future equity instrument holder at the expense of current equity

instrument holder, and paragraph BC49 of the ED provides an example of the opposite situation. The ED proposes that only the latter situation be consistent with the fixed-for-fixed condition, presumably because, in some cases, it is consistent with the pure fixed-for-fixed condition even if it would favour current equity instrument holders. We suspect, however, this may not always apply. We think that there is a need for further clarification of the rationale behind the proposal and whether there should be any limitations to which such a situation should apply.

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

The IASB proposes to clarify that:

(a) the requirements in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instruments also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments (paragraph 23).

(b) on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would, therefore, be removed from a component of equity other than non-controlling interests or issued share capital (paragraph AG27B).

(c) an entity is required to use the same approach for initial and subsequent measurement of the financial liability—measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right (paragraph 23).

(d) any gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraph 23).

(e) if a contract containing an obligation for an entity to purchase its own equity

instruments expires without delivery:

(i) the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial liability.

(ii) any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss. However, the entity may transfer the cumulative amount of those gains or losses from retained earnings to another component of equity (paragraph AG27C).

(f) written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled—consideration is exchanged for own equity instruments—are required to be presented on a gross basis (paragraph AG27D).

Paragraphs BC62–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

(Comments)

7. We have the following comments:

(a) Regarding the proposal in paragraph 23 of IAS 32 (measuring the liability at the present value of the redemption amount and ignoring the probability and estimated timing of the counterparty exercising that redemption right), we do not disagree with the proposal in light of the overall intention of the project, which is to address practice issues without fundamentally changing IAS 32. However, an entity may have other obligations with contingencies beyond its control that should be measured in accordance with other standards. Compared with this situation, the approach in paragraph 23 of IAS 32 may be perceived as being inconsistent with the requirements in other IFRS Accounting Standards. Accordingly, we think that analysis should be conducted to identify any differences between the approach in paragraph 23 of IAS 32 and the measurement concepts of liabilities in other IFRS Accounting Standards (for example, measuring financial instruments in accordance with IFRS 9 *Financial*

Instruments at fair value under IFRS 13 *Fair Value Measurement* and measuring non-financial liabilities in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

(b) The ED proposes to remove "in accordance with IFRS 9" from paragraph 23 of IAS 32 and makes it less clear whether a liability for an entity's obligation to purchase its own equity instruments should remain as a financial liability within the scope of IFRS 9. In addition, though the proposed disclosures in paragraph 30J of IFRS 7 *Financial Instruments: Disclosures* corresponds to the requirements in paragraph 23 of IAS 32, it is unclear whether other disclosures in IFRS 7 required for financial liabilities under IFRS 9 should apply to this obligation. We think that these points should be clarified.

(c) While many stakeholders agree with the proposal in paragraph 23 of IAS 32 that remeasurement gains or losses be recognised in profit or loss, some stakeholders have a reservation about this proposal, stating that counterintuitive results may arise for instruments that can be exercised at fair value and that some entities currently recognise the changes in equity. We expect that the IASB will conduct more in-depth and balanced analysis of both arguments to make its conclusion more persuasive.

Question 4—Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)
The IASB proposes to clarify that: (a) some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A); (b) the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A); (c) payments at the issuer's discretion are recognised in equity even if the equity

component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37);

(d) the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations (paragraph 11); and

(e) the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring (paragraph AG28).

Paragraphs BC94–BC115 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

(Comments)

8. Similar to our comments in response to Question 3, we think that additional analysis should be performed to determine the appropriateness or rationale for ignoring the probability of occurrence or non-occurrence of the event and the estimated timing of the event in the measurement.

9. Some stakeholders in our jurisdiction note that paragraph AG28 of IAS 32 in the ED does not add factors to consider when assessing whether the contingent settlement provision is genuine or not. These stakeholders are concerned that, without such assessment factors, regulatory change in capital requirements could always be considered genuine or not genuine.

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

The IASB proposes:

(a) to add a general requirement that prohibits the reclassification of a financial instrument after initial recognition, unless paragraph 16E of IAS 32 applies or

the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement (paragraphs 32B–32C).

(b) to specify that if the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement, an entity would:

(i) reclassify the instrument prospectively from the date when that change in circumstances occurred.

(ii) measure a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification would be recognised in equity.

(iii) measure an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification. No gain or loss would be recognised on reclassification (paragraph 32D).

(c) provide examples of changes in circumstances external to the contractual arrangement requiring reclassification (paragraph AG35A).

Paragraphs BC126–BC164 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

Would the proposal to reclassify the instrument prospectively from the date when a change in circumstances occurred give rise to any practical difficulties? If so, please describe those practical difficulties and the circumstances in which they would arise.

(Comment)

10. We basically have no objection to the proposal. However, we note that it should be noted in the main text of IAS 32 that this proposal is not a treatment for cases where the contractual terms are modified, as described in paragraph BC127 of the ED.

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

The IASB proposes:

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

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

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

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

(e) to include disclosure requirements for compound financial instruments in IFRS 7 (paragraph 17A).

The IASB proposes to require an entity to disclose information about:

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

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

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

(d)	the potential dilution of ordinary shares (paragraphs 30G–30H and B5I–B5L); and
(e)	instruments that include obligations to purchase the entity's own equity instruments (paragraph 30J).

Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

(Comments)

11. The proposed disclosures about "(a) the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments," "(b) the terms and conditions of financial instruments with both financial liability and equity characteristics," and "(c) terms and conditions that become, or stop being, effective with the passage of time" could be a significant burden for entities that issue a large number of and a variety of financial instruments. In addition, there is also the risk of more information provided in the notes, which could undermine the usefulness of the information by failing to provide targeted information about significant instruments and their contractual terms. For these reasons, we think that the following measures should be considered:

    (a) disclosures should be limited to those that are significant.

    (b) cross-referencing to information in documents other than financial statements should be permitted as permitted for the disclosures of "Nature and extent of risks arising from financial instruments" in paragraph B6 of IFRS 7.

12. Some stakeholders in our jurisdiction are concerned about the proposal to separate the carrying amounts of claims issued by the parent from those issued by subsidiaries in the proposed disclosure of "Nature and priority of claims on liquidation, arising from financial instruments." Because the parent may undertake financing of the whole group and distributes the funds to its subsidiaries, these stakeholders are concerned that the disclosure may not be a faithful representation as the information of the parent would reflect the financing of its subsidiaries within the consolidated group and not necessarily the parent itself. We think that many consolidated groups

use similar financing schemes to raise capital efficiently, and that guidance that would encourage entities to include additional explanations would facilitate the understanding of users.

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

The IASB proposes to amend IAS 1 to require an entity to provide additional information about amounts attributable to ordinary shareholders. The proposed amendments are that:

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

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

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

(d) dividend amounts relating to ordinary shareholders are presented separately from amounts relating to other owners of the entity (paragraph 107).

Paragraphs BC246–BC256 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

Would the proposed requirement to allocate issued share capital and reserves between ordinary shareholders and other owners of the parent give rise to any practical difficulties in determining the required amounts? If so, please describe the possible difficulties and specify areas in which further guidance would be helpful.

(Comment)

13. The ED does not provide guidance on calculating the amount to be allocated between ordinary shareholders and other owners of the parent, and we think that practical difficulties may arise. For example, we believe that practical difficulties may arise in allocating the amount to instruments where the entity has discretion in the timing and amount of coupon payments, and allocating the amount to warrants where no coupon payment occurs. We think that additional guidance is needed.

Question 9—Transition (paragraphs 97U–97Z of IAS 32)

The IASB proposes to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information (a fully retrospective approach). However, to minimise costs, the IASB proposes not to require the restatement of information for more than one comparative period, even if the entity chooses or is required to present more than one comparative period in its financial statements.

For an entity already applying IFRS Accounting Standards, the IASB proposes:

(a) to require the entity to treat the fair value at the transition date as the amortised cost of the financial liability at that date if it is impracticable (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) for the entity to apply the effective interest method in IFRS 9 *Financial Instruments* retrospectively (paragraph 97X);

(b) not to require the entity to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application (paragraph 97W);

(c) to require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments (paragraph 97Z);

(d) to provide transition relief from the quantitative disclosures in paragraph 28(f) of IAS 8 (paragraph 97Y); and

(e) no specific transition requirements in relation to IAS 34 *Interim Financial Reporting* for interim financial statements issued within the annual period in which the entity first applies the amendments.

For first-time adopters, the IASB proposes to provide no additional transition requirements.

Paragraphs BC262–BC270 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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

Would the proposal to apply the proposed amendments retrospectively give rise to any other cases in which hindsight would be necessary? If so, please describe those cases and the circumstances in which the need for hindsight would arise.

(Comments)

14. For entities that already applied IFRS Accounting Standards, we agree with the proposal of retrospective application of the proposed requirements and with the proposed transitional provisions. However, some of the proposals for classification in the ED may add complexity to classifying the instruments or may require a certain degree of judgment at initial recognition, and we think that the IASB should additionally consider whether the cost of applying such proposals to financial instruments that do not exist at the date of initial application of the amendments is likely to be commensurate with the benefits.

15. For first-time adopters, we think that the IASB should consider whether the transitional provisions should be aligned with any transitional provisions for entities that have already applied IFRS Accounting Standards, added as a result of further consideration in response to the comments received, such as the consideration noted in the previous paragraph.