CFA Institute

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IFRS Foundation
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

RE: Exposure Draft: Financial Instruments with Characteristics of Equity – Proposed Amendments to IAS 32, IFRS 7, and IAS 1

Dear International Accounting Standards Board Members,

CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC") [2], appreciates the opportunity to comment and provide our perspectives on the International Accounting Standards Board's ("IASB" or "the Board") Exposure Draft: *Financial Instruments with Characteristics of Equity – Proposed Amendments to IAS 32, IFRS 7, and IAS 1* ("Exposure Draft").

CFA Institute has a long history of promoting fair and transparent global capital markets and advocating for strong investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures and the related audits provided to investors and other end users are of high quality. Our advocacy position is informed by our global membership who invest both locally and globally.

INTRODUCTION

Guidance in existing International Financial Reporting Standards ("IFRS") is at times unclear with respect to the classification of financial instruments with characteristics of equity ("FICE") and disclosures for these instruments are limited. We expect these types of instruments to only grow in number, given market forces and managements' desire for favorable reporting outcomes.

The Exposure Draft is a package of three groups of amendments, aimed at improving disclosure, enhancing presentation, and the clarifying the classification of certain financial instruments with the characteristics of equity. The objective of the Exposure Draft includes improving investors

1 With offices in Charlottesville, VA; New York; Washington, DC; Brussels; Hong Kong SAR; Mumbai; Beijing; Abu Dhabi; and London, CFA Institute is a global, not-for-profit professional association of more than 190,000 members, as well as 160 member societies around the world. Members include investment analysts, advisers, portfolio managers, and other investment professionals. CFA Institute administers the Chartered Financial Analyst® (CFA®) Program. For more information, visit www.cfainstitute.org or follow us on LinkedIn and X.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

understanding of entities' capital structures and their ability to compare different entities, as well as addressing reporting challenges for preparers.

OVERALL VIEWS

We support the proposed disclosure and presentation amendments. CFA Institute has advocated for disclosure and presentation amendments similar to the proposals for nearly two decades across several comment letters including:

- *Comment Letter to the IASB on Discussion Paper: Financial Instruments with Characteristics of Equity, May 2019*
- *Comment Letter to the IASB on Exposure Draft for Classification of Liabilities: Proposed Amendments to IAS 1, July 2015*
- *Comment Letter to the IASB on Conceptual Framework Discussion Paper: Distinction Between Equity and Liabilities Instruments, February 2014*
- *Comment Letter to the IASB on Exposure Draft for Financial Instruments: Disclosures, November 2004.*

Our 2007 position paper¸ *A Comprehensive Business Reporting Model,* also provides presentation and disclosure principles – referenced in the aforementioned comment letters – that align with the IASB's direction of travel in this Exposure Draft.

While the proposed disclosure amendments are a strong step forward, we believe they represent a minimum level of disclosure for these instruments. We expect that more disclosures will be necessary once entities reveal this minimum level of information and the gaps in understanding of the hierarchy of payment and waterfall of capital structures become more evident. We believe the proposed disclosures will not only provide investors with information, but – as is always the case when new disclosures must be made – make information gaps evident to management as well.

We are not sympathetic to the view that these disclosures are too difficult or subjective to produce. Investors already perform this type of analysis and must do so with far less information than management.

We generally support the proposed classification amendments, but our support is tempered by a lack of visibility into the meaning and implications of the proposed changes. In the aforementioned comment letters related to the classification of financial instruments and the distinction between equity and liability instruments – particularly the 2014 conceptual framework letter and the 2019 FICE discussion paper letter – we highlight our proposed view that both equity and debt should be narrowly defined with all other items classified between these very narrow definitions with substantial disclosures made of the characteristics of instruments containing both debt and equity features. This is why our attention in this letter is heavily focused on the efficacy of the proposed disclosures.

The IASB has been more limited than we prefer in its review of the proposed amendments of classification provisions, but we are generally supportive of the proposals. That said, it is challenging to discern if the proposed classification amendments in the Exposure Draft are a codification of existing practices or if changes in reporting outcomes will result from the proposed revisions. The Board also does not provide any estimate as to how many entities will be affected by the proposed classification amendments and how significant the changes in reporting outcomes might be.

We support the proposed full retrospective approach to adoption. We recommend the restatement of comparative information be fully retrospective and not limited to one comparative period.

These likely won't be the last changes. As we've written previously, debates over financial instrument classification will never end so long as standard setters maintain the binary distinction between liabilities and equity. Financial markets will keep evolving, prompting ever more questions for the IFRS Interpretations Committee and the Board. Without a more fundamental change, the Board will have to keep issuing proposals like the Exposure Draft on a regular basis to keep up with financial markets.

Additionally, we believe the IASB's post implementation review of the final standard resulting from this Exposure Draft should heavily focus on the efficacy of the disclosures as the proposed disclosures are a first start, but not the full complement of disclosures sought by investors.

ANSWERS TO SELECT QUESTIONS

As we note above, our response is focused on the disclosure and presentation changes in the Exposure Draft. As such we considered only questions related to those elements and the transition below.

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.

We support the proposals.

CFA Institute has long advocated to the Board for disclosures similar to the proposals. In our comment letter to the IASB on Discussion Paper: Financial Instruments with Characteristics of Equity, May 2019, we advocated that an ideal disclosure would provide:

> …a waterfall table of claims arising from senior secured, senior unsecured, junior, subordinated claims and residual interest distributable to equity participants. Different countries could have a variation of claim categories based on local laws. However, a disclosure broadly covering these categories with simplified guidance would be operationally easier for preparers and exceptionally helpful for users.

The proposed disclosures, particularly those for nature and priority of claims against the entity on liquidation and the terms and conditions of FICE, would go a long way towards the ideal disclosure.

The goal of these disclosures is to help investors make the judgments they already make by bringing many sources of information into one place and summarizing it using management's know-how. This approach should reduce costs in the system because management crafted the financial instruments, so it is easier for management to assemble these documents and make the disclosure than investors.

The benefits of greater disclosures include:

- Transparency to enable the understanding of economic reality, specifically:
    - Improves analysis of the financing side of the balance sheet and connects it with existing disclosures on risk, liquidity, and fair values;
    - Consistent and comparable ROE and leverage ratios irrespective of structure or mode of financing;
    - Sufficient granular information for users and regulators to make adjustments to their metrics or ratios based on their internal methodologies or regulatory directives;
    - Greater transparency for markets and policymakers providing an improved macro view including having information that would be consistent at a global level;
- May deter management structuring transactions to achieve reporting outcomes
- Feedback for the Board for classification and presentation projects
- May lead to greater understanding of the entity's capital structure for management as well. The Global Financial Crisis revealed to many managements that they failed to have a complete understanding of the instruments which compromised their capital structures and how they operated together – particularly in complex financial institutions.

We are not sympathetic to the view that these disclosures are too difficult or subjective to produce. Investors already perform this type of analysis and must do so with far less information than management.

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

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

We strongly support the proposals.

These proposals would complement those made under IAS 33, *Earnings Per Share*, but provide a broader picture and "bear case" for dilution. Some companies present amounts attributable to ordinary shareholders already, but the proposals would result in greater comparability and controls over that information.

In our Position Paper: *A Comprehensive Business Reporting Model*, July 2007, we advocated for financial reporting that views the entity from the perspective of an ordinary shareholder and proposed a specific statement, a "Statement of Changes in Net Assets Available to Common Shareowners" to clearly achieve that. The proposed amendments are a step in this direction.

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 minimize costs, the IASB proposes not to require the restatement of information for more than one comparative period, even if the entity chooses or is required to present more than one comparative period in its financial statements. For an entity already applying IFRS Accounting Standards, the IASB proposes: a) to require the entity to treat the fair value at the transition date as the amortized cost of the financial liability at that date if it is impracticable (as defined in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors) for the entity to apply the effective interest method in IFRS 9 Financial Instruments retrospectively (paragraph 97X); b) not to require the entity to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application (paragraph 97W); c) to require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments (paragraph 97Z); d) to provide transition relief from the quantitative disclosures in paragraph 28(f) of IAS 8 (paragraph 97Y); and e) no specific transition requirements in relation to IAS 34 Interim Financial Reporting for interim financial statements issued within the annual period in which the entity first applies the amendments. For first-time adopters, the IASB proposes to provide no additional transition requirements. Paragraphs BC262–BC270 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why. Would the proposal to apply the proposed amendments retrospectively give rise to any other cases in which hindsight would be necessary? If so, please describe those cases and the circumstances in which the need for hindsight would arise.

We support the proposed full retrospective approach to adoption, though we recommend the restatement of comparative information to not be limited to one comparative period, but to encompass all comparative periods presented.

We do not support the proposed approach to interim disclosures, contained in paragraph BC269 of the Basis for Conclusions, which use a management approach:

> The Board is proposing no specific transition requirements in relation to IAS 34 Interim Financial Reporting for interim financial reports issued within the annual period in which an entity first applies the proposed amendments. **The entity would therefore apply judgement in determining what to disclose to meet the requirement for disclosing information about the nature and effect of changes in accounting policies, and how much information to provide to update the relevant information presented in the most recent annual financial report.** (emphasis added).

We urge the Board to require interim disclosures for any changes to what was disclosed in the prior annual financial statements, particularly any changes in the economics of the financial instruments outstanding. Investment decisions are made continuously, and the proposals in the Exposure Draft are important complements to the existing interim disclosures related to earnings per share, financial instruments, and share-based payments.

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Thank you for your consideration of our views and perspectives. We would welcome the opportunity to meet with you to provide more details. If you have any questions or seek further elaboration of our views, please contact Sandra J. Peters at sandra.peters@cfainstitute.org and Matthew P. Winters at matt.winters@cfainstitute.org.

Sincerely,

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