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Dear Andreas,

ED/2023/5 – *Financial Instruments with Characteristics of Equity (Proposed amendments to IAS 32, IFRS 7 and IAS 1)*

On behalf of the Accounting Standards Committee of Germany, I am writing to comment on ED/2023/5 *Financial Instruments with Characteristics of Equity (Proposed amendments to IAS 32, IFRS 7 and IAS 1)*, issued by the IASB on 29 November 2023 (herein referred to as 'ED'). We appreciate the opportunity to comment on the proposals.

We support the IASB's efforts to clarify and amend existing IAS 32 requirements. First of all, we like to confirm the IASB's general findings that applying current IAS 32 requirements

- works well for most financial instruments;
- broadly results in appropriate classification; and
- does generally provide useful information.

Consequently, we agree that a fundamental review of IAS 32, as envisaged in the proposals from the June 2018 IASB Discussion Paper DP/2018/1, is neither necessary nor desirable. Further, we acknowledge that many application issues have been resolved during long-term experience and practice in applying IAS 32.

On this basis, we explicitly support the ED's objective to clarify and resolve known application issues and, thus, to focus on selected IAS 32 requirements only by amending or adjusting the respective principles and/or by adding accompanying guidance.

As regards the specific proposals in the ED, we would like to confirm that the IASB has touched on the most significant issues and application challenges arising from applying current IAS 32 requirements. During deliberations with our stakeholders, we have been made aware that among all the ED's proposals the issues/questions related to "effects of relevant laws or regulations", "purchase of own equity instruments", as well as "disclosures" are most crucial and most relevant.

Our overall assessment is that we support some of the proposals, while we are not convinced about or not supportive of others. In particular, we

- agree with the proposals as regards “shareholder discretion”, “reclassification”, and “presentation”;
- are not yet convinced about the proposals on “settlement in own equity instruments”, “contingent settlement provisions”, and “transition” being appropriate or helpful;
- do not, or not fully, support the proposals on “effects of relevant laws or regulations”, “purchase own equity instruments”, and “disclosures”;
- have no view so far on the proposals regarding “disclosures for eligible subsidiaries” under IFRS 19 given there is yet no experience with applying IFRS 19.

For more details on our findings on the specific proposals in the ED, we refer to our responses to the questions which are laid out in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Jan-Velten Große (grosse@drsc.de) or me.

Yours sincerely,

Sven Morich
Vice President

Appendix – Answers to the questions in the ED

Question 1 – The effects of relevant laws or regulations

The effects of relevant laws or regulations (IAS 32.15A and AG24A–AG24B) … BC12–BC30 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.

We are **not convinced, thus not supportive**, of the proposals on how relevant laws or regulations should affect classification. After thorough discussion, we are not clear about what the IASB intends to propose and whether this results in (more) relevant information. Our lack of understanding concerns the differentiation and distinct treatment of contractual rights and obligations vs rights and obligations established by laws or regulations – in particular paras. 15A(a) second part and 15A(b). Apart from this, we fully agree with the requirement to consider rights and obligations as far as they are enforceable by laws (para. 15A(a) first part).

We basically understand, and agree, that the primary feature of assets and liabilities in general, and financial assets and liabilities in particular, is to represent in financial statements contractual rights and obligations – ie. rights and obligations that are subject to the individual agreement between two parties resulting from a contract. However, in jurisdictions with dispositive company law, the distinction between general requirements by laws and regulation and company-specific arrangements becomes artificial. There are even jurisdictions with very detailed legal requirements not leaving much room for individual (contractual) agreements, in particular with few room for deviations from law.

Hence, we take the view that any right or obligation associated with the existence of a contract must be considered and reflected. Rights and obligations that are agreed upon individually should be considered in classifying that instrument. Contrary to this, rights and obligations that result from relevant laws or regulations are not negotiated individually. We take the view that, nevertheless, these rights and obligations are similarly valid and binding for the parties of a contract, thus should similarly be considered in classifying that contract. Consequently, we do clearly prefer a classification approach as the one which the IASB refers to as "all-inclusive approach" (BC14). Conceptually, this seems the most appropriate approach, as it treats similar rights and obligations similarly, regardless of its source and/or different legal mechanisms in different jurisdictions.

> *This can be portrayed by an example: Assuming jurisdiction A where there is a legal or regulatory obligation to pay a (minimum) dividend, and an individual contract does not contain any additional or deviating agreements. The parties of this contract have the right and obligation to receive or pay that (minimum) dividend. Assuming another jurisdiction B with no legal or regulatory obligation about dividends at all, but two parties agree on a minimum dividend identical with the legal requirement in A, with this agreement becoming*

part of the contractual terms. Both contracts in two different jurisdictions were classified equally, if – and only if – legal and contractual rights and obligations are fully and equally considered.

As we understand, the IASB has acknowledged that this approach has many merits – eg. consistency with the IFRS framework, with other IFRSs, and (like our main argument) equal treatment between different jurisdictions (BC14). As we further understand, the only reason for the IASB dismissing this approach is that it would go beyond clarifying IAS 32 (BC15). This reason is not convincing, and we deem it insufficient for rejecting this superior approach.

Moreover, rejecting this approach even **contradicts two other proposals** in the ED:

The first is the proposal that <u>contractual rights and obligations that are in addition to those created by laws or regulations shall be considered in their entirety</u> (AG24B).

The following examples may help making the contraction obvious:

a) *Assuming a legal requirement for paying 5% minimum dividend, and contractual terms agreeing on 10% minimum dividend (thus, going further than the legal obligation), the entire 10% dividend must be considered in classifying this instrument (AG24B explicitly).*
b) *Further, assuming a contractual term containing a 10% minimum dividend (and no legal requirement for any dividend), again the entire 10% dividend must be considered in classifying this instrument (AG24B implicitly).*
c) *Finally, assuming a legal requirement of paying 10% minimum dividend, with no further or deviating contractual term as regards dividends, no dividend must be considered at all in classifying this instrument (BC15).*

All three fact patterns have similar overall rights and obligations and similar economic outcomes. As per the current IASB proposals, fact patterns a) and b) are treated alike, while c) is treated differently. This appears inconsistent and inadequate.

The second contradiction comes with the proposal on reclassification, requiring <u>reclassification when the substance of a contract changes because of a change in circumstances external to the contract</u> (para. 32B). One of the IASB's rationales is that such changes are not specific to the instrument (para. 32C) and cannot be modified by the parties to the contract (AG24A).

As an example, assuming that a new law establishes a redemption right not existing before. If rights and obligations established by law would change during existence of a contract, we consider this a change in circumstances external to the contract. As per para. 32B, this change must be considered when assessing whether reclassification is required. Assuming that new redemption right, the contract would potentially need to be reclassified from equity to liability. Contrary to this, paras. 15A(b), AG24A requires that rights and obligation arising solely from (a change in) relevant laws or regulations must not be considered for (re-)classification purposes. Hence, there is no basis for reclassification. Obviously, this appears contradictory and inconsistent.

As described above, the proposed approach leads to conflicting requirements and inconsistent classification outcomes. We feel it does not add to clarity but raises more questions than it answers. Instead, the "all-inclusive approach" would lead to consistent classification outcomes. In summary, we **advocate for the "all-inclusive" approach**, as it appears to be a more adequate and more coherent approach.

Question 2 – Settlement in an entity's own equity instruments

Settlement in an entity's own equity instruments (IAS 32.16, 22, 22B–22D, AG27A and AG29B) … BC31–BC61 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.

We appreciate the intention of addressing challenges in applying the fixed-for-fixed condition. However, we are **not convinced** that this should be done **by the specific proposals** in the ED, as they appear like adding rather casuistic requirements, and we wonder whether these proposals would indeed clarify and improve accounting.

We acknowledge that the IASB, in clarifying the area of accounting for settlements in own equity instruments, is addressing questions limited to very narrow fact patterns – which are obligations that constitute derivative financial instruments to be settled by a fixed number of instruments at a fixed amount. We are aware that practice issues have arisen around these particular instruments and the respective requirements. So far, focussing on these fact patterns is appropriate. However, it seems that the proposed clarifications lead to more rules for applying the fixed-for-fixed condition, thus moving away from a principles-based structure of the requirements. Since we consider the requirements around settlement in own equity instruments (paras. 16B, 22, 22A, 23) already having a rather rules-based approach, adding more details (paras. 22B-22D) does increase this unfavourable character.

Among the specific proposals, we have reservations against the <u>permitted passage-of-time adjustments</u> (para. 22C(b)). Allowing amounts that vary with the passage of time because they are, in principle, deemed consistent with the fixed-for-fixed condition does indeed slightly change the nature of this condition. However, we consider this acceptable. On this basis, we expect this to be a clear and principles-based feature, otherwise it would not add to clarity. Our perception is that the current proposals in this regard are neither clear nor principles-based. Considering in detail the different approaches the IASB had discussed (BC54), we do not fully understand why the approach in BC54(c) is deemed more consistent with the fixed-for-fixed condition than the approach in BC54(a), or even why these are considered differently. This given, we are not clear which variable interest rates would be permitted – eg. we would expect index-based variable interests to be permitted, but we are not able to derive this from the wording.

Overall, we feel that allowing passage-of-time adjustments (as currently specified in the ED) does not really add to clarity, while at the same time it raises more questions than it answers.

Further, we have some reservations against the particular understanding of functional currency (AG27A(a), AG29B). As per our reading, the proposals require that the only currency that complies with the fixed-for-fixed condition is the functional currency of the entity whose instruments will be delivered or received on settlement ("reference point", BC44). We do not agree with this understanding, and we deem it an unnecessary restriction. Instead, we suggest allowing both the functional currency of the entity within a group who initially issued the instrument or, alternatively, the functional currency of the group entity whose instruments will ultimately be delivered or received.

As regards the remaining proposals (ie. choice of settlement between two or more classes, settlement by exchanging one class with another), we have **no objections**.

Question 3 – Obligations to purchase an entity's own equity instruments

Obligations to purchase an entity's own equity instruments (IAS 32.23 and AG27B–AG27D) … BC62–BC93 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.

We support the IASB's intention to clarify accounting requirements for obligations to purchase own equity instruments (eg. forward purchase contracts or written puts over NCI), as this area has been and still is subject of long-lasting discussions and challenges. We would appreciate clarifications that are clear and consistent with IAS 32 requirements as well as with related principles in other IFRSs. Though, we are **not convinced** that the set of proposals is fully compliant with those principles. Therefore, we are **not supportive** of some of the proposals.

Our reservations mainly relate to the proposed requirement on how to deduct from equity the amount that is initially recognised as a liability (AG27B). In particular, we do not agree with the condition that if an entity does not yet have access to rights and returns associated with ownership of the relevant instruments, these instruments must be deducted from an equity component other than NCI or share capital (AG27B). Our reservations also relate to the proposed amendment that any gain and loss on remeasurement of a liability shall be recognised in profit or loss (para. 23).

More generally, the issue – and our reservation – is about whether, and why, recognition of a liability representing the obligation to purchase own instruments should, or should not, affect NCI. To our understanding, this directly interacts with the issue of whether, and why, differences on subsequent measurement should affect NCI and/or another equity component or be presented in profit or loss. Clarifying and answering these issues touches on two fundamental presentation premises – which are

1. presentation of existing ownership interests instead of potential ownership interests; and
2. presentation of transactions with owners in their capacity as owners.

We feel that both are, or seem to be, not implemented consistently throughout IFRSs, namely IFRS 10 and IAS 32. In other words, there is still a perceived lack of consistency within, and between, these two standards. We deem this as the main source of diversity in practice – the amendments would not resolve this cross-cutting issue.

1. As regards (1), we agree that the proposals are generally consistent with the premise of presenting existing ownership interests. In this respect, the proposals presumably help clarifying the accounting and reducing diversity in practice. However, we point to the fact that diversity in practice often occurs because transactions are not equal and, hence, are not accounted for equally. Therefore, applying the requirements differently can be appropriate, as far as they affect unlike transactions. Whenever this is the case, the current proposal would no longer provide that room for judgement and differentiation.
2. As regards (2), we understand that the proposals are based on the premise that NCI puts are not a transaction between owners, as long as the entity has not (yet) access to the rights and returns associated with those instruments' ownership. However, we again acknowledge that diversity in practice occurs because of a different understanding about the character of the obligation. We consider that for NCI puts or forward contracts the character of a transaction between owners is likely predominant. Therefore, removing the initial amount of the liability from NCI as well as presenting remeasurement gains and losses in equity (not in profit or loss) appears more appropriate to us.

Finally, we have reservations against determining the present value (ie. redemption amount) of a liability by assuming a redemption to occur at the earliest possible date, thereby not taking into account the probability and estimated timing of exercising the redemption right (para. 23). As this issue arises more prominently along with the proposals as regards issue/question #4 (contingent settlement provisions), we refer to our comments on Q4 below. These analogously pertain to the proposed measurement of the above-named obligations.

Question 4 – Contingent settlement provisions

Contingent settlement provisions (IAS 32.11, 25, 25A, 31, 32A, AG28 and AG37) … BC94–BC115 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.

While we agree with most of the proposals, we have **strong reservations** against the proposal for the initial and subsequent measurement of a liability (or liability component). In particular, we do not support the requirement to not take into account the probability and estimated timing of (non-)occurrence of the contingent event (para. 25A).

Our basic view is that this requirement appears counter-intuitive and seems contradictory to established measurement principles. As the concept of present value is well established, the idea of a weighted average (ie. considering different outcomes – timing and amounts –, weighing those outcomes by its probability, and discounting) is intuitive and implicitly assumed. Hence, we take the view that measuring the liability at a settlement amount which is discounted assuming a settlement to occur at the earliest possible date is not conceptually sound. We also considered the IASB's argument behind, which is that the (non-)occurrence of a contingent event – and/or the outcome of uncertain circumstances – is outside the issuer's control (para. 25A). This line of argument does not seem appropriate. Instead, we deem considering different outcomes (timing, amount, probability) being a fundamental measurement principle throughout the IFRSs for current measurement bases, even when there are uncertainties that are out of the issuer's control.

In addition, we considered and discussed whether, and how, this requirement (of not taking into account timing and probability) may severely affect the measurement outcome.

> *Giving a short example underlines our reservations against this requirement: Assuming a liability with a settlement amount of 100, and a settlement being very likely (say 90%) in 10 years, but the earliest possible settlement is in 1 year yet being very unlikely (say 10%). A present value as the weighted average of different possible outcomes would deviate considerably from a present value of the settlement amount as per the reading of para. 25A. This is also true in case of significant changes of the expected settlement amount over time (regardless of the likelihood pattern).*

As demonstrated, the way of measuring the liability is crucial, thus affirming our discomfort with the current proposal. To sum it up, we do not agree with the proposed requirement of not taking into account timing and probability of a contingent event.

Apart from this, we have **no objections to the other proposals** as regards contingent settlement provisions.

Question 5 – Shareholder discretion

Shareholder discretion (IAS 32.AG28A–AG28C) … BC116–BC125 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.

We **agree** with the proposals as they appear conceptually appropriate.

In particular, we deem the clarifications clearly and adequately reproducing and emphasizing the principle of control which is a fundamental and widely-used concept throughout the IFRSs.

Further, we like to confirm that the suggested factors are relevant and appropriate in this context. We also support that (i) these factors are (non-exhaustive) examples and (ii) whether these (or other) factors provide evidence always requires a case-by-case analysis.

To our knowledge, these factors seem to be in line with current practice. This given, we expect the proposals although providing clarity – and eventually reducing existing diversity – to not having far-reaching consequences on accounting practice.

However, we feel that the proposed wording for describing those factors could raise questions and/or has limited use. As all factors describe circumstances when shareholder decisions are "more likely" or "unlikely" to be treated as an entity decision, the reference to likelihood appears to be unfortunate – thus leaving, or opening, room for too much interpretation or judgement. We are aware, and fully agree, that the factors mentioned are intended to suggest a "tendency" instead of prescribing the outcome. On this basis, we feel that (i) entity's judgement on which factors to be assessed, (ii) different weighing of factors, and (iii) considering the degree of decision "routine" sufficiently portray the IASB's idea of avoiding a more prescriptive approach and, instead, proposing a more pragmatic approach.

Question 6 – Reclassification of financial liabilities and equity instruments

Reclassification of financial liabilities and equity instruments (IAS 32.32B–32D and AG35A) … BC126–BC164 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.

We **agree** with the proposals of (i) adding a general and explicit requirement that prohibits reclassification and (ii) adding another exception covering instruments where the contract's substance changes only because of changes in external circumstances. Further, we agree with prospective reclassification and with measurement at the date of reclassification as proposed. We also appreciate the two examples, which we consider helpful and adequate.

Question 7 – Disclosure

Disclosures (IFRS 7.1, 3, 12E, 17A, 20, 30A–30J and B5A–B5L) … BC170–BC245 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.

We are **not supportive** of the set of proposed disclosure requirements.

While we generally agree that additional disclosures might be information-useful and could be adequately accompanying amended IAS 32 requirements, we do not deem the specific proposals being appropriate.

We have deliberated and acknowledged that the entire set of additional disclosures would bring along considerable burden and costs in providing these information. Currently, it appears impossible to assess its effective – not only supposed – use or value-added, while additional costs are (reliably) assumed to be high. Consequently, whether additional information-use outweighs additional costs cannot be estimated – but is severely doubted. This is particularly valid for the proposed disclosures required by IFRS 7.30A and .30B, which are deemed most challenging and most costly. Further, the set of disclosure proposals would require many additional disclosures (and associated data collection) for, in predictably many cases, only few existing transactions or instruments. Although still inappropriate and burdensome, any such requirements should at least be accompanied by guidance allowing for some aggregation. This said, we suggest considering such reliefs.

Overall, and as a matter of principle, we think that as far as IAS 32 amendments are (intended to be) rather narrow-scope amendments or clarifications, extensive new disclosures requirements – as the proposals are perceived to be – appear not proportional and possibly not outweighing the additional efforts, thus are not adequate.

Question 8 – Presentation of amounts attributable to ordinary shareholders

Presentation of amounts attributable to ordinary shareholders (IAS 1.54, 81B and 107–108) … BC246–BC256 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.

We **agree** with the proposed amendment to the presentation requirements. We think that further aggregation, as proposed, would result in useful information.

Further, we like to mention that – to our knowledge – the proposed disaggregation appears to already be current presentation practice, at least for certain entities and under specific circumstances (eg. emissions of additional tier 1 capital).

However, we have **some reservations** as to how to determine those disaggregated amounts and about any challenges and associated costs, potentially not warranting the usefulness of this disaggregation.

Question 9 – Transition

Transition (IAS 32.97U–97Z) … BC262–BC270 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 **agree** with the transition requirements proposed, as we consider them adequate and useful.

However, we discovered two further aspects being relevant when transitioning to amended IAS 32 requirements, and we think both would deserve **additional transition guidance**.

The first aspect is a deemed lack of clarity about how to apply any amendments to instruments designated as hedged items under IFRS 9 hedge accounting requirements. Challenges could arise eg. with a financial liability, designated as hedged item, that in applying the amendments would be reclassified as an equity instrument. We think that additional transition guidance could be helpful and therefore suggest considering such guidance.

The second aspect is the well-known issue of retrospective application and hindsight. We expect hindsight questions to emerge in transitioning to the IAS 32 amendments, and we deem it helpful for many preparers if additional transition guidance would embed the principle of "prospective application due to hindsight" into these specific amendments.

Question 10 – Disclosure requirements for eligible subsidiaries

Disclosure requirements for eligible subsidiaries (IFRS XX.61A–61E and 124) … BC257–BC261 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, taking into consideration the reduced disclosure principles described in BC258.

As stated in our cover letter, we have **no view so far** about whether the proposed disclosure requirements for eligible subsidiaries are appropriate.

We acknowledge that these proposals constitute consequential amendments to, and ahead to the publication of, IFRS 19. Hence, they are virtually not relevant for assessing the appropriateness of the proposed clarifications or amendments to IAS 32.

While we are basically supportive if new IAS 32 disclosure requirements were brought forward to IFRS 19 on a reduced level, we feel not yet able to generally assess whether, and to what extent, the particular proposals are adequate. This is based on the fact that, by today, there is no experience in whether, and to what extent, the entire IFRS 19 proves to be advantageous

and appropriate compared to what its aims to be. Hence, there is yet no basis for assessing whether some additional (reduced) disclosures – like the ED's proposals – are adequate.

Finally, we like to point to our critical findings on the "disclosure" proposals (Q7), which analogously pertain to the disclosure proposals for IFRS 19.