IFRS

STAFF PAPER

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IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**	
Paper topic	Reclassification—proposed clarifications (part 2)	
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Purpose of this paper

1. This paper asks the IASB for tentative decisions on proposed clarifications related to the reclassification of financial instruments between financial liabilities and equity instruments applying IAS 32 *Financial Instruments: Presentation*.

2. In this paper, the staff present further analysis taking into account the feedback from the March 2022 IASB meeting. The analysis focuses on alternative approaches the IASB could consider and also considers whether the potential reclassification principles will result in useful information for users of the financial statements.

3. Consistent with the project objective as discussed by the IASB in October 2019, the staff explored how best to address this issue without fundamentally changing the requirements in IAS 32. The objective of the project is to address known practice issues that arise when applying IAS 32 by clarifying underlying principles in IAS 32. Where there is not an implicit or explicit principle for a particular requirement in IAS 32, the IASB could fill this gap by developing a principle and accompanying rationale. Feedback from the March 2022 IASB meeting indicated support from a number of IASB members for a principle-based solution that would reduce diversity in application by entities.

4. The staff acknowledge that where diversity in practice exists, any potential clarifications of the underlying principles may result in changes in classification outcomes for some entities. The staff will consider transition issues related to any potential amendments in the future once the project is at a more advanced stage.

5. This paper is structured as follows:

    (a) Summary of the staff recommendation;

    (b) Question for the IASB;

    (c) Staff analysis:

        i. alternative approaches;

        ii. if reclassification is required:

            1. timing of reclassification;
            2. measurement on reclassification;
            3. disclosure of reclassification; and

    (d) Staff recommendation

Summary of the staff recommendation

6. The staff recommend Approach C (see paragraphs 2828-3838 of this paper) which would add general requirements on reclassification to IAS 32 to prohibit reclassification other than for changes in the substance of contractual terms arising from changes in circumstances outside the contract. This does not affect reclassifications that are already required in IAS 32, for example specific reclassification requirements on puttable instruments and obligations arising on liquidation.

7. In the staff's view, Approach C would result in useful information provided to users of financial statements because it would faithfully reflect the substance of the contractual terms of financial instruments at the reporting date if there are changes in circumstances affecting classification. It would also be less onerous to preparers of financial statements than Approach B as that approach would require preparers to monitor and reclassify financial instruments for all types of changes in the substance of the contractual terms.

8. The staff further support accounting for a reclassification at the beginning of the first reporting period after the change in the substance of the contractual terms without a modification to the contract.

9. Consistent with the requirements in paragraph 16F of IAS 32, the staff recommend that:

   (a) on reclassification from equity to financial liability—a financial liability is measured at fair value at the date of reclassification and any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity; and

   (b) on reclassification of a financial liability to equity—an equity instrument is measured at the carrying value of the financial liability at the date of reclassification and no gain or loss is recognised.

10. The staff recommend additional disclosure requirements for reclassifications when changes in the substance of the contractual terms arise from changes in circumstances outside the contract. This would help users of financial statements better understand the change in classification and the impact on measurement, if any.

Question for the IASB

11. The staff would like to ask the IASB the following question.

Question for the IASB
Do IASB members agree with the staff's recommendations summarised in paragraphs 6-10 of this paper?

Staff analysis

Alternative approaches

12. The staff further explored the potential approaches the IASB could consider in deciding whether reclassification between financial liabilities and equity instruments should be required or prohibited for changes in the substance of contractual terms

without a modification to the contract. Resolving this issue would reduce diversity in practice.

13. In March 2022, the staff set out Approach A (prohibit reclassification unless IAS 32 specifically requires it) and Approach B (require reclassification). Under Approach B, the staff said it would also consider whether reclassification should be required only for some changes in the substance of the contractual terms but prohibited for others. In this paper, the staff refer to this latter approach as Approach C.

14. The staff do not recommend allowing an accounting policy choice to permit reclassification as this would result in continued diversity in practice which leads to a lack of comparability between entities that have issued similar financial instruments. Similarly, when the IASB discussed reclassification of financial assets, it noted that permitting reclassification would decrease comparability, both between different entities and for instruments held by a single entity, and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognised.

15. Reclassification of a financial instrument as a financial liability or equity would not only affect its presentation in the statement of financial position but also its measurement (equity is not remeasured whereas financial liabilities are) and depending on what the IASB decides, it may result in a remeasurement gain or loss recognised in equity or profit or loss. Classification, measurement and presentation as financial liabilities or equity will also give different information to users of financial statements about the nature, timing and amount of future cash flows of the entity.

16. Bearing in mind that the scope of any proposed clarifications will be limited to the changes in the substance of the contractual terms without a modification to the contract discussed in Agenda Paper 5A of this meeting, the staff set out three alternative approaches below.

Approach A: prohibit any reclassification other than those specifically required

17. This approach is based on a view that IAS 32 intended to generally prohibit subsequent reclassification. This view is grounded in the principle in paragraph 15 of IAS 32, which requires classification on initial recognition of a financial instrument considering all the contractual terms and conditions of the instrument. If the IASB

decides on this approach, a further clarification could be added to that paragraph that financial instruments are not subsequently reclassified between financial liabilities and equity instruments *unless* IAS 32 specifically requires it.

18. IAS 32 contains specific reclassification requirements in paragraphs 16E–16F of IAS 32 for puttable instruments and obligations arising on liquidation. The staff understand that one of the reasons for adding the requirement in paragraph 96B of IAS 32 that the puttable instruments exception cannot be applied by analogy was to avoid it being used for reclassifications in other cases. Approach A would therefore limit reclassifications to those required by IAS 32. Approach A therefore appears to be consistent with the objective of this project which is to clarify the underlying principles without a fundamental change to IAS 32.

19. If the IASB decides on Approach A, it could consider requiring entities to still disclose information about the effects of changes in the substance of the contractual terms on the nature, timing and amount of the cash flows. Users of financial statements have told us on several occasions that they need to understand the impact on the future cash flows of the entity as they evaluate investment alternatives and their evaluation can be assisted by quality disclosures of contractual terms of financial instruments.

20. The staff think it would be appropriate to include disclosures about changes in the substance of the contractual terms in the proposed disclosures on the key terms and conditions of financial instruments with characteristics of both debt and equity discussed by the IASB in April 2021. The IASB's tentative decision at that meeting included disclosures of 'equity-like' features in financial liabilities and vice-versa. Such additional disclosures would provide useful information to users of financial statements about the features of those financial instruments at the reporting date. This will help investors better understand the nature, amount, timing and uncertainty of cash flows arising from issued financial instruments and highlight cash flow characteristics that are not 'typical' of the instrument's classification.

21. Approach A takes a narrow view on reclassification. It emphasises the disadvantages of reclassification (discussed in Agenda Paper 5A of this meeting) and finds support from other cases in financial instrument accounting where reclassification or reassessment is prohibited such as the prohibition of:

    (a) reclassification of financial assets based on changes in contractual cash flow characteristics;

(b) reclassification of financial liabilities; and

(c) subsequent reassessment of whether embedded derivatives should be separated from host contracts that are not assets in the scope of IFRS 9.

Approach B: require reclassification for all changes in the substance of contractual terms without a modification to the contract

22. Under this approach, general requirements on reclassification would be added to IAS 32 stating that reclassification would be required to reflect all changes in the substance of the contractual terms without a modification to the contract. No distinction would be made between the types of changes in the substance of the contractual terms. Therefore reclassification would reflect the substance of the contractual terms that are effective for the remaining life of the financial instruments at the reporting date. Although paragraph 15 of IAS 32 refers to initial recognition, it specifically advocates classification in accordance with the substance of the contractual arrangement. Reclassification would therefore allow the accounting to reflect the substance of the contractual arrangement at each reporting date.

23. Approach B would represent a fundamental change to the requirements in IAS 32 and would go further than just clarifying underlying principles. It would add a principle on reclassification which would represent a fundamental change to IAS 32. Requiring reclassification for all types of changes in the substance of the contractual terms without a modification of the contract would mean expanding the requirements for reclassification in IAS 32 beyond puttable instruments and obligations arising on liquidation and could lead to inconsistencies with the requirements in other areas of financial instrument accounting (for example the SPPI assessment based on contractual cash flow characteristics in IFRS 9).

24. The staff considered the example of the convertible bond where the number of shares that will be delivered if the conversion option is exercised is determined only at a future date when the conversion price becomes fixed. In this case, the number of shares the entity has an obligation to deliver changes from variable to fixed with the passage of time. Applying Approach B, a reclassification would be required even though the contractual terms were known at initial recognition based on the following arguments:

(a) the unit of account is the conversion option containing an obligation to deliver shares. The requirements for derecognition and recognition are not met because the obligation to deliver shares is not discharged, cancelled or expired and the entity already became a party to the contractual terms on the initial date of classification.

(b) a change in classification would better reflect the substance of the contractual obligation. When the conversion ratio becomes fixed, the nature of the obligation substantially changes from an obligation to deliver a variable number of shares into an obligation to deliver a fixed number of shares.

25. The underlying principle in IAS 32 for classification between financial liability and equity is whether an entity has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. If the financial instrument had been issued at the date when the substance of the contractual terms changes, it would have been classified differently. Approach B would require reclassification to reflect such a change.

26. Reclassification would therefore allow the statement of financial position to reflect circumstances at the reporting date. The classification as financial liability or equity will affect key ratios used by investors in their analyses such as leverage or return on equity. Reclassification would thus provide useful information to users of the financial statements in assessing the entity's prospects for future net cash inflows and management's stewardship of the entity's economic resources in line with the objective of financial statements (set out in paragraph 3.2 of the *Conceptual Framework*). For example, it would be confusing to users of financial statements to classify an instrument as a financial liability if it no longer meets the definition of a financial liability.

27. Referring to the discussion in paragraph 40 of Agenda Paper 5A of this meeting, one of the concerns about reassessing the separation of embedded derivatives in IFRS 9 related to recognition and measurement if a previously separated embedded derivative was no longer required to be separated and there had been no transaction, no change in the value of the total contract or its components or no change in the economics of the whole contract. The staff think in the case of most changes in the substance of the contractual terms, there is likely to be a change in the economics of the contract. For example, if a linked instrument (as described in Agenda Paper 5A of this meeting) is

settled and there is no longer an obligation to pay coupons on the base instrument, there would be a change in the economics of the contract because the issuer's cash flows will be affected. Approach B would thus reflect this change in the economics of the contract.

Approach C: prohibit reclassification other than for changes in circumstances

28. Applying this approach would result in adding general requirements on reclassification to IAS 32 which prohibiting reclassification other than for changes in the substance of contractual terms arising from changes in circumstances outside the contract.

29. The staff note that in practice there could be a variety of changes to the substance of the contractual terms without a modification of the contract. In determining which additional scenarios would require reclassification, the staff focused on *specific types of changes* for example, 'changes in circumstances outside the contract', rather than focusing on a *specific change* for example, changes in functional currency. Focusing on the types of changes will make application of the proposed requirements easier which should result in consistent application. We note from the examples in the published guidance of large accounting firms that there are differing views in practice and focus has been on specific circumstances eg changes in organisational structure affecting the fixed-for-fixed condition generally require reclassification whereas changes in functional currency affecting the fixed-for-fixed condition generally permit reclassification.

30. The staff acknowledge that Approach C would still be seen as a change to the requirements in IAS 32, although not as fundamental a change as Approach B would be. This is because it would add general requirements for when reclassification is required ie when changes in circumstances outside the contract result in a change in the substance of the contractual terms.

31. Similar to Approach A, the starting point is that reclassification is generally prohibited in IAS 32 so the emphasis is on limiting cases that require reclassification rather than limiting cases that prohibit reclassification. Similar to Approach A, if the IASB decides on this approach, a further clarification could be added to paragraph 15 of IAS 32 that financial instruments are not subsequently reclassified between financial liabilities and equity instruments *unless* IAS 32 requires it.

32. The staff considered whether a similar requirement for reclassification as that in paragraph 16E of IAS 32 could apply to other changes in the substance of contractual terms without a modification of the contract. The cases leading to reclassification of puttable instruments and obligations arising on liquidation are more similar to the changes in substance of contractual terms arising from a change in circumstances outside the contract rather than when existing contractual terms become or cease to be effective with the passage of time. This is because reclassifications required by paragraph 16E also do not arise from modifications to the contract but rather from a change in circumstances outside the contract. For example, the classification of puttable instruments could be changed by the issuance or redemption of another class of financial instrument that is in the most subordinated class but does not have identical features. Therefore, the staff do not believe any inconsistency would be created within IAS 32 if reclassification due to other changes in circumstances is required and reclassification of 'passage-of-time changes' is prohibited.

33. Applying Approach C as described in paragraph 28 of this paper, could be seen as consistent with the requirements for reclassification of financial instruments in IFRS 9. As discussed in Agenda Paper 5A of this meeting, IFRS 9 has a 'mixed model' on reclassification ie it prohibits reclassification of financial assets if the contractual cash flow characteristics change and reclassification of financial liabilities but requires reclassification if the business model for managing financial assets changes.

34. Reclassification of 'passage-of-time changes' would be *prohibited* for a similar reason to why reclassification is prohibited when the contractual cash flow characteristics of a financial asset change over time based on its original contractual terms. In both cases, the contractual terms are known at initial recognition and an entity classifies the financial instrument at initial recognition on the basis of the contractual terms over the life of the instrument. For derivatives with 'passage-of-time changes', Approach C would see the fact that there is some variability in the contractual terms over the derivative's contractual life (which causes it to fail the fixed-for-fixed condition) as sufficient support to classify the derivative as a financial liability until it is settled.

35. Reclassification due to changes in circumstances would be *required* for a similar reason to why reclassification is required when the business model for managing financial assets changes. In both cases, reclassification is determined at a higher level than the individual instrument and reflects a change that is significant to the entity's

operations. Reclassification in these cases would provide useful information to users of financial statements in assessing the entity's prospects for future net cash inflows and management's stewardship of the entity's economic resources in line with the objective of financial statements.

36. The staff expect that Approach C would not be unduly onerous to apply. The staff expect the events or circumstances outside the contract that would require reclassification to be less frequent and clearly identifiable. However, 'passage-of-time changes', for which Approach B would require reclassification, are more common than changes in circumstances outside the contract because they are commonly found in derivative contracts on own equity instruments and in convertible bonds. Depending on the types of financial instruments an entity issues, requiring reclassification for these types of changes could be more onerous for some preparers and would necessitate monitoring or tracking of various contractual terms each reporting period.

37. Approach C would address subsequent measurement concerns. In the case of 'changes in circumstances', if a financial instrument is initially classified as equity but there is a change in the substance of the contractual terms such that it would meet the definition of a financial liability at that point in time, prohibiting reclassification would prohibit subsequent remeasurement of the financial instrument, which in some cases could distort key ratios used by investors. In the case of 'passage-of time changes' where the terms were known at inception, the staff expect the financial instrument would initially have been classified as a financial liability (due to the variability in the contractual terms) and a change in the substance of the contractual terms would likely affect the nature, timing and amount of the settlement terms. Approach C would not create any measurement concerns because the measurement of the financial liability would reflect the changes in the substance of the contractual terms (either the amortised cost would be updated to reflect actual and revised estimated contractual cash flows or the fair value would be updated for such estimates).

38. Similar to Approach A, if reclassification is prohibited for 'passage-of-time-changes', additional disclosures could be provided to assist users of financial statements in understanding the key terms and conditions of financial instruments with these features (see paragraph 20 of this paper).

If the IASB decides to require reclassification under Approach B or C

39. The staff considered the implications of requiring reclassification between financial liabilities and equity instruments under Approach B or C.

Timing of reclassification

40. If the IASB requires reclassification for changes in the substance of contractual terms under Approach B or C, continuous reassessment would effectively be required. The staff expect the events or circumstances outside the contract that would require reclassification to be less frequent and clearly identifiable. However, the requirement to assess whether an existing contractual term becomes or ceases to be effective with the passage of time could be onerous.

41. Some stakeholders have questioned the timing of accounting for the reclassification. A reclassification could be recognised at the date the substance of the contractual terms changes which would coincide with a particular event or change in circumstance eg expiry of an option, change in functional currency or redemption of a linked instrument. Alternatively, similar to IFRS 9 requirements on reclassifying financial assets, a reclassification could be recognised on the first day of the first reporting period following the change in the substance of the contractual terms that results in the reclassification.

42. Paragraph BC4.119 of IFRS 9 explains that the IASB also considered the date at which reclassifications of financial assets could take effect. Some respondents stated that reclassifications should be reflected in the entity's financial statements as soon as the entity's business model for the relevant instruments changes. To do otherwise would be contradictory to the objective of reclassification—ie to reflect how the instruments are managed. However, the IASB decided that reclassifications should take effect from the beginning of the following reporting period. In the IASB's view, entities should be prevented from choosing a reclassification date to achieve an accounting result. The IASB also noted that a change in an entity's business model is a significant and demonstrable event; therefore, an entity will most likely disclose such an event in its financial statements in the reporting period in which the change in business model takes place.

43. If the IASB decides that reclassification will result in remeasurement of the financial instrument and recognition of a remeasurement gain or loss, a similar concern might

exist regarding entities choosing a reclassification date to achieve an accounting result. In addition, making any change in classification during a reporting period will have measurement consequences which would be more onerous for preparers. However, on the other hand, reclassification at the date the trigger event occurs will ensure that reclassification does not depend on the frequency of reporting and that the substance of the contractual terms is reflected at the reporting date.

44. The staff considered whether reclassification at the date the trigger event occurs would be consistent with the reclassification requirements for puttable instruments and obligations arising on liquidation in IAS 32, which requires reclassification from the date when the instrument has or ceases to have all the features and/or meets or ceases to meet all the conditions set out in paragraphs 16A-16B or 16C-16D. For example, if an entity redeems all its issued non-puttable instruments and any puttable instruments that remain outstanding have all the features and meet all the conditions in paragraphs 16A and 16B, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

45. The trigger event in the case of reclassification of puttable instruments and obligations arising on liquidation coincides with a distinct event such as the issue or redemption of other instruments. In the changes in circumstances outside the contract described in Agenda Paper 5A of this meeting, the trigger events happen over time. For example, changes in functional currency or changes in control over an entity may not happen on a particular date.

46. Based on the above arguments and to achieve consistency with reclassifications in IFRS 9, the staff therefore support accounting for reclassification at the beginning of the first reporting period after the change in the substance of the contractual terms without a modification to the contract.

Measurement on reclassification

47. The staff note that in practice when there is a change in the substance of the contractual terms and an equity instrument is reclassified to a financial liability, there appears to be no diversity in how gains or losses are recognised because it is treated as similar to a cancellation of an equity instrument. Paragraph 33 of IAS 32 states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. In addition, a financial liability is

required by IFRS 9 to be recognised at fair value on initial recognition (adjusted for transaction costs if not measured at fair value through profit or loss). Consequently, any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity.

48. The staff note that this accounting treatment for reclassifications from equity instruments to financial liabilities is consistent with paragraph 16F(a) of IAS 32 on reclassification of puttable instruments and obligations arising on liquidation from equity to liability, which requires any difference between the carrying value of equity and fair value of the financial liability to be recognised consistently with the original classification ie in equity. The difference arising on reclassification from equity to liability arose during the period in which the instrument was classified as an equity instrument. Recognising a financial liability at the carrying value of equity rather than at the fair value of the financial liability would be inconsistent with the requirements of IFRS 9.

49. Similarly, the staff recommend the IASB clarifies that any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity on reclassification from equity to financial liability. This is because a financial liability in the scope of IFRS 9 should be initially measured at fair value even though the financial liability results from a reclassification and not the recognition of a new financial instrument as the entity did not become a party to a new contract. Such a clarification will ensure that no internal inconsistency is created within IAS 32 when accounting for a reclassification from equity to financial liability.

50. Diversity in practice appears to exist for recognising a gain or loss on reclassification of a financial liability to equity when the substance of the contractual terms changes without a modification of the contract. In practice, entities either analogise to the requirements in IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* for 'debt for equity swaps' (ie recognise gain or loss in profit or loss) or paragraph AG 32 of IAS 32 on the conversion of compound instruments at maturity (ie recognise no gain or loss). However, the staff note that both these requirements relate to derecognition events.

51. Instead, the staff considered the requirement in paragraph 16F(b) of IAS 32 on reclassifying puttable instruments and obligations arising on liquidation from financial liability to equity—measure an equity instrument at the carrying value of the financial

liability at the date of reclassification and recognise no gain or loss. When the IASB discussed this issue in September 2007, it acknowledged that reclassification from financial liability to equity is relatively straight forward because the liability will be carried at the discounted future settlement amount due to the requirements of IAS 32 and IAS 39 (paragraph AG8, which has been carried forward to paragraph B5.4.6 of IFRS 9). Therefore, the instrument is reclassified as equity with a carrying value equal to its previous carrying value and there would be no gain or loss.

52. Similarly, the staff think that remeasurement of the financial instrument upon reclassification as an equity instrument would not necessarily provide useful information to users of financial statements. In particular, the staff do not think the benefits would exceed the costs of remeasuring the financial instrument at fair value if the financial liability had been measured at amortised cost. There is no requirement to measure equity initially at fair value. The staff further think no gain or loss should be recognised on reclassification of a financial liability to an equity instrument because there has not been any modification to the contract, there has not been any derecognition or recognition event and such accounting would be consistent with the requirement in paragraph 16F(b) of IAS 32.

53. The staff recommend the IASB clarifies that on reclassification of a financial liability to equity, the equity instrument is measured at the carrying value of the financial liability at the date of reclassification and no gain or loss is recognised. If the financial liability is measured at amortised cost, for example in the case of a base instrument linked to another instrument, then it would be reclassified to equity at the carrying amount which is the amortised cost of the financial liability. If the financial liability is measured at fair value through profit or loss, for example in the case of a derivative on own equity that does not meet the fixed-for-fixed condition, then it would be reclassified to equity at the carrying amount which is already the fair value of the financial liability.

Disclosure of reclassification

54. The staff think additional disclosure requirements about reclassification would be beneficial if the IASB decides on Approach B or Approach C.

55. Paragraph 80A of IAS 1 *Presentation of Financial Statements* contains requirements for reclassification specifically between financial liabilities and equity but only

addresses reclassification of puttable instruments and obligations arising on liquidation. It requires disclosure of the amount reclassified into and out of financial liabilities or equity, and the timing and reason for that reclassification.

56. We believe that similar disclosures for other required reclassifications between financial liabilities and equity would result in better transparency and help users of financial statements better understand the change in classification and the impact on measurement, if any.

Staff recommendation

57. Although Approach A may be most consistent with the objective of the FICE project which is to clarify underlying principles in IAS 32 without fundamental changes, the staff do not recommend Approach A because we think a change is needed to meet the overall objective of the FICE project which is to improve the information entities provide in their financial statements about financial instruments they have issued. Approach A would not allow any of the advantages of reclassification listed in Agenda Paper 5A of this meeting to be achieved for example it may not result in faithful representation of the financial instruments at the reporting date.

58. The staff think including general requirements for reclassification would also be useful to users of financial statements because it is consistent with the objective of financial statements in paragraph 3.2 of the *Conceptual Framework.* Such objective is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows and management's stewardship of the entity's economic resources.

59. The staff recommend the IASB adds a principle that reclassification between financial liabilities and equity instruments to IAS 32 is required when there is a change in the substance of the contractual terms without a modification to the contract. To be consistent with the objective and the scope of this project, such a principle should not result in a fundamental change to IAS 32.

60. Approach B would require reclassification for all types of changes in the substance of the contractual terms ie for both 'passage-of-time changes' and 'changes in circumstances'. This would represent a fundamental change to IAS 32. Approach B

would maximise the advantages of reclassification (listed in Agenda Paper 5A of this meeting), particularly faithful representation of the economic substance of the contract at reporting date. However, the staff think the disadvantages would likely outweigh the advantages. In particular, the staff think requiring reclassification for ‘passage-of-time changes’, would result in onerous reassessment of individual contracts by preparers.

61. Approach C would require entities to distinguish between types of changes in the substance of contractual terms ie between ‘passage-of-time changes’ and ‘changes in circumstances’. The staff believes such an approach would be feasible and operational because these types of changes are distinct from each other.

62. Approach C would reflect some advantages of reclassification and reduce the disadvantages of reclassification. Approach C would result in useful information provided to users of financial statements because it would faithfully reflect the substance of the contractual terms of financial instruments at the reporting date if there are changes in circumstances affecting classification. Approach C also reduces the risk of opportunistic classifications from structuring the terms of the contract by prohibiting reclassification for ‘passage-of-time changes’. For preparers, Approach C is less onerous than Approach B because Approach C would not require reassessment of all contracts to determine whether there is a change in the substance of the contractual terms.

63. The staff acknowledge that there will be changes in classification outcomes in practice because Approach C would require reclassification for all ‘changes in circumstances’ which change the substance of the contractual terms whereas practice has developed to permit reclassification for some of these changes in circumstances. In addition, Approach C would prohibit ‘passage-of-time changes’ whereas practice has developed to permit or require reclassification for ‘passage-of-time changes’.

64. Approach C is consistent with the reclassification requirements in IFRS 9 and the reclassification requirements in paragraph 16E of IAS 32. The staff therefore recommend Approach C. Although it represents a change to IAS 32, the staff do not think it is as fundamental a change as Approach B would be.

65. The staff further support accounting for a reclassification at the beginning of the first reporting period after the change in the substance of the contractual terms without a modification to the contract.

66. Consistent with the requirements in paragraph 16F of IAS 32, the staff recommend that:

    (a) on reclassification from equity to financial liability—a financial liability is measured at fair value at the date of reclassification and any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity; and

    (b) on reclassification of a financial liability to equity—an equity instrument is measured at the carrying value of the financial liability at the date of reclassification and no gain or loss is recognised.

67. The staff recommend additional disclosure requirements for reclassifications when changes in the substance of the contractual terms arise from changes in circumstances outside the contract. This would help users of financial statements better understand the change in classification and the impact on measurement, if any.