IFRS Accounting

Staff paper

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Topic	**Detailed feedback—reclassification of financial liabilities and equity instruments**
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Introduction

1. In this paper, the staff summarises the feedback from comment letters and outreach on the proposed reclassification of financial liabilities and equity instruments requirements in the Exposure Draft *Financial Instruments with Characteristics of Equity* (the ED) issued in November 2023. This paper does not ask for any decisions from the IASB. The staff will present their analysis and recommendations at a future IASB meeting.

2. This paper is structured as follows:

    (a) background and questions in the ED;

    (b) summary of feedback;

    (c) question for the IASB; and

    (d) Appendix A—proposed reclassification amendments to IAS 32 in the ED.

Background and questions in the ED

3. Paragraph 15 of IAS 32 *Financial Instruments: Presentation* requires the issuer of a financial instrument to classify the instrument on initial recognition as a financial liability or an equity instrument, based on the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. However, IAS 32 does not contain any general requirements on whether or when to reclassify the instrument after initial recognition.

4. When the substance of the contractual arrangement changes without a modification, questions in practice arise about:

   (a) whether or when reclassifications between equity and financial liabilities are required, permitted or prohibited; and

   (b) if reclassifications are required or permitted, how to account for those reclassifications.

5. The kind of changes to the substance of the contractual arrangement the IASB had in mind, were those changes resulting from a change in circumstances external to the contractual arrangement—for example, a change in an entity's functional currency or its group structure.

6. The ED proposed that a company shall not reclassify a financial liability or an equity 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.[1]

[1] Paragraph 16E of IAS 32 states: 'An entity shall classify a financial instrument as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D from the date when the instrument has all the features and meets the conditions set out in those paragraphs. An entity shall reclassify a financial instrument from the date when the instrument ceases to have all the features or meet all the conditions set out in those paragraphs. For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument 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.'

7. The IASB asked these questions in the ED:

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.

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

Summary of feedback

Overview

8. Most stakeholders provided feedback on the reclassification proposals. Stakeholders generally appreciated the IASB's efforts to clarify the requirements for the reclassification of financial liabilities and equity instruments. They welcomed the clarification because it would address the diversity in practice that has arisen due to the lack of guidance in IAS 32. However, specific feedback on the reclassification proposals was mixed (as described in paragraphs 9-13 of this paper).

9. Some stakeholders (across the main stakeholder groups) agreed with the reclassification proposals. They said specifying that reclassification is generally prohibited apart from specific circumstances, would improve consistency and comparability of financial information across entities with similar instruments. Additionally, they believed that this approach would achieve a better balance between the benefits to users of financial statements and the costs to preparers than other reclassification approaches. An accountancy body specifically noted the proposed approach would disincentivise opportunistic structuring to achieve a particular classification outcome at initial recognition and also save preparers from reassessing the classification of each financial instrument at each reporting date.

10. However, many stakeholders across the main stakeholder groups, suggested the IASB consider requiring reclassification also for passage-of-time changes. Although they agreed with requiring reclassification when the substance of the contractual

arrangement changes due to a change in external circumstances, they disagreed with prohibiting reclassification for passage-of-time changes.

11. A few other preparers suggested the prohibition of any reclassification, regardless of the reasons. They raised concerns over the practicability of monitoring changes in external circumstances and potential disruption to practice. They suggested the IASB consider prohibiting reclassification under all scenarios.

12. On the other hand, an accountancy body disagreed with requiring reclassification following changes in external circumstances but would support requiring reclassification for passage-of-time changes.

13. Additionally, a few other stakeholders questioned the necessity of adding reclassification proposals to IAS 32. An accounting firm held the view that these proposals align with the requirements in paragraphs 9-11 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*.[2] Similarly, a preparer group suggested the IASB leave this issue open to accounting policy choices, given such accounting policy choices have already been established in practice.

Reclassification requirement for changes in external circumstances

14. Most stakeholders (ie those mentioned in paragraphs 9 and 10 of this paper) agreed with the proposal to require reclassification for changes in external circumstances. In their view, such reclassification would reflect the economic substance of transactions and would therefore provide useful financial information to users of financial statements.

15. However, many of these stakeholders (across the main stakeholder groups) raised concerns about the practical implementation of the proposals, especially around the

[2] IAS 32 establishes principles for the classification of financial instruments as financial liabilities or equity, which apply to the classification of puttable instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument. To address challenges in applying IAS 32 to members' shares in co-operative entities and similar instruments, the IASB issued IFRIC 2, which provides guidance on how redemption terms should be evaluated in determining the classification of those shares.

meaning or scope of external circumstances. They said this broad criterion could introduce challenges in identifying external changes consistently. While agreeing that changes in an entity's functional currency or an entity's group structure are both changes in external circumstances, they questioned whether other scenarios could be regarded as changes in external circumstances, specifically:

(a) changes in laws or regulations such as those that either create incremental contractual obligations or prevent the enforceability of contractual terms;

(b) changes in assessing the effect of shareholder discretion and the effect of applying judgement based on the proposals in the ED.[3] Stakeholders questioned whether reclassification would be triggered if, following the initial assessment, facts and circumstances change, which affect whether settlement is at the discretion of the entity.

(c) changes based on the occurrence or non-occurrence of contingent events that are outside the control of both parties to the contract.

(d) changes related to the issuance or redemption of linked instruments. Some instruments contain obligations that are linked to other instruments issued by the entity, for example, an entity might be required to pay dividends on a 'base instrument' only if interest is required to be paid on another 'linked instrument'. If the linked instrument is redeemed, the base instrument ceases to impose any obligation on the entity. Conversely, if the linked instrument is reissued, the entity's linked obligation is reinstated.

16. To improve clarity of the meaning and scope of external circumstances, some stakeholders provided suggestions to the IASB that included:

(a) defining 'external circumstances';

[3] The ED proposed to clarify that an entity is required to use judgement to assess whether shareholder decisions are treated as entity decisions and result in the entity having an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation.

(b) clarifying whether the scenarios in paragraph 15 of this paper (such as changes in laws or regulations) can be considered as changes in external circumstances; and

(c) providing application guidance and illustrative examples to help entities understand and apply the proposals consistently.

17. A few stakeholders noted that paragraph 9 of IFRIC 2 requires that a change in the redemption prohibition imposed by local law, regulation or the entity's governing charter leads to a transfer between financial liabilities and equity.[4] To be consistent with this requirement, they suggested the IASB clarify that changes in laws or regulations would qualify as changes in external circumstances and therefore could result in reclassification of financial liabilities and equity instruments.

18. A few other stakeholders also provided drafting suggestions that included:

(a) removing reference to 'initial recognition' or 'that have not been considered in classifying the financial instrument on initial recognition' in draft paragraph 32C of IAS 32 in the ED. In their view, such restriction is unduly restrictive because it is possible that an instrument would be reclassified more than once in its contractual life and therefore the change would be assessed against the circumstances that existed the last time the instrument was reclassified;

(b) revising the wording in draft paragraph AG35A of IAS 32 in the ED because in their view a change in functional currency may not necessarily result in a change to the substance of the contractual arrangement, provided the currency denomination of the shares and the cash consideration remained the same.

[4] Paragraph 9 of IFRIC 2 states: 'An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7 or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.'

Reclassification prohibition for passage-of-time changes

From financial liabilities to equity instruments

19. Many stakeholders disagreed with prohibiting reclassification from financial liability to equity when the substance of the contractual arrangement changes due to a contractual term that starts or stops being effective with the passage of time. Their reasons for disagreeing included:

    (a) failure to provide relevant information to users of financial statements. Prohibiting reclassification would not faithfully represent the instrument's economic substance at the reporting date and for the remaining life of the instrument. For example, they noted that continuing to classify a conversion feature as a financial liability after its variability has lapsed would be misleading.

    (b) perceived inconsistency with paragraph 3.3.1 of IFRS 9 *Financial Instruments* which requires a financial liability to be removed from an entity's statement of financial position when it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

    (c) concerns about structuring opportunities or unintended consequences for the issuers to recognise gains in profit or loss when an obligation included in a financial instrument no longer exists. For example, an instrument with a contingent settlement provision is initially recognised as a financial liability. When the contingent settlement provision stops being effective due to the passage of time, the reclassification prohibition would result in the financial liability continuing to exist. In their view, applying draft paragraph 25A of IAS 32 in the ED, this liability would be remeasured to nil with a gain recognised in profit or loss.[5] In addition, in other cases concerns were raised

[5] Draft paragraph 25A of IAS 32 clarifies that financial liabilities with contingent settlement provisions are measured at the present value of the settlement amount, assuming settlement will occur at the earliest possible settlement date specified in the contract. Any gains or losses on remeasurement of the financial liability would be recognised in profit or loss.

that a gain might be recognised in profit or loss, either through derecognising a financial liability applying paragraph 3.3.3 of IFRS 9, or remeasuring a financial liability applying paragraph B5.4.6 of IFRS 9.

(d) disruption to practice as many entities currently adopt an accounting policy to reclassify financial liabilities and equity instruments based on all changes in the substance of the contractual arrangements. These entities would face challenges and complexity to implement the proposed reclassification requirements because they would for example need to change their accounting policies and restate prior periods if reclassification is prohibited for passage-of-time changes.

(e) inconsistency and lack of comparability between similar instruments. For example, when a redeemable preference share's redemption feature expires, it would continue to be classified as a liability despite becoming economically equivalent to a non-redeemable preference share (which is classified as equity from inception). The proposed approach would result in two instruments with similar features being classified differently. In addition, prohibiting reclassification would create an inconsistency with paragraph 23 of IAS 32, which requires reclassification to equity when eg a written put option on own equity instruments expires unexercised.

20. Despite the proposed disclosure requirements in draft paragraph 30F of IFRS 7 *Financial Instruments: Disclosures* in the ED, some stakeholders did not think disclosing passage-of-time changes would overcome the perceived limitations of the accounting.[6] They referred to paragraph 18 of IAS 1 *Presentation of Financial Statements* which says that an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.[7]

[6] Draft paragraph 30F of IFRS 7 in the ED requires the disclosure of information about terms and conditions of financial liabilities that become, or stop being, effective with the passage of time before the end of the instrument's contractual term.

[7] In April 2024 the IASB issued IFRS 18 *Presentation and Disclosure in Financial Statements* which replaces IAS 1. This requirement has been incorporated into paragraph 6D of IAS 8 *Basis of Preparation of Financial Statements*.

21. Among the stakeholders that disagreed with prohibiting reclassification from financial liability to equity for passage-of-time changes, some questioned the IASB's consideration to analogise with reclassification principles in IFRS 9 for financial assets (see paragraph 32 of this paper). A standard-setter also questioned the view that IAS 32 intends to generally prohibit reclassification (as stated in paragraph BC136 of the Basis for Conclusions on the ED) based on their recollection of earlier versions of IAS 32.[8] Furthermore, in their view, stakeholder requests for clarification and diversity in practice demonstrate that IAS 32 is not widely understood as generally prohibiting reclassification.

22. In addition, many stakeholders (including standard-setters, accountancy bodies, preparers and accounting firms) disagreed with the IASB's cost analysis in paragraph BC145 of the Basis for Conclusions on the ED.[9] Reasons given included:

    (a) many entities have already reclassified instruments to reflect the change in the substance of the contractual arrangement, as described in paragraph 19(d) of this paper.

    (b) financial instruments issued to finance an entity are typically limited in number and are subject to ad hoc negotiation and structuring. Therefore, many entities closely monitor all changes in practice.

    (c) reassessing instruments for passage-of-time changes at the reporting date would not add significant cost or effort to preparers, especially considering that draft paragraph 30F of IFRS 7 would require tracking to disclose information about terms and conditions of financial liabilities that start or stop being effective with the passage of time before the end of the instrument's contractual term.

[8] Paragraph BC136 of the Basis for Conclusions on the ED states: 'The approach in paragraph BC135(a) is based on a view that the requirements in IAS 32 are intended to generally prohibit subsequent reclassification of a financial instrument.'

[9] Paragraph BC145 of the Basis for Conclusions on the ED states: '…On the other hand, contractual terms that become, or stop being, effective with the passage of time are common in derivative contracts on own equity instruments and in convertible bonds. Such instruments would require various contractual terms to be monitored or tracked in each reporting period, which could be onerous for preparers.'

(d) continuing the financial liability classification would incur higher costs and complexity compared to allowing reclassification. For example, consider a warrant that provides the instrument holder with the right to buy a fixed number of the entity's own equity instruments at a price that will be fixed at a future date. When the purchase price is subsequently fixed such that the fixed-for-fixed condition is met, continuing to measure the warrant at fair value through profit or loss would be more complex and more costly than accounting for an equity instrument if reclassification were allowed.

23. To address concerns about prohibiting reclassification from financial liabilities to equity instruments for passage-of-time changes, many stakeholders suggested the IASB require (or at least allow) such reclassifications. This would reduce the confusion that an instrument would remain classified as a financial liability when it no longer meets the definition of a financial liability.

From equity instruments to financial liabilities

24. Contrary to the IASB's view provided in the ED—passage-of-time changes are irrelevant to equity-classified instruments—a few stakeholders reported that equity instruments may later meet the definition of financial liabilities due to perceived passage-of-time changes.[10] For example:

(a) an accounting firm noted a financial instrument that gives the issuer a conversion option for the first 5 years and the holder a put option which is exercisable from year 5. The conversion option enables the issuer to convert the instrument to ordinary shares at its own discretion and thus avoid an outflow of cash if it elects to convert before the put option becomes exercisable. In their view, applying the current IAS 32 requirements, the instrument would be classified as equity until year 5 if the conversion option

[10] Paragraph BC132 of the Basis for Conclusions on the ED explains that change in substance for passage-of-time changes relates only to instruments that meet the definition of a financial liability on initial recognition and would not occur if an instrument met the definition of an equity instrument on initial recognition.

meets the fixed-for-fixed condition and then reclassified to a financial liability from year 5 if the conversion option expires unexercised.

(b) a preparer group said an equity instrument could be subject to a tender offer, buyback, or issuer call option which is integral to the terms of the instrument or part of a buyback programme. Once these terms become enforceable, the issuer can no longer avoid delivering cash or another financial asset. This stakeholder also said some entities reclassify the instrument from an equity to a financial liability.

(c) a preparer noted there could be a contingent event within the control of the entity. For example, if the entity pays a dividend on ordinary shares, it must redeem instrument X. The entity has an unconditional right to avoid paying a dividend on ordinary shares, and therefore, it also has an unconditional right to avoid paying cash in relation to instrument X. At initial recognition, such instrument is classified as equity. However, when the entity pays a dividend on ordinary shares at its discretion, it no longer retains an unconditional right to avoid settling the obligation related to the redeemable instrument.

(d) a user group expressed concerns over structuring opportunities for entities to achieve specific accounting outcomes. For example, an instrument could be structured to satisfy the classification of equity instruments initially and thereafter become more debt-like with the changes of effective terms.

25. These stakeholders therefore suggested the IASB consider the implications of prohibiting reclassification in such scenarios mentioned in paragraph 24 of this paper and clarify if the IASB intends to retain equity classification, even when the instrument's substance changes. They cautioned that retaining equity classification would fail to provide useful information by not accurately reflecting the obligations in the financial statements.

26. A few stakeholders suggested the IASB clarify the requirement in paragraph AG25 of IAS 32 when an issuer of shares exercises its call option. Despite the fact that this

paragraph states that 'an obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares', a standard-setter said the required accounting treatment is not sufficiently specified. They understood the IASB would in such circumstances require the equity instrument to be derecognised and a financial liability to be recognised.

Measurement on and timing of reclassification

27. Not many stakeholders commented on the proposed measurement approaches and timing for reclassifying financial instruments. However, feedback that was received on these proposals was overall positive.

28. Regarding the proposed measurement approaches, all stakeholders supported the measurement of financial liabilities reclassified from equity at fair value, with the difference recognised in equity, and the measurement of equity instruments reclassified from financial liabilities at their carrying amount, with no gain or loss recognised on reclassification. These approaches were considered reasonable and practical for reflecting the reclassification impacts in the financial statements.

29. Regarding the timing of reclassification, most stakeholders agreed with the proposal to reclassify instruments prospectively from the date when a change in circumstances occurs and did not anticipate any practical difficulties. A standard-setter said it was reasonable for the reclassification of financial liabilities and equity to take place at an earlier point in time than the reclassification of financial assets under IFRS 9 considering the different nature of changes leading to reclassification. However, a few accountancy bodies and accounting firms suggested that the IASB consider allowing reclassification at the end of the reporting period in which the change in circumstances occurs if the exact date of the change is not determinable. This flexibility would help entities implement the reclassification requirements in a timely and practical manner.

Interactions with IFRS 9 requirements

30. Some stakeholders questioned the interaction between the reclassification proposals and the IFRS 9 derecognition requirements, particularly related to the expiry of obligations. Stakeholders questioned if and when an entity is discharged from a current obligation and should derecognise a financial liability because a contractual term stops being effective due to the passage of time. Further, as mentioned in paragraph 19(c) of this paper, stakeholders also raised concerns over income recognition based on the derecognition or measurement principles in IFRS 9 after obligations expire.

31. To address these concerns, some stakeholders (including standard-setters, preparers and accounting firms) suggested the IASB add requirements on the interaction between reclassification of financial liabilities and equity instruments and the derecognition principles in IFRS 9. The IASB could:

    (a) state explicitly in the body of IAS 32 that the derecognition requirements of IFRS 9 do not apply to situations when the terms and conditions in a contractual arrangement have expired or stopped being effective with the passage of time. They said this clarification would be necessary to address concerns about the distinction between reclassification and derecognition, despite paragraph BC128 of the Basis for Conclusions on the ED already explaining the IASB's considerations.[11]

    (b) alternatively, provide application guidance on when a derecognition assessment of a financial liability would apply if the IASB decides to retain the proposal to prohibit reclassification for passage-of-time changes.

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[11] Paragraph BC128 of the Basis for Conclusions on the ED explains that reclassification refers to a change in the classification of an issued financial instrument if:

(a) the requirements for derecognition of a financial instrument are not met;

(b) the entity has not become a party to a new contract to be recognised; and

(c) the nature of the obligation has substantially changed without any modification to the contractual terms.

32. Some standard-setters, accounting firms and preparers commented on the IASB's consideration to keep the reclassification principles consistent with those of reclassifying financial assets applying IFRS 9.[12] They disagreed with such an analogy due to the following reasons:

(a) IFRS 9 is more criteria-driven and IAS 32 is more definition-driven, making it inappropriate for IAS 32 to benchmark with the reclassification concepts under IFRS 9.

(b) classifying financial instruments as financial liabilities or equity under IAS 32 is substantially more fundamental than classifying financial assets under IFRS 9 as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss. Reclassification between financial liabilities and equity has a more prominent effect on the statement of financial position, has more significant measurement effects, and often has more fundamental effects on the entity's key performance indicators. A standard-setter pointed out that the IFRS 9 reclassification primarily serves measurement purposes, determining whether financial assets are measured at amortised cost or fair value.

(c) reclassification of financial assets occurs only for changes in business model, which is assessed on a portfolio basis whereas reclassification between financial liabilities and equity would be assessed on an individual instrument basis.

[12] Paragraph BC149 of the Basis for Conclusions on the ED states: 'The Board also noted that the approach in paragraph BC135(c) is consistent with the approach used in IFRS 9 for reclassifying financial assets when there is a change in the business model for managing financial assets. IFRS 9 has a 'mixed model' of reclassification—it prohibits the reclassification of financial assets if the contractual cash flow characteristics change (similar to passage-of-time changes discussed in paragraph BC130(a)), but requires reclassification if the business model changes because of changes outside of the contract (similar to changes described in paragraph BC130(b)).'

Other feedback

33. A few stakeholders noted that the reclassification proposals would not address some practical issues they encountered when applying IAS 32. These stakeholders therefore suggested the IASB consider:

(a) developing requirements for contract modifications to equity or compound instruments and providing application guidance on how to assess and account for such modifications. They said current requirements in IFRS 9 seem unclear or not applicable to such cases. A standard-setter suggested that the IASB consider incorporating into the body of IAS 32, the November 2006 Agenda Decision of the IFRS Interpretations Committee which clarifies the accounting when changes in the contractual terms of an existing equity instrument result in it being reclassified to a financial liability.[13]

(b) clarifying how **holders** of financial instruments should account for their financial assets upon reclassifications by the issuer. Paragraph 5.7.5 of IFRS 9 permits holders to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument when certain criteria are met. In their view, to determine whether they hold an equity instrument, stakeholders generally refer to IAS 32 which provides definitions of an equity instrument and related classification requirements. Questions arose regarding whether holders should reclassify their financial assets if the issuer reclassifies such instruments from equity to financial liabilities (or vice versa), and how to account for such reclassifications if required.

(c) providing application guidance and illustrative examples on how the reclassification proposals would apply specifically to compound financial instruments.

[13] In the November 2006 Agenda Decision, the IFRS Interpretations Committee decided not to add the issue to the agenda, because the requirements of IFRS accounting standards were sufficiently clear, and the issue was not expected to have widespread relevance in practice.

Question for the IASB

Question for the IASB
Does the IASB have any questions or comments on the matters discussed in this paper?

Appendix A—Proposed reclassification amendments to IAS 32 in the ED

A1. The IASB proposed adding the following paragraphs to IAS 32 related to the reclassification of financial liabilities and equity instruments:

Paragraph 32B:

An entity shall not reclassify a financial liability or an equity instrument after initial recognition unless paragraph 16E applies or the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement. If the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement, an entity shall reclassify any affected financial liability or equity instrument (see paragraphs 32C–32D).

Paragraph 32C:

Changes in circumstances external to the contractual arrangement arise from events not specified in the contract that have not been considered in classifying the financial instrument on initial recognition. Such events are not specific to a particular instrument, but would affect an entity's business activities and operations, for example, a change in an entity's functional currency or a change in an entity's group structure.

Paragraph 32D:

If an entity reclassifies an instrument as a financial liability or an equity instrument in accordance with paragraph 32B, the entity shall apply the reclassification prospectively from the date the change in circumstances occurs. The entity shall not reverse in profit or loss any previously recognised items of income, expense, gains or losses. The entity shall measure:

(a) a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification. The entity shall recognise in equity any difference between the carrying amount of the equity instrument and the fair value of the financial liability at that date.

(b) an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification. The entity shall recognise no gain or loss on reclassification.

Paragraph AG35A:

Examples of changes in circumstances external to a contractual arrangement that could change the substance of the contractual arrangement, as described in paragraph 32C, include:

(a) an entity issuing an instrument that will be settled by delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash denominated in its functional currency and classifying the instrument on initial recognition as an equity instrument (see paragraph 22B). If, after initial recognition, the entity's functional currency changes, the substance of the contractual arrangement would change because the instrument will no longer be settled by delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash denominated in the entity's functional currency. This change in the substance of the contractual arrangement would lead to the equity instrument being reclassified as a financial liability.

(b) a parent entity issuing an instrument that will be settled by delivering a fixed number of a non-group entity's equity instruments in exchange for a fixed amount of cash and classifying the instrument on initial recognition as a financial liability in its consolidated financial statements (see paragraph 22B). If, after initial recognition, the parent gains control of the non-group entity such that it becomes a subsidiary, the substance of the contractual arrangement would change because the instrument would be settled by delivering a fixed number of the group's own equity instruments in exchange for a fixed amount of cash. This change in the substance of the contractual arrangement would lead to the financial liability being reclassified as an equity instrument.