Australian Government

Australian Accounting Standards Board

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21 December 2018

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Hans,

IASB DP/2018/1 *Financial Instruments with Characteristics of Equity*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity* (DP). In formulating these comments, the views of our Australian constituents were sought and considered.

The DP was issued in Australia by the AASB as Invitation to Comment ITC 40 *Financial Instruments with Characteristics of Equity* in July 2018. The AASB received 1 submission, which is available on the AASB's website[1]. The AASB conducted several meetings with the AASB's Financial Instruments Project Advisory Panel members and other Australian constituents including audit firms, banks, regulators and investors by way of roundtable discussions.

The AASB acknowledges the efforts of the International Accounting Standards Board (IASB) to address conceptual challenges and practical application issues in applying IAS 32 *Financial Instruments: Presentation* to financial instruments with characteristics of equity and provide better presentation and disclosure information about these instruments for users. We also agree there is a need to future proof IAS 32 due to the constant innovation in financial instruments.

However, the AASB does not support the preferred classification approach in the DP. We are also not convinced that the purported benefits of the proposals outweigh the costs that entities would incur in understanding and applying the proposed principles and new terminology in the DP and the consequential emergence of new issues and uncertainties.

We have two main concerns:

A) Lack of linkage to the *Conceptual Framework for Financial Reporting* and codification of current rules

In our view the DP proposals appear to be trying to codify the rules in IAS 32, rather than determining the most appropriate principles. We also note there is a lack of clarity and conceptual underpinning as to why some of the exceptions in IAS 32 have been retained (puttables) and some not (foreign currency right issues). Accordingly, the "principles" still appear rules-based. We also note that the guidance on what is "independent" in the various scenarios is dependent on rules and not clearly articulated which is perhaps indicative that this is not the most effective principle on which liability/equity classifications should be determined.

Despite the revised Conceptual Framework being completed prior to the DP being issued, there is no linkage to or evaluation of the proposals against the Conceptual Framework. While acknowledging that the IASB intended the project to focus on developing principles based on the underlying rationale for the current requirements in IAS 32, rather than start with a blank sheet of

1 Refer to AASB website for submissions received on ITC 40.

paper, our concern is that this approach results in proposals that are not clearly linked with the Conceptual Framework.

The AASB have previously stated our concerns with the IASB amending the revised Conceptual Framework based on the outcome of a research or standard-setting project, such as this. Determining the conceptual principles for distinguishing liabilities from equity seems a logical and essential first step before addressing specific issues in practice. We continue to recommend starting with the principles of the revised Conceptual Framework first with the objective to develop robust principles to distinguish liabilities from equity and to future proof the accounting.

The liability definition in DP/2018/1 is broader than the definition of a liability in the Conceptual Framework as it classifies claims as liabilities where:

- there is no obligation to transfer economic resources before liquidation, even though the entity continues to operate as a going concern; and
- there is no transfer of economic resources but there is transfer of own shares to an amount independent of the entity's available economic resources.

The outcomes of the DP proposals would fundamentally change the accounting of some financial instruments that are currently well understood (cumulative irredeemable shares and foreign currency rights issues), and we are not convinced that these changes are warranted and there has been no clear case made for such a change. We are not supportive of such a classification change now mainly because we are of the view that the IASB should first consider debt/equity classification from a conceptual perspective. IAS 32 considers that those amounts payable only at liquidation are not financial liabilities and we continue to support this treatment. The AASB has also identified the following possible issues that may arise from the IASB's preferred approach:

- measuring perpetual instrument as liabilities would be difficult given the entity is a going concern. The IASB would also need to provide a view on whether they should be measured at amortised cost or fair value and how to factor in discretionary dividends; and
- if such liabilities are measured at fair value – entities would face difficulties in determining the fair value of such instruments as most are not actively traded and therefore do not have readily determinable fair values. There is also likely to be increased subjectivity and volatility in reported earnings.

We note that a presentation exemption is provided as part of the proposals to enable some dividends/interest to be included in OCI rather than the statement of financial performance as the underlying instruments have "equity like" characteristics. We question why these characteristics are not part of the classification proposals and only a presentation exemption is proposed.

We also note that the IASB considered and rejected accounting for the components of derivative transactions as separate components on the basis of cost and complexity. However, we have been advised by some investors that they are effectively treating financial instruments in this way, when classifying them as debt or equity. We suggest that further discussions of this approach may be warranted. If investors are managing to do this already, the cost and complexity issues may not be as significant as the IASB currently considers, and it may be possible to consider circumstances when the benefits of such treatment might outweigh the costs.

B) Complexity of the proposals

We note that whilst there are some DP outcomes not consistent with IAS 32 outcomes, for the vast majority of transactions the outcomes will be the same. However, stakeholders will need to understand new concepts and terminology, which are complex and not intuitive. It will also likely increase the risk of new uncertainties and practical challenges particularly as a result of the amount feature being linked with liquidation criteria, which will result in valuation issues when the timing of liquidation is highly uncertain.

Although we acknowledge that IAS 32 is complex and has some classification challenges, for most financial instruments the requirements in IAS 32 and its classification outcomes are well understood by preparers and users of financial statements. Therefore, we question the cost/benefit of introducing new complexities and changes to classification outcomes, especially without having first considered the distinction between liabilities and equity from a conceptual perspective.

The AASB recommends the IASB not proceed with the project in its current form. We would prefer the project to develop appropriate classification principles starting with those in the revised Conceptual Framework. Whilst we understand the Conceptual Framework was completed on the basis that changes may be necessary as a result of the FICE project, our view is that the starting point of any FICE project should be with the Conceptual Framework principles, and that if changes/modifications are necessary, the reasons and empirical evidence should be clearly articulated.

In the interim, we recommend the IASB considers introducing a robust, transparent and comprehensive set of disclosures to address some of the challenges identified in the DP.

In responding to the DP, we have limited our response to some specific issues as described in Appendix A of this submission.

If you have any questions regarding this letter, please do not hesitate to contact Shachini Dassanayake, Project Manager (sdassanayake@aasb.gov.au).

Yours sincerely,

K. E. Peach

Kris Peach
AASB Chair

APPENDIX A

Additional specific comments on the proposals in the DP

1. Economic entity concept

We disagree with the comments in paragraph 2.47 on the implications of the entity perspective when considering liability/equity classifications. The entity perspective is why non-controlling interests are considered equity and not a liability. If a proprietary/parent-entity perspective were adopted then NCI would be a liability, not equity. The entity perspective is also why:

- the Conceptual Framework (CF) paragraph 4.10 statement that an entity cannot have a right to economic benefits from itself means that an entity's own shares are not considered an asset (which creates much of the current tension in IAS 32). We note that the IASB removed the statement that an entity's own shares cannot be a liability from the CF.
- the CF paragraph 4.70 statement that transactions with owners in their capacity as owners does not give rise to a profit or loss (these transactions do not result in an increase or decrease in net assets versus a proprietary/parent-entity approach where transactions between the parent and non-controlling interests do give rise to a profit and loss).
- an entity's obligation to issue its own shares conceptually does not give rise to an obligation to transfer economic resources and hence not a liability under the CF. (which creates much of the current tension in IAS 32).

We consider that understanding the implications of this perspective is fundamental to any principles developed for classification of liabilities and equity and strongly recommend that the IASB ensure that any further work on distinguishing liabilities and equity clearly articulates the impact of the entity perspective. If modification of, or departure from, this perspective is considered necessary, a clear rationale should be provided. We note the original dissenting opinion on IAS 32 would advocate not using the entity perspective for derivatives on own equity, more on the basis that these are executory contracts better accounted for on a net basis.

2. Definitions

If the IASB proceeds with the current DP proposals, the AASB considers that the terms 'entity's available economic resources' and 'amounts independent of the entity's available economic resources' should be more clearly articulated as they appear circular in nature and based on our outreach there is considerable uncertainty as to how they should be interpreted. In particular, all final amounts payable on liquidation are "dependent" on the actual amounts available on liquidation.

3. Comments on the 'amount feature'

The AASB agrees that information provided in the financial statements about claims on an entity should help users to assess the entity's liquidity and solvency. The AASB considers the timing leg to be consistent with the CF.

However feedback from constituents has been that they have concerns with the amount leg of the proposed principles specifically as it does not limit the principles to events 'other than at liquidation'. The AASB notes that this leg of the principles would result in certain instruments that are currently classified as equity (see appendix C for more information) to be liabilities. Given our previous comments on considering the CF, the AASB considers such changes in classifications to be unwarranted as the current classifications for these instruments are well understood by users and preparers. The AASB is also concerned that there may be other unwarranted changes in classification that are counter-intuitive to the real substance of the transaction.

The AASB notes that the IASB has not limited the principles to only consider events other than liquidation to help address the question of whether economic compulsion should be considered in classification. We acknowledge that there are operational difficulties with including the concept of economic compulsion in classifying financial liabilities as liabilities or equity. However, the AASB also considers that the treatment of economic compulsion should be consistent with the CF. We refer to the principles articulated in paragraphs 4.34 – 4.36 of the IASB's CF, which discuss situations where an entity has an obligation because it has no practical ability to avoid payment or transfer. In these situations, the assumption is that an entity is a going concern and if the entity has the practical ability to avoid a payment as long as it is a going concern, then there is no liability. The IASB's CF also states that neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer. Furthermore, the AASB considers that it is conceptually inconsistent to determine classification of an instrument (ie liability or equity) based on how claims are prioritised and amounts distributed on liquidation, when financial statements are prepared on a going concern basis.

We question whether useful information would not be better provided through disclosure in the notes rather than impacting the classification as equity or a liability.

4. Comments on retaining the puttable exception

The AASB prefers not including exceptions in principle-based standards developed on a conceptual basis. Including exceptions in a principle-based standard makes the standard rules-based, inconsistent with the CF, reduces comparability and internal consistency, and increases the complexity of financial statements.

Notwithstanding the comments above, if the IASB goes ahead with this project in its current form and subject to understanding how much it is actually used in practice, we would support retention of the puttable exception as the reasons for the original exemption set out in BC50 of IAS 32 still remain.

We note that the exemptions do not appear to be widely used in Australia, largely because the puttable amount is usually for a fixed amount. Feedback has been that it is difficult to understand the IAS 32 requirements regarding puttables, so if kept, some additional examples and guidance may be necessary.

5. Comments on attribution of income and expenses to some equity instruments other than ordinary shares

Based on the feedback received from preparers, users and investors, the AASB disagrees with the IASB's preliminary view that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares.

The AASB is not convinced of the usefulness to investors of the attribution approaches suggested in the DP. We are of the view that the cost of providing this information would significantly exceed the intended benefits. We do not believe it is appropriate to allocate total comprehensive income to certain derivatives when they are not entitled to dividends or income of the entity. The AASB is also of the view that the approach suggested in the DP does not cover other forms of equity outside IAS 32 such as employee share options. Accordingly, the proposals would provide incomplete information.

However, the AASB recommends providing disclosures on the expected maximum number of potential ordinary shares, which would be useful to users.

6. Comments on presenting equity-like returns of financial liabilities in the OCI for certain financial instruments such as fair value NCI puts and foreign currency right issues

The AASB does not support the IASB's proposals of presenting income and expenses that arise from certain liabilities in OCI as they would:

- result in an additional item presented in OCI, increasing the complexity of OCI, with a practical question as to whether or not to recycle these returns to profit or loss;

- lead to an exception in presentation – replacing one rule with another rather than a principle-based outcome; and
- appear to be at odds with the IASB's intention detailed in paragraph 7.17 of the revised Conceptual Framework.

7. Specific transaction comments

Please refer to the table below for issues arising from the DP proposals for specific transactions

7.1 Non-controlling interest written put options (NCI puts)

<table>
<tr><th>What is the issue?</th><th>AASB's comment</th></tr>
<tr><td>Applying the Board's preferred approach on NCI puts would require:

recognition of a liability component at the redemption amount (which will be subsequently measured in accordance with IFRS 9);
derecognition of the NCI—the ordinary shares of the subsidiary that represent the NCI—on which put options are written, at the fair value of the ordinary shares of the subsidiary at the date the put options are issued; and
recognition of an equity component for the—implicit—written call option on the subsidiary's shares.

We agree that the IASB's preferred approach provides a solution to the accounting for of written puts on NCI, however the solution does not explain the interaction with IFRS 10. For example, whether a portion of the subsidiary's profit or loss should continue to be attributed to the NCI as required by paragraph B94 of IFRS 10 Consolidated Financial Statements, after NCI puts are written and NCI is derecognised as proposed in the DP.

NCI puts are relatively common in Australia as they create a mechanism for minority shareholders to exit from their investments at a future date, particularly in instances when the entity's shares are not traded in an active market.</td><td>The AASB considers the DP does not adequately explain why the analogy with the convertible bonds is appropriate. The analogy is valid where shares are issued simultaneously with a put option, as it can be argued that in substance these combined transactions are equivalent to issuing a convertible bond. However, put options over own shares are not always issued at the same time as the shares are issued. In these instances it is not clear why the substance of the transaction is the same as for a convertible bond – the substance of the combined transactions is not a financing transaction. We acknowledge that the DP proposals were based on explaining the current IAS 32 outcomes, however, in our view the DP has not adequately justified the accounting required by paragraph 23 of IAS 32 and why there is a derecognition of equity when the NCI's rights to dividends and the net assets of the subsidiary are unchanged. As noted above, we recommend starting with the CF, particularly the entity perspective and in this case, executory contracts and unit of account when determining the appropriate principles for derivatives on own equity.</td></tr>
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7.2 Contingent Convertible Capital Instruments (CoCo bonds)

What is the issue?	AASB's comments
CoCo bonds are financial instruments that convert into a variable number of the issuer's own equity instruments contingent on the occurrence of an uncertain future event, which may or may not be beyond the control of both the issuer and the holder of the instrument. In the wake of the financial crisis, Australian regulators imposed new regulatory requirements in Australia to strengthen the capital base of financial institutions, particularly the banking sector. To comply with these new regulatory requirements financial institutions may issue financial instruments that convert into a variable number of the issuer's own ordinary shares in the event the institution breached minimum regulatory requirements (this type of contingent event is called a 'non-viability' event). The AASB understands that these instruments are widely used by Australian banks to meet regulatory requirements. We are aware of at least five alternative accounting treatments being applied in practice as shown below: • The entire instrument is classified as a liability because the issuer has a contractual obligation to deliver a variable number of its own equity instruments should a contingent non-viability event occur. • The instrument is treated as a compound instrument, whereby a liability component is recognised reflecting the issuer's obligation and an equity component reflecting the discretionary interest payments. • The instrument is treated as a compound instrument, whereby a liability component is recognised reflecting the issuer's obligation and an equity component reflecting the discretionary interest payments – but the equity component is measured at zero initially. • The instrument is treated as a compound instrument, whereby a liability component is recognised and an embedded derivative for the conversion feature that obliges the issuer to settle in a variable number of its own shares. • The entire instrument is classified as equity as the instrument has no stated or pre-determined maturity date and represents a residual interest in the entity's net assets.	Under the DP proposals it is not clear whether the Coco bonds include a variable which is independent of the entity's available economic resources. The contingent event of breaching the regulatory capital requirements is prima facie within the issuer's control, as it could issue new capital etc, and take other actions to make sure it does not breach the regulatory requirements. However, the events of the Global Financial Crisis suggest that this may not, in practice, be the case. Outreach suggests that different interpretations of the "independent" variable guidance is likely.

7.3 foreign currency rights issue exemption and accounting for foreign currency convertible bonds

What is the issue?	AASB's comments
Currently, an entity can apply the foreign currency rights issue exception in IAS 32 and classify rights to shares issued for a fixed amount of foreign currency as equity, if such rights are issued pro-rata to all of an entity's existing shareholders in the same class for a fixed amount of currency, regardless of the currency in which the exercise price is denominated. The IASB is proposing removing this exception in DP/2018/1, meaning that such instruments would be classified as a liability due to the foreign currency being an independent variable. This is a significant issue in Australia because these transactions are commonly issued only to existing shareholders on the basis of the number of shares they already own, and are therefore similar in nature to dividends paid in shares – meaning the IASB's proposed classification would not reflect the substance of these transactions (a similar conclusion was reached by the IASB in the Basis for Conclusions (BC) paragraph BC4F[2] of IAS 32). To mitigate the impact of this, the IASB has proposed that related returns can be presented in Other Comprehensive Income (OCI), if certain criteria are met. Similar to foreign currency rights, mandatorily convertible bonds at a fixed for fixed ratio issued in a foreign currency would also be classified as a liability under IAS 32 and DP/2018/1 due to the foreign currency being an independent variable.	The AASB does not support the proposal to remove the foreign currency rights exception and present income and expenses that arise from such liabilities in OCI. We acknowledge the IASB's concerns that derivative financial instruments that meet this exception are classified differently to conversion options in foreign currency convertible bonds, which are classified as financial liabilities. We agree that convertible bonds and rights are economically similar and therefore the accounting should be the same. However, the IASB has not adequately explained why they should both be liabilities rather than both being equity. The IASB has provided a rationale for retaining the puttable exception in the DP as the DP proposals would not address issues causing the original exception and we are of the view that it is the same case when it comes to the foreign currency right issue exception. While preferring no exceptions, we question why the IASB would remove this exception and retain the puttable exception. The IASB has not provided sufficient explanation as to how the issues that warranted the foreign currency rights issue exception in IAS 32 have been resolved to warrant the removal of the exception. The issues that gave rise to this exception are still prevailing similar to the issues that gave rise to the puttable exception. The DP proposes a presentation exception for these right issues if the criteria in paragraph 6.34 are met. We do not agree that the presentation exception is enough and suggest that the same criteria can be used to justify equity classifications for these instruments. We question why these characteristics are not part of the classification proposals and only a presentation exemption is proposed. Therefore, the AASB recommends that the IASB considers classifying these foreign currency right issues and foreign currency convertible bonds as equity based on the criteria in paragraph 6.34 in the DP.

2 BC4F states 'The Board agreed with the IFRIC's 2005 conclusion that a contract with an exercise price denominated in a foreign currency would not result in the entity receiving a fixed amount of cash. However, the Board also agreed with the IFRIC that classifying rights as derivative liabilities was not consistent with the substance of the transaction. Rights issues are issued only to existing shareholders on the basis of the number of shares they already own. In this respect they partially resemble dividends paid in shares.

What is the issue?	AASB's comments
	As explained below the only independent variable in these types of instruments is the foreign currency fluctuation: • the instrument has a net amount that otherwise is unaffected by any other independent variable; the only independent variable is a currency other than the entity's functional currency. In other words, the only independent variable in these instruments is the foreign currency element; • the foreign currency exposure is not leveraged; • the foreign currency exposure does not contain an option feature; and • the denomination in the foreign currency is imposed by an external factor. For example, the currency denomination is imposed by law or regulation, or market forces are such that denominating the derivative in the entity's functional currency would not have been practically possible. Many entities issue these rights in currencies other than their functional currency because they are listed in more than one jurisdiction; are required to do so by law or regulation; and/or need access global markets as the local market does not meet their needs. Thus we are of the view that these right issues are of equity nature if not for the foreign currency element. The counter argument is that these instruments are exposed to foreign currency fluctuations, which users of the financial statements would be interested in understanding – by classifying these as liabilities, foreign currency gains and losses can be observed through movements through profit or loss. The AASB considers that this issue can be overcome through disclosures about the volatility resulting from these instruments being issued in a foreign currency without removing the exception. Alternatively, the IASB might also consider if the foreign currency element embedded in these instruments should be bifurcated from the host contract in accordance with IFRS 9. Feedback from the investors has been that they are effectively treating these financial instruments in this way, when classifying them as debt or equity.