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Mr David Boymal  
Chairman  
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P.O. Box 204  
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Dear David

### **Financial Instruments with Characteristics of Equity**

Thank you for the opportunity to comment on the Discussion Paper 'Financial Instruments with Characteristics of Equity'.

It is our primary position that the economic substance of financial instruments should determine their classification. An instrument should be classified as equity only if it gives rise to participation in the risks and rewards of ownership of an entity. The approach that exists under the current IFRS requirements (IAS 32) is based on this principle, particularly when one takes into account the substance over form notion. Therefore, as the requirements under IFRS/IAS 32 are operative and effective, we see little benefit in undertaking a complete restructure of the approach to the debt versus equity classification issue. We also consider that a review of this nature should not be undertaken until such time as the Conceptual Framework project is finalised, as the outcome of this project could have direct consequences on any approach taken.

Regardless of our position, we have taken the opportunity to provide comments on the various approaches set out in the discussion paper. However, we have not provided detailed answers to all questions as in some instances the proposed approach fundamentally contradicts our overall position.

### **QUESTIONS ON THE BASIC OWNERSHIP APPROACH**

- 1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of the Preliminary Views and provide minimal structuring opportunities?*

**No, we do not support the basic ownership approach. Simplification offered by this approach may result in situations whereby classification does not represent the true nature and economic substance of the instrument. Acceptance of this approach would therefore contradict our fundamental position when determining classification.**

## Perpetual Instruments

2. *Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential concerns, if any, does this classification present?*

**If we apply the fundamental principle that instruments which give rise to a participation in the risks and rewards of ownership should be classified as equity, appropriate classification should result. We are opposed to an approach which achieves a different outcome.**

3. *The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.*

**In our view the measurement principles must follow the classification of the instrument, consistent with the existing measurement principles for financial instruments under IFRS.**

## Redeemable Basic Ownership Instruments

4. *Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?*

**No comment**

## Separation

5. *A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?*

**We support the separation of compound instruments into their respective liability and equity components when this appropriately represents the underlying characteristics of the instrument. If a dividend is truly non-discretionary, then it would be more characteristic of a liability.**

## Substance

6. *Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification or measurement under the basic ownership approach? Additional, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?*

**We agree that the economic substance of an instrument should be the main driver of its classification. We support a substance override for any approach taken with respect to debt versus equity classification.**

#### **Linkage**

7. *Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?*

**No Comment**

#### **Measurement**

8. *Under current accounting, many derivatives are measured at fair value with changes in value reported in net outcome. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?*

**Again, if the economic substance of an instrument creates embedded derivatives then these should be appropriately recognised and measured. Furthermore, we do not agree with excluding derivative instruments from an equity classification if the instrument participates in the risks and benefits of ownership of the entity.**

#### **Preparation Issues**

9. *Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities requirements to be settled with equity instruments be reported separately from those required to be settled with cash?*

**We believe separate classification on the basis of liquidity is not necessary on the face of the balance sheet. Liquidity information can be provided by way of note disclosures.**

10. *Income Statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.*

**It is our view that the income statement should display the nature and business economics of the underlying instrument. We are not opposed to a greater degree of detail in relation to fair value movements but consider that this is not a matter directly related to the question of debt and equity classification.**

## Earnings per Share (EPS)

11. *The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

**Due to the focus on EPS as a significant measure of financial performance, it is important that EPS is affected in a manner consistent with the classification of the instrument.**

## QUESTIONS ON THE OWNERSHIP-SETTLEMENT APPROACH

1. *Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, explain why you believe the benefits of the approach justify its complexity?*

**We consider that the ownership settlement approach is the approach which is the most consistent with our fundamental principle in relation to debt/equity classification. Thus this approach, in our view, would best reflect the economic substance of the instruments.**

2. *Are there ways to simplify the approach? Please explain.*

**We favour an addition to the substance principle which allows non-substantive or minimal features within instruments to be disregarded in applying the classification requirements. This addition to the substance principle would reduce complexity without compromising the classification principles.**

## Substance

3. *Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?*

**A substance override principle is currently operative in the IFRS environment and is proving not overly complex in application.**

## Presentation Issues

4. *Statement of financial position. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an equity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

**As mentioned above, liquidity information can be provided through note disclosures. We do not consider that the form of settlement should warrant disclosure as a separate line item on the balance sheet.**

## Separation

5. *Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?*

**We consider that separation of compound financial instruments provides useful information to users and better reflects economic reality.**

## Earnings per Share

6. *The Board has not discussed the implications of the ownership-settlement approach from the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

**EPS is an important measure of financial performance. It is important that the EPS should be affected in a manner consistent with the classification of the instrument.**

## Settlement, Conversion, Expiration or Modification

7. *Are the requirements described in paragraphs A35-A38 operational? Do they provide meaningful results for users of financial statements?*

**We are not opposed to the proposed accounting for settlement, conversion, expiration or modification.**

## QUESTIONS ON THE REO APPROACH

1. *Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.*

**The REO approach is sufficiently complex and thus the benefits of application are not considered justifiable.**

## Separation and Measurement

2. *Do the separation and measurement requirements provide meaningful results for the users of financial statements?*

**No comment**

## Earnings per Share

3. *The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

**No comment**

## OTHER ALTERNATIVES

1. Some other approaches the Board has considered but rejected are described in Appendix E. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?

**No comment**

## IASB SPECIFIC QUESTIONS

- B1 Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?*

IAS 32 is based on sound principles and has not resulted in considerable application issues in the current IFRS environment. Therefore a project lending itself towards a restructure of the requirements of this standard is, in our view, not warranted..

- (a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?*

**Our general position on each approach is as follows:**

**The basic ownership approach appears to reduce complexity however, it does not result in equity classification in all instances whereby the holder is exposed to the residual risks and rewards of an entity.**

**The reassessed expected outcomes approach will create an overly complex environment with little added benefit.**

**The ownership-settlement approach is preferred because classification is primarily dependant upon the exposure of an investor to the residual risks and rewards of an entity. This approach is therefore fundamentally an extension of current generally accepted practice.**

- (b) Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?*

**No.**

- B2 Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?*

**Overall, this project is considered unwarranted in the IFRS environment. Furthermore, any review should be postponed until the Conceptual Framework project is complete.**

B3 *Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?*

**Some instruments in certain investment trusts in Australia are puttable at a prescriptive value. These instruments would not meet the definition of equity under the basic ownership approach on the basis that the formula value does not approximate fair value. We consider that although this value would not approximate fair value, all members share equally in the residual interests and therefore an equity classification should result.**

B4 *Are the other principles set out in FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance). If so, to which types of entities or in which jurisdictions are they inappropriate and why?*

**Local law, an entity's governing charter, regulation, or other specific feature may restrict redemption of instruments. We consider that this must affect classification when applying the substance principle.**

B5 *Please provide comments on any other matters raised by the discussion paper.*

**No Comment**

Yours sincerely



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