20 December 2018

Mr Hans Hoogervorst

Chairman

International Accounting Standards Board

30 Cannon Street

London EC4M 6XH United Kingdom

Dear Hans,

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

The Asian-Oceanian Standard-Setters Group (AOSSG) 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 the constituents within each jurisdiction were sought and considered.

The AOSSG currently has 26 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Syria, Thailand, Uzbekistan and Vietnam.

To the extent feasible, this submission to the International Accounting Standards Board (IASB) reflects in broad terms the collective views of AOSSG members. Each member standard-setter may also choose to make separate submissions that are consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard-setters may hold. This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG Financial Instruments and Liabilities Working Group.

AOSSG members acknowledge the efforts of the 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.

However, most AOSSG members are not convinced that the IASB has achieved all of its objectives set out in the DP and are of the view that the cost that entities would incur in understanding and applying the proposed principles and new terminology in the DP would exceed the intended benefits.

The majority of members have the following main concerns:

1. Some AOSSG members did not consider that the IASB had met the objectives of the project. Other AOSSG members were supportive of developing principles for debt/equity classification to replace the “rules-based” nature of IAS 32, but were unsure if the objectives set out in the DP have been fully met. Most members noted the following shortfalls in achieving the objectives:
   - the DP does not appear to address some of the current practical issues appropriately (eg Coco bonds);

- DP proposals appear to be trying to codify the rules in IAS 32, rather than determining the most appropriate principles;
- there is a lack of clarity and conceptual underpinning as to why some of the exceptions in IAS 32 have been retained (puttable instruments) and some not (foreign currency right issues);
- the "principles" in the DP proposals still appear rules based; and
- new principles and terminologies are quite complex and are likely to result in new interpretation and implementation issues.

2. Most AOSSG members are of the view that the IASB's preferred approach creates new problems and unsupported classification changes (eg cumulative irredeemable shares). Most AOSSG members note that the IASB's objective is to re-look at IAS 32 without fundamentally changing the classification outcomes that are well understood and they believe that the IASB's stated objective will not be achieved if the proposed amount leg of the classification principle significantly departs from the current classification approach in IAS 32. However, one AOSSG member notes that classification changes cannot be totally avoided, if classification is to be guided by a single set of principles in place of the arbitrary and inconsistent rules in IAS 32.

3. AOSSG members have mixed views regarding the IASB's next steps in relation to this DP. Some members suggest that the IASB should proceed with the project but only after the IASB has addressed the key areas of concern and provided a clear rationale for why certain outcomes that are currently understood need to be changed. Another group of members suggest that the IASB should not proceed with the project in its current form until the principles in the DP are compared with those in the *Conceptual Framework for Financial Reporting* to future proof the Standard. Another member recommended that the IASB enhances the disclosures about claims as a short-term solution in parallel (e.g. about the terms and conditions of claims). A few members suggested that IASB should not proceed with the project but instead should provide implementation guidance within IAS 32 to help alleviate current challenges (generally IAS 32 is seen as working well in practice).

4. Most members suggest that proposed principles should be consistent with the principles set out in the revised *Conceptual Framework for Financial Reporting*. Where there is a need to deviate from the Conceptual Framework, the reasons for doing so and why this is necessary for financial liabilities despite not being necessary for non-financial liabilities should be explained. Some members also suggest it would be helpful to determine the conceptual principles for distinguishing liabilities from equity first, prior to addressing specific issues in practice in order to truly future-proof the Standard.

5. Most members consider 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 their outreach there is considerable uncertainty as to how they should be interpreted.

In responding to the DP, members have limited their responses to some specific issues as described in Appendix A of this submission. Furthermore, the views of the Islamic Finance Working Group members are outlined in Appendix B of this submission.

If you have any questions regarding this submission, please contact either one of us.

Yours sincerely,

Yibin Gao	Kris Peach
AOSSG Chair	*AOSSG Financial Instruments Working Group Leader*

APPENDIX A

Additional specific comments on the proposals in the DP

1. Comments on the 'amount feature'

Most AOSSG members 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 members are of the view that this leg of the principles would result in certain instruments that are currently classified as equity to be liabilities (eg cumulative irredeemable preference shares). The members also consider such changes in classifications to be unwarranted as the current classifications for these instruments are well understood by users.

Three AOSSG members further commented that the definition of 'amount independent of entity's available economic resources' in the amount feature might not fit well with the instruments on liquidation because one might argue that any claim amount would be dependent on the amount of the entity's assets that will be distributed to the claims based on the order of claims. In this sense, it is confusing how claim amounts can be independent of the entity's available economic resources on liquidation since all claims including the entity's available economic resources (i.e. residual amount) are dependent on the entity's assets (i.e. the economic resources).

However, two AOSSG members agree with IASB preferred approach and the classification principles as set out in the DP. One out of those two members is of the view that the Conceptual Framework defines equity as a residual interest – a notion that ought to include both features of timing (i.e. interest at liquidation) and amount (i.e. interest in net assets). The notion of equity representing a residual interest in net assets also underpins the widely-accepted puttable exception. There is an information value, particularly for holders of financial instruments, in classification outcomes that allow an assessment of whether the issuer would have sufficient economic resources to settle the obligations, even if settlement is due at liquidation only. The other member is of the view that there may be some application challenges with respect to determination of 'amount independent of the entity's available economic resources'. For example, measurement of unrecognised assets and claims.

2. Comments on retaining the puttable exception

Most AOSSG members agree with the IASB's preliminary view that the puttable exception should be retained as suggested in the IASB's preferred approach. The members consider that it is important that the puttable exception continues to be available to avoid counter-intuitive outcomes in classification as set out in BC50 of IAS 32.

However, three AOSSG members disagree with retaining the exception. They prefer not including exceptions in a principle-based standard developed on a conceptual basis. They are of the view that if the objective of the IASB is to develop a principle-based standard from a conceptual point of view, such a standard should not contain carve outs or exceptions to the general principles.

One member out of these three members has noted that most fund's financial position is not evaluated based on equity/liability classification under the puttable exception. Instead the alternative presentation of the statement of financial position provided by Example 7 in the Implementation Guidance to IAS 32 gives sufficient useful information. Therefore, the member suggests that the IASB establishes the extent to which the exception is used in practice, the application challenges arising from it and whether potential improvements could be made before deciding whether to retain the exception. However, two out of these three members agree that if the IASB goes ahead with this project in its current form the puttable exception should be retained. These members support such a retention as they consider that it is important the puttable exception continues to be available in the absence of a principle-based standard due to the reasons set out in BC50 of IAS 32.

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

Most AOSSG members disagree 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. Based on the feedback received, investors are not convinced of the usefulness of attribution approaches suggested in the DP. They are also of the view that the cost of providing this information would significantly exceed the intended benefits. One member questions whether there is a relevance of allocating income and expenses using fair values.

4. Concerns with the classification outcome for cumulative irredeemable preference shares and perpetual bonds and possible practical challenges resulting from them

Most AOSSG members do not agree with classifying irredeemable cumulative preference shares and perpetual bonds as liabilities as suggested by the DP proposals.

The current classification of these instruments under IAS 32 is well understood and as such, the members are not convinced that the classification outcomes for these instruments should be changed under the new classification principles developed by the IASB. The members are also of the view that if the IASB starts with the conceptual framework and develops principles for equity/liability classification first, the outcome may be different.

Furthermore, the members noted that the following issues may also 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.

However, one AOSSG member notes that if perpetual instruments are classified as equity, their carrying amount will not be updated, and therefore, the reported and actual amounts of the obligations may be different. The concept of updating the measures of perpetual instruments is not new in IFRS Standards; instruments with discretionary dividend/interest payments do not have contractual cash flows that are solely payments of principal and interest and are measured at fair value in accordance with IFRS 9.

5. Concerns with the removal of the foreign currency rights issue exception

Most AOSSG members do not support the proposal to remove this exception and the IASB's proposals of presenting income and expenses that arise from such instruments in OCI. The members do not agree with removing the exemption at this time given the arguments for the exception as set out in IAS 32 BC4F are still valid. 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, which is retained under the IASB's preferred approach.

Members acknowledge the IASB's question as to why derivative financial instruments that meet this exception should be classified differently to conversion options in foreign currency convertible bonds, which are classified as financial liabilities. Most members agree with the fact that convertible bonds and rights are economically similar and therefore accounting should be the same. However, members recommend considering both convertible bonds and rights issued in foreign currency as equity and not as liabilities as suggested in the DP.

The DP proposes a presentation exception for these right issues if the criteria in paragraph 6.34 are met. Most AOSSG members 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 and question why these characteristics are not part of the classification proposals and only a presentation exception is proposed.

Therefore, AOSSG members recommend 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. 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.

However, one AOSSG member notes that the exception is narrowly defined and limited to foreign currency rights that are offered pro rata to all of the existing owners of the same class of non-derivative equity instruments. The member does not support extending the exception to foreign currency convertible bonds because they do not think they represent equity transactions with owners in their capacity as owners. If the IASB decides to proceed with the classification principles, there is little basis for such an exception because all convertible bonds would be classified as a non-derivative financial liability (and a derivative instrument for the conversion option) on the premise that the entity does not have an unconditional right to avoid the liability settlement outcome.

Most AOSSG members do not support the IASB's proposals of presenting income and expenses that arise from certain liabilities in OCI as it:

- results 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; and

- appears to be at odds with the IASB's intention detailed in paragraph 7.17 of the revised Conceptual Framework.

However, one AOSSG member is of the view that, if the IASB decides to proceed with the OCI presentation, the amounts presented in OCI should not be subsequently reclassified. If changes in the carrying amount of those liabilities are irrelevant to an assessment of financial performance, the same holds true for the cumulative amount to be reclassified from OCI.

6. Warrants with re-fixing clauses

One member has a concern with the classification outcome for warrants with re-fixing clauses. Warrants with re-fixing clauses are classified as a financial liability under IAS 32. The issue arises when a share price increases because the increase in share price leads to an increase in liability and thus a loss is recognised in profit or loss which is counter-intuitive. The AOSSG member notes these warrants would still be classified as a financial liability based on paragraph 4.58(b) of the DP. Therefore, the member recommends that the IASB further explores the accounting treatment for warrants with re-fixing clauses.

7. Contingent Convertible Capital Instruments (Coco bonds)

Most AOSSG members noted there is diversity in practice in accounting for Coco bonds. Most members are of the view that the guidance on what is “independent” in the various scenarios is dependent on rules in the DP, which is perhaps indicative that this is not the most effective principle on which determining liability/equity classifications should be determined. Therefore, members are of the view that 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.

AOSSG members recommend the IASB performs more research into this topic to address practical challenges associated with Coco bonds and to better explain conclusions in the DP for accounting for such instruments.

One AOSSG member is also of the view the DP proposals do not adequately address the recognition and measurement of Interest and Dividend in certain compound instruments, such as Coco bonds. Section 5 of the DP indicates that classification of financial instruments with alternative settlement outcomes in which the entity (the issuer) does not control the settlement outcomes will be consistent with that of compound instruments. The DP further states compound instruments would be classified as financial liabilities, financial assets or equity and this requirement is consistent with those of IAS 32. Coco bonds are an example of instrument where the settlement outcomes are not controlled by the issuer nor the holder. IFRS IC Agenda paper 9 of Jan 2014 meeting notes an unresolved issue regarding accounting for discretionary interest payments on Coco bonds when the entire amount was allocated to the financial liability component with a nil equity component. The IFRS IC Staff Paper also noted that there is a lack of clarity in IAS 32 and paragraphs 36 (dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond) and AG37 (discretionary dividends paid relate to the equity component and, accordingly, are recognised as a distribution of profit or loss) give conflicting answers.

8. Non-controlling interest written put options (NCI puts)

AOSSG members agree that the IASB’s preferred approach provides a solution to the accounting for written puts on NCI. However, most AOSSG members question why NCI puts should be accounted for differently from other derivatives written on an entity’s own equity. The members further state that the IASB’s preferred approach 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 and whether the issuance and expiry of NCI puts should be accounted for as changes in the proportion of equity held by NCI in accordance with paragraph B96 of IFRS 10.

AOSSG members understand the IASB has analogised NCI puts to a conversion option in a convertible bond. Most AOSSG members do not agree that it is the right analogy. They disagree that the accounting for a written put on own shares should be the same as for a convertible bond. Whilst the outcomes are similar once they have been exercised, during the period that they are outstanding the impact on the financial resources of the entity are very different. When it comes to convertible bonds the entity is dealing with external parties who do not own shares of the entity at the time of issuing the convertible bonds. NCI put holders already own shares of the entity. Thus derecognising NCI before the put option attached to it is exercised is arguably conceptually incorrect. Therefore, most AOSSG members consider the right analogy is accounting for NCI puts in the same way as other derivatives written on an entity’s own equity.

Most AOSSG members are also of the view that analogising NCI puts to convertible bonds without developing clear principles on equity/liability classification would create unintended consequences.

One AOSSG member notes that the analogy of redemption obligation arrangements to compound instruments has the benefit of consistent classification between arrangements that have the same settlement outcomes. If the IASB decides to proceed with the classification for redemption obligation arrangements, the IASB may consider further work on whether the accounting for the debit leg of NCI puts as a contra-equity account, rather than derecognition of NCI, would achieve a better balance of information needs between the unavoidable obligation arising from NCI puts and the existing ownership interest held by NCI put holders.

Appendix B

Additional specific comments on the proposals in the DP from the Islamic Finance Working Group members

Generally, the Islamic Finance Working Group members supported the DP's preferred approach in classifying claims into either a financial liability or equity. However, the members would like to bring to the attention of IASB that the preferred approach may inadvertently bring about a change in classification of perpetual sukuk (common in Malaysia, Pakistan and Saudi Arabia – not for listed companies).

Perpetual sukuk (securities) is commonly used in Islamic capital market as an alternative source of financing. Additionally, this instrument is also structured to meet the classification of additional tier 1 capital for financial institutions. One common feature of a perpetual sukuk is that payment of profit/coupon – which is usually cumulative but not compounding – is at the discretion of the issuer and could be deferred to perpetuity. Based on the current wordings of IAS 32, perpetual sukuk is classified as equity as the issuer has discretion over deferment of distribution even though there may be no discretion to determine the amount of distribution. In the application guidance to IAS 32, paragraph AG26[1] provides guidance on non-redeemable preference shares that may be applicable to perpetual sukuk.

Applying the DP's preferred approach, perpetual sukuk is likely to be classified as a financial liability due to the 'amount feature'. The coupon payment is certain (for example the coupon rate is contractually fixed) and there is an obligation for an amount independent of the entity's available economic resources although the issuer has the ability to defer the payment to perpetuity (or until liquidation – see paragraph 2.5 (e) of the DP).

The potential change in classification of perpetual sukuk from equity to liability may be a fundamental[2] change to the issuers. It would affect the amount of borrowings presented in the statement of financial position, adversely affecting the leverage or debt/equity ratio and some issuers may need to seek alternative financing arrangements as a result. This seems inconsistent with the IASB's objective of not 'fundamentally changing the existing classification outcomes of IAS 32'. However, some believed that the DP's preferred approach is a move to the right direction to inform users about the financial position of an entity in a realistic manner. For example, classification of perpetual sukuk as financial liability is consistent with the economic substance and business intent of the issuers – the instrument is often analysed as a financial liability rather than equity when its issuance was contemplated and planned. Therefore, Members seek the IASB to explain the rationale behind the DP's proposals that imply the principles in IAS 32 was 'broken'.

1 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or noncumulative, are at the discretion of the issuer, the shares are equity instruments.

2 For example, the size of perpetual bond/sukuk in Malaysia is material. Based on a desktop research as at 7 November 2018, there are 32 issuances in the market amounting to approximately RM180 billion (≈USD 43 billion) out of which RM35 billion (≈USD 8 billion) are outstanding.