Agenda Paper 4

asian-oceanian standard-setters group

THE TENTH ANNUAL AOSSG MEETING

Joining hands in regional cooperation and the development of IFRS

21-22 November 2018 Singapore

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

[Comments from AOSSG Financial Instruments and Liabilities Working Group]

Presented by Australian Accounting Standards Board (AASB)

Objectives of today's session

- Share comprehensive views[1] of the AOSSG's working group members
- Obtain feedback from broader AOSSG members
- Agree on key feedback to the IASB on the proposals in DP/2018/1

[1] The views presented in this slide pack are based on the comment received from the members as at 9 November 2018. Further comments are expected since outreach activities are still being carried out by the working group members.

About the FICE project

- **Research project**
- **Project objectives**
  - To address the challenges arising from the application of IAS 32 *Financial Instruments: Presentation* through **clearer principles for classification** and **enhanced requirements for presentation and disclosure**
  - Improve information that entities provide in their financial statements about financial instruments

IASB's preferred approach

A claim is a **financial liability** if it contains an **unavoidable obligation**:

a) To transfer economic resources at a **specified time** other than at liquidation;

Timing feature → Funding liquidity and cash flows

and/or

b) For an amount **independent** of the entity's available economic resources.

Amount feature → Balance sheet solvency & returns

An equity instrument is any contract that evidences a **residual interest** in the assets of the entity, after deducting all of its liabilities

IASB's preferred approach – Classification outcomes

Amount feature / Timing feature	**Obligation for an amount independent of the entity's available economic resources** (such as fixed amounts, based on interest rates or other financial variables)	**No obligation for an amount independent of the entity's available economic resources** (such as an amount indexed to the entity's own share price)
Obligation to transfer economic resources at a specified time other than at liquidation (such as scheduled cash payments)	**Liability** (e.g. simple bonds, loans)	**Liability** (e.g. shares redeemable at fair value)
No obligation to transfer economic resources at a specified time other than at liquidation	**Liability** (e.g. share-settled bonds, cumulative preference shares)	**Equity** (e.g. ordinary shares)

What we've heard so far from AOSSG FI WG members

(refer to the Appendix 4.1 for more information on these issues)

- Current practical debt/equity classification **issues remain unaddressed**, such as accounting challenges for:
  - Non-controlling interest written put options (NCI puts)
  - Contingent Convertible Capital Instruments (CoCo bonds)
  - Convertible bonds issued in a foreign currency
  - Warrants with re-fixing clauses

- **New practical issues and classification outcomes** would arise that are counter-intuitive to the substance of some financial instruments. For example:
  - cumulative irredeemable preference shares and perpetual bonds
  - foreign currency rights issues (driven by the removal of foreign currency rights issue exception)

Questions for AOSSG members

1. Based on the above feedback, do you agree that the FICE DP has met the objectives noted on Slide 3? Why?

   a) Yes

   b) No

2. Do you consider the IASB has addressed challenges that are causing issues in practice and what is causing them? Why?

   a) Yes, all challenges and causes have been addressed

   b) Partly, some challenges and causes have been addressed but not all

   c) No, some of the key challenges and causes have not been addressed and others have been created by proposals in the DP

Questions for AOSSG members

3. Should the IASB proceed with this project based on the proposals? Why?

   a) Yes – all the key issues have been addressed and the proposals future-proof the Standard

   b) Yes – but only after the IASB have addressed the key areas of concern and provided rationale for why certain outcomes that are currently working well need to be changed

   c) No – the IASB should align principles with those in the Conceptual Framework to future proof the Standard

   d) No – the IASB should provide implementation guidance within IAS 32 to help alleviate current challenges, as by and large the Standard is working well in practice.

   e) No – the IASB should stop focus on implementation support for recently issued or upcoming Standards (i.e. IFRS 9, 15, 16, 17)

If the IASB's decides to go ahead with the DP - What would we recommend?

Question 2 in the DP

The preferred approach to classification would classify a claim as a liability if it contains:

a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

b) an unavoidable obligation for an amount independent of the entity's available economic resources.

In the IASB's view, information about **both** of these features is relevant to assessments of the entity's financial position and performance (summarised in paragraph 2.50 of the DP).

Information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

AOSSG FI WG Members' views on Question 2 of the DP

Concerns with the 'amount feature'

- **Japan and Australia** recommend limiting the 'amount feature' to events other than at liquidation. This would result in classification outcomes more in line with the economic substance of the transactions

- **Hong Kong, Australia, Japan, Singapore and Korea** recommend clearly defining the terms 'entity's available economic resources' and 'amounts independent of the entity's available economic resources' to avoid potential risks of unnecessary disruption and unintended consequences

- **Korea** recommends disaggregating obligations to transfer economic resources only at liquidation into two types of claims:

  - Type A contracts be grouped together and be classified as **equity instrument** – the obligation that requires no settlement at a specified time (for example, ordinary shares and cumulative shares); and

  - Type B contracts be grouped together and be classified as financial **liability** – obligation that requires a settlement by delivering the entity's own shares at a specified time (for example, a derivative on own equity with net-share settlement or gross physical settlement)

AOSSG FI WG Members' views on Question 2 of the DP (cont.)

Classification doesn't appear to link with the *Conceptual Framework*

- **Korea and India** recommend the IASB clarifies how the preferred approach aligns conceptually with other liabilities and other financial liabilities, and how the DP's proposals interacts with the definition of a liability in the revised Conceptual Framework

- **Australia, Japan, India and Hong Kong** recommend the IASB determines conceptual principles for distinguishing liabilities from equity first, aligning these to the *Conceptual Framework*, prior to addressing specific issues in practice

- **Australia and Hong Kong** recommends the IASB enhances disclosure requirements around financial instruments (such as NCI puts), instead of changing classification outcomes. This could be done by requiring specific disclosures on liquidity, the potential impact of economic incentives, laws and regulations on the settlement of financial instruments. These disclosures could be in the form of sensitivity analysis, expected cash flows of the claims and/or voting rights of equity instruments.

Question for AOSSG members

4. Do you agree with limiting the 'amount feature' to 'amounts independent of the entity's available economic resources', **other than those due at liquidation?** Why?
   a) Yes
   b) No

5. Do you agree that the terms 'entity's available economic resources' and 'amounts independent of the entity's available economic resources' should be clearly defined by the IASB? Why?
   a) Yes
   b) No

6. Do you agree with disaggregating obligations to transfer economic resources only at liquidation into two types of claims as suggested by Korea? Why?
   a) Yes
   b) No

Questions for AOSSG members

7. Do you agree that proposed principles should be consistent with the principles set out in the *Conceptual Framework*? Why?
   a) Yes
   b) No

8. Do you agree that IASB should determine conceptual principles for distinguishing liabilities from equity first, prior to addressing specific issues in practice? Why?
   a) Yes
   b) No

If the IASB's decides to go ahead with the DP - What would we recommend?

Question 4 in the DP

The IASB's preliminary view is that the puttable exception would be required under the IASB's preferred approach.

Do you agree? Why, or why not?

AOSSG FI WG Members' views on Question 4 of the DP (cont.)

Retain the puttable exception and explore extending its use

Agree:

- Members are generally supportive of retaining puttable exception
- **Singapore, Australia, and Japan** recommend that the IASB further explores:
  - The extent to which the exception is used in practice;
  - Whether the requirements of paragraphs 16A to 16F of IAS 32 can be improved; and
  - The possibility of providing examples and guidance on how the puttable exception can be applied.

Disagree:

- **Hong Kong** has a different view, because most trust funds do not use the exception currently. Hong Kong prefers the alternative balance sheet presentation permitted under IAS 32 where units are shown as a separate class of liability and measured at the net asset amount.

Questions for AOSSG members

9. Do you agree with retaining puttable exception ?

   a) Yes
   b) No

10. Have you encountered any other issues in applying this exception in your jurisdiction?

   a) Yes (please provide examples)
   b) No

If the IASB's decides to go ahead with the DP - What would we recommend?

Question 8 in the DP

The IASB's preliminary view is 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 attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33.

Do you agree? Why, or why not?

The IASB did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, approaches considered:

(a) a full fair value approach;

(b) the average-of-period approach;

(c) the end-of-period approach; and

(d) not requiring attribution, but using disclosure

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

AOSSG FI WG Members' views on Question 8 of the DP

Feedback on attribution of income and expenses of some equity instruments other than ordinary shares

Agree:

India agrees with the IASB 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

Disagree:

- Users and investors from **Australia, Japan, Korea, Hong Kong** are not convinced of the usefulness of attribution approaches suggested in the DP
- **Australia, Japan, Korea, Hong Kong** consider the cost of providing this information significantly exceeds the intended benefits
- **Australia** recommends providing disclosures on the:
  - expected maximum number of potential ordinary shares;
  - priority of claims on liquidation; and
  - terms and conditions affecting the timing and amount of cash flows

AOSSG FI WG Members' views on Question 8 of the DP (cont.)

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

Australia , Hong Kong and Japan do not support the IASB's proposal of presenting income and expenses that arise from certain liabilities in OCI for the following reasons:

- It 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 through profit or loss;
- It would lead to an exception in presentation – replacing one rule with another rather than a principle-based outcome; and
- It would be inconsistent with the IASB's intention detailed in paragraph 7.17 of the *Conceptual Framework*

Questions for AOSSG members

11. Do you agree with attributing income and expenses to some equity instruments other than ordinary shares? Why?

    a) Yes
    b) No

12. Do you agree with presenting equity-like returns of financial liabilities in the OCI? Why?

    a) Yes
    b) No

13. Do you have any further comments to add in addition to what has been discussed?

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IASB DP/2018/1 *Financial Instruments with Characteristics of Equity* (Appendix to the Agenda paper 4)

[Comments from AOSSG Financial Instruments and Liabilities Working Group]

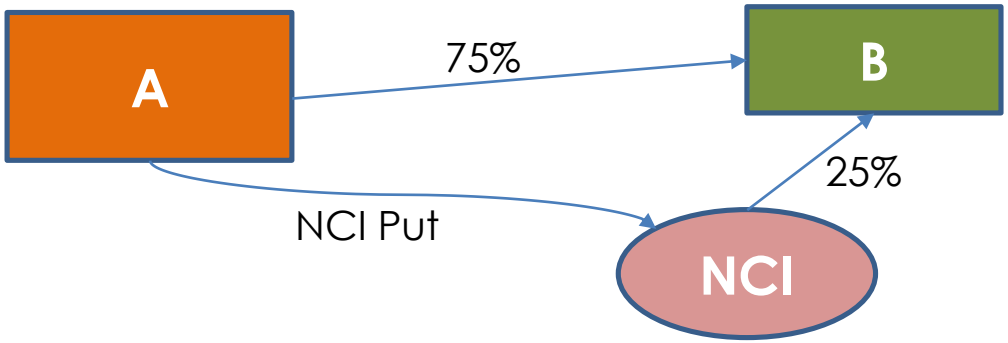
Presented by Australian Accounting Standards Board (AASB)

Practical challenges that remain unaddressed in DP/2018/1

1. Accounting challenges for non-controlling interest written put options (NCI puts)

What is a NCI put – A non-controlling interest (NCI) written put option refers to transaction where the issuer has an obligation to purchase business interests (i.e. shares) of NCI when the NCI offer these interests for sale. Frequently, the right of the NCI can be exercised at a fixed date in the future, after which it lapses. NCI puts are used to create a mechanism for minority shareholders to exit from their investments at a future date.

Eg: Company A buys 75% of the shares of Company B. As part of the acquisition, the remaining 25% shareholders receive an option to sell their shares to Company A after a 3 year period for the fair value of the shares at that time.



Practical challenges that remain unaddressed in DP/2018/1

1. Accounting challenges for non-controlling interest written put options (NCI puts)

What is the issue?	Extent of the issue	Proposed solution and recommendation
Per IAS 32, a financial liability is recognised for the present value of the redemption amount (that is, the full purchase price of the NCI shares). Due to this treatment, when an entity performs well, the carrying amount of the liability increases and a loss would be recognised through profit and loss which is counter-intuitive. Applying the Board's preferred approach in the DP 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.	NCI puts are relatively common in Australia, India, Hong Kong and Singapore.	❑ NCI puts and NCI forwards should be accounted for in the same way as other derivatives written on an entity's own equity. ❑ The IASB should also explore enhanced disclosure opportunities to better represent the information required by users of the financial statements on NCI puts.

Practical challenges that remain unaddressed in DP/2018/1

2. Accounting challenges for Contingent Convertible Capital Instruments (CoCo bonds)

What is a Coco Bond – 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 is beyond the control of both the issuer and the holder of the instrument.

Many financial institutions issued financial instruments that converted 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) to comply with these new regulatory requirements.

Eg: Bank A issued CoCo bonds where the bonds will be converted in to variable number of shares if Bank A's Common Equity Tier 1 (CET1) capital ratio falls below 7% of risk-weighted assets. This could result from large write downs in the loan book that could reduce the capital ratio to say 6.5%.

Practical challenges that remain unaddressed in DP/2018/1

2. Accounting challenges for Contingent Convertible Capital Instruments (CoCo bonds)

What is the issue?	Extent of the issue	Proposed solution and recommendation
The key issues for these instruments are whether: ❑ they should be classified as equity, financial liabilities or a combination of both ❑ the conversion feature may be an embedded derivative that requires separate accounting The leading question is how to measure these instruments and components of these instruments.	These instruments are widely used by banks to meet regulatory requirements in Australia, India, Singapore and Korea.	Members' preliminary view for Coco bonds is that the entire instrument should be accounted as equity, because the instrument has no stated or pre-determined maturity date and represents a residual interest in the entity's net assets.

Practical challenges that remain unaddressed in DP/2018/1

3. Accounting challenges for convertible bonds issued in a foreign currency

What is the issue?	Extent of the issue	Proposed solution and recommendation
Under IAS 32 and DP/2018/1, mandatorily convertible bonds at a fixed for fixed ratio issued in a foreign currency would be classified as a liability due to the foreign currency being an independent variable. Similar to foreign currency rights issues many entities operating in the Asia-Oceanic region issue these instruments in a foreign currency to access the deep markets in the US, UK and Europe.	These instruments are common in Australia and India.	The IASB should consider classifying such instruments as equity using the criteria in paragraph 6.34 in the DP.

Practical challenges that remain unaddressed in DP/2018/1

4. Accounting challenges for warrants with re-fixing clause

What is the issue?	Extent of the issue	Proposed solution and recommendation
Under IAS 32 and the DP, warrants with re-fixing clauses (for example the exercise price is refixed when The entity's share price decreases) are classified as liabilities. This is counter-intuitive because the increase in share price leads to the increase in liability and thus a loss is recognised in profit or loss.	These instruments are common in Korea.	The IASB should consider addressing this issue.

New practical challenges as a result of the DP/2018/1

1. The classification outcome for cumulative irredeemable preference shares and perpetual bonds

What is the issue?	Extent of the issue	Proposed solution and recommendation
Under IAS 32, irredeemable cumulative preference shares and perpetual bonds are classified as equity. Under DP/2018/1, these instruments would be classified as financial liabilities even though the entity has a right to indefinitely defer the payments on these instruments until upon liquidation. The classification of these instruments as liability based on the DP proposals would also result in measurement challenges. (eg how such instruments would be valued given they only fall due on liquidation)	These instruments are commonly used by financial institutions and large corporates in Australia, Korea, Hong Kong and Singapore.	❑ Classifying irredeemable cumulative preference shares and perpetual bonds as liabilities does not represent the substance of these transactions. ❑ The IASB should consider including 'other than liquidation' into its 'amount feature', which would result in these instruments not being classified as liabilities.

New practical challenges as a result of the DP/2018/1

2. The removal of the foreign currency rights issue exemption

What is the foreign currency right issue exception – These are the rights entitling the holder to receive a fixed number of the issuing entity's own equity instruments for a fixed amount of a currency other than the issuing entity's functional currency (foreign currency). The entity issues one or more rights to acquire a fixed number of additional shares pro rata to all existing shareholders of a class of non-derivative equity instruments.

Currently, an entity can apply the foreign currency rights issue exemption in IAS 32 and classify rights 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.

More information is available in the Basis for Conclusions in IAS 32, paragraphs BC4A–BC4G.

New practical challenges as a result of the DP/2018/1

2. The removal of the foreign currency rights issue exemption

What is the issue?	Extent of the issue	Proposed solution and recommendation
The IASB is proposing removing this exemption in DP/2018/1, meaning that such instruments would be classified as a liability due to the foreign currency being an independent variable.	These instruments are used by financial institutions and large corporates in Australia, India, Hong Kong, Korea and Singapore. Many entities issue these rights in foreign currencies because they are listed in more than one jurisdiction; are required to do so by law or regulation; and/or need access global markets.	❑ The IASB should consider classifying these instruments as equity using the criteria in paragraph 6.34 in the DP. ❑ Conceptually, the foreign currency variable is not like the other independent variables as the entity has more control in choosing whether they want to have exposure to that variable or not. ❑ Introduce disclosures about the volatility resulting from these instruments being issued in a foreign currency rather than presenting the income and expenses arising from these types of instruments in OCI.