INSTITUTE OF PUBLIC ACCOUNTANTS®

Submission to the International Accounting Standards Board

Discussion Paper 2018/1

Financial Instruments with Characteristics of Equity

International Accounting Standards Board 16 January 2019
30 Cannon Street
London EC4M 6XH
United Kingdom

commentletters@ifrs.org

Dear Sir/Madam

Re: Discussion Paper 2018/1 *Financial Instruments with Characteristics of Equity*

On behalf of the Institute of Public Accountants (IPA), I am pleased to comment on the Discussion Paper DP 2018/1 *Financial Instruments with the Characteristics of Equity*.

The IPA *supports* the proposed definition of financial liabilities (the consequential definition of equity). In our view, the proposed definition is consistent with the Framework and should ensure a more appropriate underlying principle for the classification of financial instruments as financial liabilities or equity.

Nonetheless, the IPA has *reservations* in relation to some of the IASB approaches set-out in the discussion paper including:

- The IPA is uncomfortable with the complexity of an attribution methodology to indicate the performance of the various components of earnings. Also, the costs to implement such a methodology would be in excess of the potential benefit to users. The IPA considers disclosure basis of performance measurement to be appropriate, as in described in our response to Question 8.
- The IPA has concerns relating to the use of OCI to record changes in financial liabilities with no obligation independent of the entity's economic resources; derivatives that have net amounts that are unaffected by independent variables; and partly independent derivatives meeting the criteria at paragraph 6.34. The IPA is of view that it is not evident this would meet users' specific needs. We have concerns that including movements in instruments that have not met the definition of equity in OCI subverts the objectives of distinction between liability financial instruments and equity that the discussion paper is attempting to achieve.

- The IPA agrees with the need to enhance equity disclosures but has concerns that improvement are also required in relation to financial liabilities – existing requirements for financial liabilities have not met the needs of the users.
- The discussion paper introduces new terminology and while the IPA acknowledges that some of the problems in the application of the requirements of IAS 32 *Financial Instruments: Presentation* relate to poor understanding the current terminology. The IPA does not necessarily believe the introduction of new terminology will assist in providing better outcomes.

Our detailed comments and responses to the questions in the discussion paper are set out in Appendix A.

If you would like to discuss our comments, please contact me or our technical advisers Mr Stephen La Greca (stephenlagreca@aol.com) or Mr Colin Parker (colin@gaap.com.au) (a former member of the AASB), GAAP Consulting.

Yours sincerely

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About the IPA

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members in Australia and in over 65 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures the views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) on issues affecting our members, the profession and the public interest. The IPA recently merged with the Institute of Financial Accountants of the UK, making the new IPA Group the largest accounting body in the SMP/SME sector in the world.

APPENDIX A

Question 1

Paragraphs 1.23-1.37 describe the challenges identified and provide an explanation of their causes.

(a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?
(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

IPA response

The IPA broadly agrees with challenges identified by the IASB in relation to the classification of equity and liabilities. However, the IPA believes that the IASB has underestimated the implementation difficulties many preparers and auditors have with the current regime and the resulting diversity in practice and errors in classification of financial liabilities and equity. The IPA believes the major issues in relation to implementation of the IAS 32 classification regime include:

- Poor application guidance in IAS 32
- Failure to correctly identify and measure embedded derivatives in compound financial instruments and consequential incorrect measurement of the residual liability
- Incorrect application of the "fixed-for-fixed" principle
- Inadequate understanding of the impact on anti-dilutive provisions on the classification of compound financial instruments, and
- The lack of understanding of the issues in relation to the put options over NCI and the application of IAS 32, IFRS 3 and IFRS 10.

Innovation of financial instruments has resulted in an increasingly complex assessment of the compound financial instruments and consequential higher risk of diversity in practice and potential for misstatement.

The IPA agrees that challenges are important enough to users of financial statement to warrant rectification. The IPA Consider that it has taken too long to address these issues and is disappointed that the Board and IFRIC have been reluctant implement remedial actions at earlier opportunities i.e. when matters have been referred as agenda issues. The IPA is of the view that the classification of equity and liabilities is fundamental to the understanding of the overall financial standing of an entity, including its capital structure, solvency, liquidity and loss absorption capability.

Question 2

The Board's 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.

This is because, in the Board's view, information about both of these features is relevant to assessment of the entity's financial position and financial performance, as summarised in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

IPA response

The IPA supports the proposed approached to classification as described at 2.34. and 2.36 of the discussion paper as it results in a financial instrument being equity on a basis that is consistent with the framework definition of equity i.e. the residual interests in the assets of an entity after deducting all of its liabilities.

While the IPA supports the Board's view the other features of claims should be provided through presentation and disclosure, we are of the opinion that current levels of disclosure in relation to equity and debt instruments often does not present these features adequately and the in the absence of clear requirements to disclose there is a risk this information is not provided to users.

The IPA is concerned of the impact of IFRS Practice Statement 2 *Making Materiality Judgements* and in particular paragraphs 81-83 and example P on the disclosure features of claims. The IPA is of the view that prepares and auditors may take the view that if a feature of the claim is remote it should not be disclosed. The IPA is concerned this would be detrimental to the interests of existing and potential investors in the instrument as while original investors may have offer documents that explain the features of the instrument these documents may not readily available to subsequent investors.

Question 3

The Board's preliminary view is that a non-derivate financial instrument should be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or
(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

This will be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability.

Do you agree? Why, or why not?

IPA response

The IPA agrees with the proposed treatment of that non-derivative financial instruments meeting the criteria at paragraph 3.8 as a financial liability as the criteria indicate the financial instrument is not in the nature of a residual interest.

The IPA believes additional guidance needs to be given in two areas:

- Where the financial instrument is settled in the entity's own shares, and
- Provide clarification on the relationship of the requirement to apply the paragraph 3.8 criteria where the financial instrument includes multiple settlement options and the proposed requirements for compound financial instruments in section 5 of the discussion paper.

Question 4

The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

IPA response

The IPA supports the retention of the existing IAS 32 puttable exception. The continued use of trust/mutual investment structures necessitates the existence of such an exemption. The classification of members units as liabilities would create a similar non-sensical outcome that prior to existence of the exemption where such entities had no real equity except undistributed income.

The IPA, however has some concern as to whether the puttable exemption has been used to structure off-balance sheet debt and suggests the IASB undertakes a review the use of the exemption and the necessity for anti-avoidance amendments to be included within the exemption.

Question 5

The Board's preliminary view for classifying derivatives on own equity – other than derivatives that include an obligation to extinguish an entity's own equity instruments – are as follows:

- *(a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and*
- *(b) a derivative on own equity is classified as a financial asset or a financial liability if:*
  - *(i) It is net-cash settled-the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation: and/or*
  - *(ii) The net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.*

Do you agree? Why, or why not?

IPA response

The IPA broadly supports the IASB's proposals for derivatives on own equity and suggest that additional guidance provided on:

- Variables that effect the net settlement amount, as the IPA is of the view the discussion paper is vague and non-definitive on this matter
- Puts on NCI especially the required accounting for group accounts and parent company accounts, and
- The impacts of contingencies (paragraphs 4.63-4.66), in particular, contingencies such as: changes in regulatory capital requirements including regulatory actions; changes in tax status such as deductibility of distributions; changes arising from turnover, profits or other performance measures; changes in control; and listing/IPO status.

Question 6

Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)-(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33-5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as descried in paragraphs 5.43-5.47.

- *(a) Do you think the Board should seek to address the issue? Why, or why not?*
- *(b) If so what approach do you think would be most effective in providing the information, and why?*

IPA response

While the IPA supports the principles in 5.48(a)-(b), we have concerns with the potential impacts as described in the discussion paper:

- The IPA is unconvinced that the outcomes of accounting for the conversion option of compound financial instrument should be the same as that of written option on shares already issued (paragraphs 5.33-34). In particular, the IPA is uncomfortable with concept of "derecognition" of issued shares and the recognition of a financial liability, and
- While we welcome the clarification of the accounting for put options written over NCI, the IPA is uncomfortable with the "derecognition" of the portion of NCI to which the put relates and the recognition of new component of equity. We also believe the attribution of future NCI earnings will not be readily understood by users and is an unwarranted complication for preparers. In addition, the proposed accounting for NCI written put options does not deal with the inconsistencies with the IFRS 10 and IAS 1 of the proposed approach i.e. the treatment of transactions between equity holders.

In relation to financial instruments with alternative settlement outcomes controlled by the entity, the IPA is of the view that equity could be disaggregated either on the face of the balance sheet or in the notes to reflect the different settlement outcomes. In addition, the disaggregation of such financial instruments, enhancements should be made to the required disclosures of terms of conditions of such instruments.

The IPA has observed some confusion amongst preparers for the need to identify and measure conversion options. Additional guidance should be provided for circumstances such as:

- Conversion prices is determined by reference to a yet to be issued offer document price or market price subsequent to listing
- Where the conversion price is adjusted to reflect failure to issue by a certain date (e.g. if the instrument is not converted within 90 day there is 20% discount on the conversion price, at 180 days 30% etc), and
- Where the conversion price is market price less a discount.

Question 7

Do you agree with the Board's preliminary views stated in paragraphs 6.53-6.54? Why. Or why not?

The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37-6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

IPA response

While the IPA recognises that recording changes in obligations to transfer an entity's economic resources are a result of its own performance through the profit and loss may result in outcomes that appear non-sensical, we are unconvinced that the proposal to record in OCI income and expenses relating to such liabilities and derivatives is the best response.

The IPA recognises that in some circumstances the use of OCI may be appropriate, but we a concern as the conceptual basis for the use of OCI as blanket solution. The IPA has a view that other liabilities can be affected by the entities performance e.g. cash settled share-based payments.

The IPA is also concerned that the "overuse" of OCI raises questions as to the "underlying" performance of the entity. The IPA has concerns that instruments covered by this approach have not met the definition of equity and prima facie recording movements in such instruments in OCI subverts the objective of the discussion paper in making a clear distinction between financial instruments that are liabilities and those that are equity.

We would prefer the use OCI be restricted to specific circumstances where there is strong conceptual basis for doing so.

The IPA is unconvinced that where a derivative is partly independent of the entity's economic resources that either the disaggregation approach or the criteria approach is justified as:

- They both incorporate a high level of subjectivity that would need to be supplemented by extensive criteria
- They would increase the complexity of presentation without necessarily increasing the usefulness to users, and
- Further expand the use of OCI.

In conclusion, the IPA is of the view that in relation to derivatives partly independent of the entity's economic resources should be included in profit and loss as only instruments solely dependent on the entity's economic resources meet the definition of equity and recording movements in financial liabilities that partially meet the definition taints the objective of clearly differentiating equity and financial liabilities.

In relation to embedded derivatives in hybrid instruments, if the IASB requires separate presentation of financial liabilities in OCI, the IPA is of the opinion this requirement should only apply to those embedded derivatives that have been separated from the host instrument and are solely dependent on the entity's available economic resources.

For the statement of financial position, the IPA has reservations as to the practicality and effectiveness of the presentation on the face of the statement of financial position on arranging claims by priority when the vast majority of non-financial institutions use a current/non-current basis of presentation. As a result, the IPA is of the view that claims priority should be required as a note to the financial statements.

Question 8

The Board'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. Do you agree? Why, or why not?

The Board's preliminary view is that 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 Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

- *(a) a full fair value approach (paragraphs 6.74-6.78);*
- *(b) the average-of-period approach (paragraphs 6-79-6.82);*
- *(c) the end-of-period approach (paragraphs 6.83-6.86); and*
- *(d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87-6.90 and developed in paragraphs 7.13-7.25.*

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

IPA response

While the IPA concedes the proposed attribution approach(es) does provide information in relation to the returns of the different classes of equity, nonetheless we cannot support the attribution approach proposed due to:

- Concerns that the cost and complexity of the approach outweigh the benefits of the attribution approach(es)
- The potential dislocation of categories of equity (i.e. the embedded derivative component) of a hybrid financial instrument and the actual financial instrument held by the user and the total return attributed to the financial instrument as a whole, and
- The impacts on the statement of changes in equity affecting its readability and usefulness to users.

The IPA would prefer to see a disclosure-based approach which would include:

- Enhanced terms and conditions disclosures of both financial liabilities and equity, and
- Disclosure by instrument issued of interest, dividends and "equity" (i.e. increase/decrease in net assets of the entity which the instrument is entitled) for the period with interest and dividends reconciled to the statement of financial performance.

The IPA welcomes a revisit of the IAS 33 treatment of potential dilutive instruments and the consideration of disclosures of potential dilutive instruments that are not included in diluted eps calculations.

Question 9

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7-7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8-6.9).
(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21-7.22).
(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26-7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

IPA response

The IPA supports the above disclosures however draws the IASB attention to responses to Question 1 and Question 8.

In addition, the IPA suggest the IASB consider the inclusion of disclosure of loss absorption capacity, while this is often similar to priority on liquidation, priority tends to assume an orderly wind-up were as loss absorption deals with stress events on the entity.

Question 10

Do you agree with the Board's preliminary view that:

(a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?
(b) The requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

IPA response

The IPA supports continuing to exclude economic incentives from the consideration of the classification of financial instruments as equity or financial liabilities. However, we believe the IASB should consider requiring the disclosure of the impact of the "failure" to respond to the economic incentive e.g. the quantum of the increased distribution for an instrument, the amount(s) to be included in trust accounts etc.

The IPA also supports the retention of IAS 32.20, however suggest the IASB provides guidance on the impacts of regulatory and legislative requirements and require disclosure of such impacts (e.g. regulatory mandated conversions of hybrid instruments to equity etc.)

Question 11

The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

IPA response

We supports the IASB preferred approach of an entity applying the Board's approach to contractual terms consistent with the scope of IAS 32, however would suggest the IASB provides guidance on the impacts of regulatory and legislative requirements and require disclosure of such impacts (e.g. regulatory mandated conversions of hybrid instruments to equity etc.).

In addition, given the specific scope of IFRIC 2, the IPA supports is continued application.

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