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Mr Hans Hoogervorst
IFRS Foundation
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Canary Wharf
London E14 4HD
United Kingdom

By online submission:- www.ifrs.org

Dear Hans

Discussion Paper DP/2018/1 – Financial Instruments with Characteristics of Equity

CPA Australia represents the diverse interests of more than 163,000 members working in 125 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest. We have restricted our comments below to the question relating to simplifying or removing search fees.

CPA Australia acknowledges the efforts of the International Accounting Standards Board (IASB) in seeking to address the many challenges associated with the debt/equity classification of financial instruments applying IAS 32 *Financial Instruments: Presentation* (IAS 32). However, for the following reasons, we do not support the proposals to introduce a new conceptual basis, under the preferred approach, for classifying financial instruments as debt or equity:

- As stated in the Discussion Paper, the application of IAS 32 to a majority of financial instruments provides classification outcomes that adequately meet the information needs of users. We appreciate the concerns that although IAS 32 remains fit for purpose in most circumstances, it did not adequately address the classification of some complex financial instruments. However, in our view, a fundamental rethink of the concepts as proposed will result in an overly complex approach to classification that is likely be expensive to implement. We are not convinced the costs associated with a move to a fundamentally different classification model are sufficiently justified in the Discussion Paper.
- We do not believe the Discussion Paper aligns the proposed concepts with those within the IASB's Conceptual Framework. It is our view that any conceptual basis for the classification of financial instruments as debt or equity should be aligned with the concepts within the IASB's Conceptual Framework. In our submission in response to Exposure Draft ED/2015/3: *Conceptual Framework for Financial Reporting* we recommended that the concepts relating to financial instruments with characteristics of debt/equity should be developed as part of the Conceptual Framework project. It remains our view that fundamental concepts such as those proposed in this Discussion Paper should be aligned with the concepts within the Conceptual Framework.
- A new conceptual model for classifying financial instruments as debt or equity should be able to comprehensively address the issues identified under the previous approach. Although we agree with the retention of the "puttable exception", including such an exception undermines the robustness of the proposed concepts, and the principles-based approach to IASB's standard-setting. It could be argued that the proposed

new classification principles in the Discussion Paper are inadequate, as the exceptions considered under IAS 32 may still need to be considered under this proposed new approach.
- We agree that the classification of financial instruments under the preferred approach will provide some information that assists users assess the liquidity and solvency of the entity. However, we are concerned that the classification of some financial instruments as liabilities that arise on liquidation applying the 'amount feature' is inconsistent with the substance of such instruments, and with the going concern concept.
- The Discussion Paper notes that market forces, financial innovation and changes in bank capital regulations have generated a wide range of financial instruments. In our view, the creation of new types of financial instruments are also driven by the ability to claim tax deductions. There is no consideration of this key factor in the Discussion Paper.

In addition to the above comments, we have provided responses to the questions raised in the Consultation as an attachment. If you require further information on our views expressed in this submission, please contact Ram Subramanian, Policy Adviser – Reporting, on +61 3 9606 9755 or at ram.subramanian@cpaaustralia.com.au.

Yours sincerely

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Attachment

Specific questions/ comments

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?**

Paragraph IN7(a) of the Discussion Paper states that there is a lack of clear and consistent rationale in IAS 32 and the Conceptual Framework when developing consistent classification requirements, for financial liabilities and equity. We are concerned this infers that the definitions of liabilities and equity in relation to financial instruments in IAS 32 and the Conceptual Framework are inadequate. We suggest this statement is clarified in further developing the project.

Subject to the above, CPA Australia agrees with the factors highlighted in the Discussion Paper that contribute to the generation of a wide range of financial instruments, and the challenges associated with the classification of such financial instruments. As set out in our above cover letter, one of the factors that could contribute to the challenges is the ability for entities to claim tax deductions for the costs associated with such financial instruments. This key factor has not been considered in the Discussion Paper. While we appreciate that topics such as taxation are not the focus of financial reporting standards, given the influence taxation may have on the development of complex financial instruments, we expect some discussion of this topic in the development of the proposals.

We agree that the challenges identified in the Discussion Paper are pervasive enough to warrant standard-setting activity. However, for the reasons stated in our cover letter, we are unable to support the preferred approach described in the Discussion Paper. We agree with the comment in paragraph 1.15 of the Discussion Paper that the IASB has found "little evidence that it needs to reconsider all, or even most, of the classification outcomes that result from IAS 32". If the IASB intends to pursue a standards-level solution to the challenges identified, we suggest the IASB focuses on narrow-scope amendments to IAS 32 that address the identified challenges.

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 assessments 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?

CPA Australia is of the view that the preferred approach introduces a significant change that brings about further complexity in distinguishing financial instruments with characteristics of debt and equity. We are not convinced that the costs of implementing this significant change is outweighed by the benefits that may arise. We are also concerned that the introduction of a new "time feature" and "amount feature" under the preferred approach will bring about significant change in practice. For example, in the financial services sector, some perpetual financial instruments that convert to equity if the "Common Equity Tier 1 (CET 1)" ratio falls below a certain level are currently classified as equity. Such instruments may be classified as liability under the proposed preferred approach. Further, without clear definition of the terms associated with the "time feature" and the "amount feature", there is a risk that different interpretations could give rise to further diversity in practice.

Question 3

The Board's preliminary view is that a non-derivative 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 also 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?

The Discussion Paper highlights examples of classification outcomes that will be different under the preferred approach compared to the current approach under IAS 32. Feedback we have received also indicates there are likely to be different classification outcomes under the preferred approach. Concerns have been expressed about the rationale behind an approach that is likely to result in different classification outcomes, and whether users will find such information more helpful than what is available currently.

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?

As stated in our above cover letter, a new conceptual model for classifying financial instruments as debt or equity should be able to comprehensively address the issues identified under the previous approach. Although we agree with the retention of the "puttable exception", including such an exception undermines the robustness of the proposed concepts, and the principles-based approach to IASB's standard-setting

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?

CPA Australia supports an approach where the derivatives on own equity are classified in their entirety, and not based on the classification of individual legs. Splitting a derivative could introduce unnecessary complexity.

CPA Australia does not support classifying a derivative as a financial asset or liability where the "the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources". IAS 32 currently provides an exemption where a fixed number of an entity's own shares for a fixed amount of a non-functional currency would normally fail the fixed for fixed requirement and permit equity treatment. This current exemption is reversed under the preferred approach on the basis that the exchange rate is independent of the entity's available resources. It is not clear why the currency of issue in this instance would drive a different classification outcome.

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 described 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?

Given the overall concerns we have expressed above in relation to the preferred approach, we have provided no further comment in response to this specific question.

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?

We have raised concerns in our above cover letter about the potential for inconsistencies between the "amount feature", and the substance of the underlying financial instruments and the going concern concept. We also suggest the IASB undertake a cost/benefit analysis before proceeding with the presentation of information in the statement of financial position proposed in paragraph 6.53(a).

We do not support presenting in the statement of other comprehensive income (OCI), the proposed information under paragraph 6.53(b). The role of the OCI and its usage remains open to debate, and we note the statement in the Conceptual Framework that income and expenses should be included in the OCI in "exceptional circumstances". There is insufficient discussion in the Discussion Paper whether classifying such movements in the OCI would meet the criteria set out in the Conceptual Framework.

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?

Any expansion of information in relation to attribution of income and expenses to some equity instruments should be subject to a cost/benefit analysis.

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?

While we have no objections to additional disclosures that are considered useful by users of such information, we suggest the IASB gives consideration to its objectives under the “Better Communication” project to ensure alignment.

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?

We agree that the economic incentives that might influence the issuer’s decision should not be considered when classifying a financial instrument as equity or liability. IAS 32 is currently silent on this matter and we would welcome the clarification.

We agree with the retention of the paragraph 20 requirement in IAS 32 as this guidance eliminates any issues that may arise where the manner of settlement is at the option of the issuer.

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?

We support continuing assessment of the contractual terms of a financial instrument, consistent with the current approach under IAS 32. However, further consideration should be given to local regulatory requirements to determine whether different outcomes would arise dependent on whether an entity includes local law-based criteria in contractual terms or not.