SUMMARY OF MEETING WITH THE HKICPA FINANCIAL INSTRUMENTS ADVISORY PANEL

IASB Discussion Paper on Financial Instruments with Characteristics of Equity

Date: 26 October 2018

Time: 9:30 am – 11:30 am

Venue: HKICPA Conference Room, 37/F Wu Chung House, Wanchai

Present: Byron Khoo, Ernst & Young
Joe Ng, Ernst & Young
Isabel Lin, KPMG
Martin Friedhoff, KPMG
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Christina Ng, Standard Setting, HKICPA
Eky Liu, Standard Setting, HKICPA
Nigel Dealy, Standard Setting, HKICPA

Objectives, scope and challenges

- Panel members are in general agreement with the DP's description of the challenges and their causes identified in distinguishing financial liabilities from equity when applying IAS 32.
- However, they noted that there were other challenges not explicitly addressed, such as:
  - Definition of the entity vs the shareholders – it is important when deciding what is in the control of the entity and when do shareholders as a body act as the entity
  - Inconsistencies of the definition of a liability in the Conceptual Framework and IFRS 2 and the definition of a financial liability in IAS 32
  - Usefulness of equity/liability distinction for investor vs issuer
  - Reclassification between liabilities and equity and vice versa
  - Measurement under IFRS 9 of the financial liabilities created by IAS 32. Confusion arises where IAS 32 imposes its own measurement rules to financial liabilities, in conjunction with, or in substitution for, IFRS 9 requirements. For example, the grossing up of the legs of a written put option over own shares.
- Some panel members considered that the principles in IAS 32 are generally well understood and the application issues arise from a lack of guidance. They were not convinced that the IASB should do more than an "issues fix" approach.

- One Panel member suggested that there is a need to look at providing more measurement guidance in IFRS 9 where the obligation is not for a fixed amount and has to be estimated.
- Panel members acknowledged that the DP aims to clarify the rationale for the classification outcomes. However, they were concerned about proposing new conceptual principles using new and untried terminology and not addressing application issues may lead to application challenges and potentially unintended consequences.

The IASB's preferred approach / Classification of non-derivative financial instruments

- Panel members welcomed the removal of "fixed-for-fixed" requirement which has proved to be more variable than it might be thought. However, the proposed two pronged approach to classifying a claim as a liability is thought to suffer from similar shortcomings to the existing IAS 32.
- Part of the confusion caused by the new terminology is that it is treated as synonymous with the wording in IAS 32, which they are not.
- Panel members were concerned about where to draw the line between "dependent on" and "independent of" an entity's available economic resources.
- One Panel member considered that the confusion stemmed from the way that the DP used the term "independent", which as used in the DP does not mean totally independent but in fact is used as meaning independent in a particular way.
- One Panel member commented that overall the proposed approach was more complex than it needs to be, in particular for the "amount" feature.
- Another Panel member thought that the amount feature could be manipulated to give an equity classification outcome by structuring an instrument's obligation to be a payment of the lower of net asset per share and a fixed amount thus establishing a dependency upon the entity's available economic resources. It was suggested that the only defence would be whether the term was "genuine". However, this was not thought to be viable given the struggle IFRIC had in determining what is meant by genuine.
- It was noted that the instrument (irredeemable fixed-rate cumulative preference shares) whose classification outcome would change to a financial liability from its IAS 32 equity classification due to the articulation of the amount feature had been largely retired from the banking space as a result of regulatory changes. However, some banks still have these instruments in their balance sheets and reclassification would not be attractive. It was noted that these types of perpetual instruments were popular in Mainland China, particularly with property developers.

- One Panel member questioned how to apply the “formula” as mentioned in the DP to determine an entity’s available economic resources when there were other instruments with rankings equal to or lower than that of the instrument being tested.
- Panel members noted that although the DP professes not to deal with measurement, it nonetheless introduces measurement considerations without proper explanation, discussion or guidance. For example, discounting – what rate to use? what to do in negative interest situations? what period to discount over (particularly when estimating the timing of potential future events)?
- Panel members concluded that what is being proposed is not an improvement to the current classification requirements in IAS 32.

Puttable exception

- Most panel members disagreed with the proposal to retain the puttable exception.
- Paragraph 3.37(c) of the DP says that the IASB is not aware of application issues involving the puttable exception; however, panel members noted that the criteria for the puttable exception do create application issues. For example, some funds have “Founders Shares”, which legally may be the lowest subordinated claim but are usually of minimal amount, have no voting and distribution rights and merely exist to facilitate start up of the fund. Presenting these shares as the “equity” of the funds and the other shares as liabilities is considered misleading as the “Founders Shares” are not in substance the real equity of the funds.
- Some Panel members noted that most funds do not evaluate their financial position based on the equity/liability classification under the puttable exception. Instead, the balance sheet presentation provided by Example 7 in the Implementation Guidance to IAS 32 provides sufficient useful information to users of financial statements.
- It was noted that the corporate entity for which the exception could be said to have been created no longer uses the exception.

Derivatives on own equity

- Panel members consider that the classification proposals for derivatives on own equity are confusing and complex.
- Anti-dilution provisions – It would be preferable to have a simpler approach to deal with assessments of anti-dilution provisions. It would be useful if the impact of “down round” protection provisions on the classification of a claim could be clarified.

- Foreign currency – Panel members noted that foreign currency risk is not a feature of an instrument's contractual terms but of the circumstances in which the entity operates. Consequently, if an entity issues a fixed number of equity the foreign currency risk should not matter. Foreign currency rights issues would not need the exception to be classified as equity and the conversion feature in a foreign currency convertible bond would similarly achieve equity classification; hence removing the noted anomaly.
- Time value of money – One Panel member noted that in the discussion of the time value of money (paragraph 4.53 of the DP) implies that a floating interest rate (eg 3 month LIBOR) is dependent upon an entity's available economic resources. He considered that 3 month LIBOR doesn't depend on any entity's economic resources.
- Contingencies – Panel members considered that the DP does not address the problems under paragraph 25 of IAS 32 in measuring the liability due to estimating when the contingent event (eg a change of control) may happen. Should the measurement take into account the probability of the event occurring? Should it be the earliest point in time that the contingency might occur (which could be the next day) or try to estimate when it might occur?
- Written puts over NCI – Some Panel members considered that the proposals added clarity to the accounting under paragraph 23 of IAS 32 for the "grossing up" and the debit entry to equity. However, concerns were expressed over the deemed derecognition of shares that have not yet been redeemed and are outstanding and on which dividends are being paid. Other Panel members considered that the "grossing up" should not apply to net-settled derivatives.

Presentation and Disclosure

- Panel members were of the view that the proposed attribution of total comprehensive income to different subclasses of equity instruments would be complex, burdensome and not well understood and therefore the output would be of questionable quality.
- Panel members were not convinced about the expanded use of OCI (without recycling) to take the "counter-intuitive" effects out of profit or loss when presenting income and expenses of financial liabilities. They considered that it would be more reasonable to question why gains or losses of an instrument classified as a liability do not go through profit or loss? If it is acceptable to use the OCI in this way, why not move other "non-operating" items to OCI?
- It was noted that a consequential amendment to IFRS 9 would be required to allow use of the OCI in this manner when measuring liabilities under IFRS 9.

Contractual terms

- Economic compulsion – Panel members were not convinced that economic compulsion is adequately addressed by the “amount” feature. A better approach would be to be clear as to whether there is “unconditional right to avoid”.
- Indirect obligations – Panel members considered that retention of paragraph 20 of IAS 32 was necessary to prevent structuring to achieve a desired classification outcome. It is a necessary anti-abuse provision.
- Laws and regulations – there were mixed views among the Panel members.
  - Some agreed with the IASB’s preferred approach to exclude consideration of laws and regulations in determining classifications other than in the narrow circumstances of co-operatives as dealt with in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*.
  - Others believed that it is necessary to consider relevant laws and regulations and that, in effect this happens as contracts arise under law and the law can impose features of a contract from which the parties are not at liberty to deviate. It was questioned why financial instrument contracts are different from other contracts dealt with in IFRS 15 *Revenue from Contracts with Customers* and IFRS 17 *Insurance Contracts* where consideration of laws and regulations is mandated. Whilst IFRS 9 prohibits consideration of laws and regulations in the assessment of cash flows in the SPPI test this is a measurement issue and not scoping. The prohibition is viewed as a fix so that holders could accept the outcome and not be tripped up by non-viablity clauses.