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By email: [commentletters@hkicpa.org.hk](mailto:commentletters@hkicpa.org.hk) and by post

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Dear Christina

**The Hong Kong Association of Banks's comments on HKICPA "Invitation to comment on IASB Discussion Paper DP/2018/1 Financial Instruments with Characteristics of Equity"**

Thank you for your letter dated 4 July 2018 inviting our comments on the captioned IASB discussion paper. Our comments on the specific questions raised in the discussion paper are set out below for your consideration.

***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?***

We generally agree and acknowledge the challenges and their causes. However, we believe that these challenges could be addressed by some amendments and clarifications to IAS 32, such as additional disclosures of terms of instruments where not already provided and additional guidance to deal with contingent settlement options and to explain the order in which to do the analysis of components.

There are also concerns regarding the preferred approach as explained in our responses to questions below.

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Vice Chairman Standard Chartered Bank (Hong Kong) Limited  
Bank of China (Hong Kong) Limited  
Secretary Steve Choi

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***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?***

We generally agree that information about other features of claims should be provided through presentation and disclosure to differentiate different types of liabilities and equities to the extent to facilitate the financial statement users to understand the economic substances of different liabilities and equities.

***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?***

We welcome the Board's efforts to improve IAS 32's requirements on classification of financial instruments as a way to address the lack of clarity in the existing guidance and the absence of guidance on some areas that leads to divergence in practice.

However, there are certain areas that the approach has created some concerns:

- Although majority of the classification under IAS 32 would remain the same by applying the Board's preferred approach, the preferred approach leads to changes in classification for some instruments. For example, irredeemable fixed-rate cumulative preference shares are currently classified as equity under IAS 32 but would be classified as financial liabilities under the Board's preferred approach because the entity has an obligation for an amount independent of the entity's available economic resources, even the entity is only required to transfer economic resources at liquidation. It is unclear as to why this is a better accounting outcome. Also, it seems somewhat inconsistent with the going concern basis on which financial statements are prepared. In addition, this will have a knock-on impact to the holders of additional tier 1 (AT1) instruments. AT1 instruments are currently classified as equity but may be classified as liability under the Board's preferred approach in the discussion paper. The holders of AT1 instruments are therefore required to revisit the

classification and measurement of AT1 instruments (e.g. measured under FVTPL under IFRS 9 instead of HKAS 27 as investment in subsidiary).

- The preferred approach introduced new terminologies in the description of the timing and amount feature. We find that the new terminologies are difficult to understand and apply. It would require lengthy guidance on how to interpret those new terminologies and we are concerned that it may not produce a more consistent result than IAS 32.

Additional effort is also required to reconsider past classification decisions. Accordingly, a careful weighing of potential cost and benefit is required.

- Moreover, the timing feature currently focuses on liquidation, but for banks, the issue could be more related to “resolution” instead of “liquidation”. We recommend the Board to take into account the concept of “resolution” in considering the timing feature.

***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?***

We agree that the exception should be retained. However, we consider that the Board should take the opportunity to understand the extent to which the exception is used in practice, the application challenges arising from it and whether potential improvements can be identified. The principle that is articulated in paragraph 2.49 does not appear to fully address the principles that the Board would like to be in place, since an exception for puttable instruments is still desired by the Board. It would be helpful to understand if any other proposals were considered that would have addressed all the key concerns in paragraph 3.31 without the need for exception to the key principle, and why those proposals are not the preferred approach.

***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?***

As stated in paragraph 4.42(a) of the discussion paper, a net-share settled derivatives to deliver a fixed number of own shares in exchange for receiving a variable number of own shares with a total value equal to a fixed amount of the entities functional currency would be classified as equity while the reverse, i.e. to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares would be financial assets or liabilities. It seems there would be an inconsistent outcome by applying the concept in the discussion paper as the net result of both instruments is that the entity either receives or delivers shares depending on the movement of the share price.

Moreover, we have concern on the removal of foreign currency rights issues exception in IAS 32 (paragraph 4.42(b) of discussion paper) because it looks counterintuitive for entities that issue equity instruments in foreign currency to access particular markets where there is demand for the instruments to have to classify derivatives on these as financial assets or liabilities rather than equity if the same instruments would be equity in the functional currency. To illustrate, a derivative that requires an entity to deliver 100 ordinary shares of the entity for receiving CU100 in cash in the entity's functional currency would be equity but in a foreign currency would be financial asset or liability as FX is independent of the available economic resources of the entity.

We also suggest the Board to further analyse the option of accounting for all derivatives on own equity as derivative assets or liabilities under the scope of IFRS 9 to facilitate the accounting for derivatives in general.

Furthermore, additional guidance is required to address new uncertainties arising from new terminologies (e.g. the identification of different types of derivatives such as asset/equity and liability/equity exchanges).

***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?***

We acknowledge that the Board's preferred approach to redemption obligation arrangements will ensure that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured, and it also provides financial statement users better visibility of the obligation that exists. However, we are not convinced that written put options on own shares are similar to convertible bonds and thus should be treated similarly. In case of a written put option on own shares, the entity has issued shares and might be required to repurchase them. In addition, the holder of the put option may be different from the party holding the entity's shares. However, in case of a convertible bond, the entity might be required to issue shares in the future to settle the claim and the holder of the convertible bond would be the same party who receives the entity's shares should the bonds be converted.

The discussion paper proposes new guidance on accounting within equity for written put options on own shares. It introduces a new concept of derecognising equity which may potentially cause confusion since legally the shares are still outstanding and the entity still has to pay dividends on them if dividends are declared. Though the discussion paper notes that the derecognition does not mean that the equity instrument have been extinguished, but it merely reflects the change in the characteristics of the equity instruments because of the written put option, it is not clear what, if any, implications of such a new type of derecognition would have. In addition, a gross-up liability is recognised when there is still optionality on the obligation though this is the same treatment under IAS 32.23.

We are concerned that the notion of what is an amount independent of the entity's available economic resources will involve judgment and could create confusion. In particular, the discussion paper states that share price is dependent on an entity's economic resources, this is not intuitive to the reader, thus further explanation and guidance would be required. Likewise, it is not clear that only qualitative assessment should apply to make the assessment, nor how dependent the variable needs to be on the available economic resources. The analysis of the separate legs of the derivative for assessment of the net amount is also confusing as the principle is only if the net amount is affected by a variable that is independent of the entity's available economic resources.

Additional disclosures on the potential outcome of different types of derivatives on own equity may be an effective way to provide information to the investors.

As mentioned in our response to Question 5, we suggest the Board should further analyse the option of accounting for all derivatives on own equity as derivative assets or liabilities under the scope of IFRS 9 to facilitate the accounting for derivatives in general.

***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?*

For the disclosure requirements under paragraph 6.53, our view is that presenting separately the carrying amounts of partly independent derivatives that meet the criteria in paragraph 6.34 of discussion paper and financial liabilities based on if there is an obligation for an amount independent of the entity's available economic resources will introduce significant operational complexity.

We also suggest the Board to consider to include the options of presenting the carrying amounts either on the statement of financial position or in the notes of the financial statements, depending on the size, nature and function of the amounts of financial instruments. Moreover, additional guidance on application and subsequent accounting is required for consistent application and fair value calculation.

Also, application should be limited to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, are solely dependent on the entity's available economic resources.

***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?*

We in general agree that the attribution approach has some benefits, such as providing information about distribution of returns among the different types of classes of equity. However, concerns do arise on whether the benefits of the information provided by the attribution approaches would exceed the implementation costs.

For example, approach (a) to (c) require the fair value of equity derivatives which could be difficult if those fair values are not observable and incurs additional cost of preparing the financial information.

Improvements to existing presentation requirements without the attribution mechanism (i.e. more disaggregation of equity components on the face of the financial statements to help users to, for example, distinguish existing shareholders from potential shareholders) and providing information about dilution through improvements to IAS 33 and disclosures is preferred from cost and benefit perspective and provides useful information to financial statement users.

***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?*

We agree that disclosures are a key part of the project and welcome the IASB’s discussions.

However, further guidance is required on how to apply those disclosure principles so as to enhance comparability of financial statements.

***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 in general agree with the proposal of discussion paper to clarify that 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 equity instrument. As different issuers may have different considerations and hence would impair comparability of financial statements.

We also consider that retaining and improving the indirect obligations requirements in paragraph 20(b) of IAS 32 may clarify some of the issues related to economic compulsion (to consider for example whether an entity is legally prohibited from exercising one of the settlement alternatives). Accordingly, these requirements should be retained and more guidance can be developed on this basis.

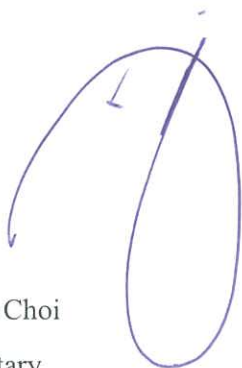
***Question 11: The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?***

We generally support retaining the broad approach in paragraph 15 of IAS 32, which focus on the substance of the contractual arrangement in a financial instrument.

However, additional guidance is still required to address challenges that arise in practice from the interaction between the contractual rights and obligations and laws and regulations.

Should you have any questions, please contact our Manager Ms Emily Ngan at 2526 6080 or our Officer Ms Hebe Hung at 2567 1780.

Yours sincerely



Steve Choi

Secretary