Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Mr Hans Hoogervorst
International Accounting Standards Board
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Canary Wharf
London E14 4HD
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Dear Hans,

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

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing and ethics for professional accountants, in Hong Kong. We are grateful for the opportunity to provide you with our views on this Discussion Paper (DP).

The HKICPA supports the IASB's initiative and efforts to address various challenges that have arisen from the application of IAS 32 *Financial Instruments: Presentation* to financial instruments with characteristics of equity.

However, the HKICPA does not support the IASB's preferred classification approach as set out in the DP.

The HKICPA considers the DP has not justified why the benefits outweigh the costs of adopting the classification proposals when the outcomes are predominantly similar to those under IAS 32 but use new terminology and wordings that are difficult to understand and apply. Many of our stakeholders have voiced concerns that the proposals would cause disruption and give rise to more interpretation problems because of new terminology and the drafting of some areas of the DP such as 'amount independent/partly independent of an entity's available economic resource'. Therefore, the HKICPA considers that the IASB's preferred approach is unlikely to be the solution to the challenges posed by financial instruments with debt and equity characteristics.

Some areas of the DP lack conceptually sound and clearly explained principles, for example, the focus on 'liquidation' in the timing feature, the retention of the puttable exception and the use of other comprehensive income to present income and expenses of financial liabilities. The HKICPA considers the 2018 *Conceptual Framework for Financial Reporting* (2018 CF) would be a logical starting place in developing principles to distinguish financial liabilities from equity. For example, guidance in the 2018 CF provides the conceptual rationale for the classification of instruments settled in an entity's own shares, whether of a fixed or a variable amount. The 2018 CF also provides the principles about the use of other comprehensive income to present income and expenses. If using the concepts in the 2018 CF as a starting point proves unsuccessful, there should be a clear explanation of the reasons why those concepts have not been applied.

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10 years ago in its response to the IASB's 2008 Discussion Paper on *Financial Instruments with Characteristics of Equity*, the HKICPA said it was not persuaded that the shortcomings in IAS 32 warranted the development of a substantially new conceptual approach to equity and liabilities at that time. With the passage of time, the continuous development of new innovative instruments and the 2018 CF, the HKICPA considers that the time has come for the IASB to carry out a fundamental review of the underlying concepts and what constitutes an entity's equity.

The HKICPA understands that a fundamental review of concepts is unlikely to be concluded quickly and thus the HKICPA recommends that the IASB urgently addresses users' needs for improved information on financial liabilities and equity instruments by first developing some of the DP's proposals on presentation and disclosure. Priority should be given to improving transparency by developing disclosures about terms and conditions of instruments and introducing separate line item presentation in the statement of financial position of relevant sub-classes of financial liabilities and equity instruments that are not straightforward in their classification. The HKICPA considers that disclosures dealing with the priority of claims and potential dilution of shares would also provide useful information to users if entities also disclose the basis and assumptions used in preparing the disclosures.

The HKICPA does not support developing the proposals on attributing total comprehensive income to equity instruments. The HKICPA agrees with the sentiments in paragraph 6.95 of the DP that all the attribution approaches are complex and costly. Our investors and analysts also doubt the quality and usefulness of information that could be derived from the proposed fair value based attribution approaches. Therefore, instead of developing the proposals on attribution, disclosures about financial instruments should be improved to help users of financial statements to assess the distribution of returns among equity instruments and how such distribution may change in the future.

Our detailed responses to the questions raised in the DP are in the Appendix.

If you have any questions regarding the matters raised in this letter, please contact me or Eky Liu (eky@hkicpa.org.hk), Associate Director of the Standard Setting Department.

Sincerely,

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Christina Ng
Director, Standard Setting Department

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<u>Work undertaken by HKICPA in forming its views</u>

The HKICPA:

(a) issued an Invitation to Comment on the DP on 3 July 2018 to our members and other stakeholders;

(b) held an education session with financial institution preparers on 24 October 2018;

(c) met with preparers on 30 October 2018, comprising representatives of listed companies in Hong Kong;

(d) held a roundtable discussion for investors and analysts on 1 November 2018, comprising representatives from asset managers, and private equity investment and securities firms;

(e) sought input from its Financial Instruments Advisory Panel and Small and Medium Practitioners Technical Issues Working Group comprising technical and industry experts and auditors from large as well as small and medium accounting firms (collectively, Practitioners); and

(f) developed its views through its Financial Reporting Standards Committee, having reflected on its stakeholder feedback. The Committee comprises academics, preparer representatives from various industry sectors, regulators, and technical and industry experts from small, medium and large accounting firms.

This submission outlines the HKICPA's views as well as most of our stakeholders' comments on the DP. You may access our stakeholder responses to the DP here: https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Our-views/pcd/financial-reporting-submissions/2019

<u>Detailed comments on the DP</u>

Question 1 – Objective, scope and challenges

Stakeholders' views

Challenges of applying IAS 32

Our stakeholders generally agree with the challenges and their causes as described in the DP.

Practitioners from large accounting firms consider that there are other challenges not explicitly addressed by the DP, which include:

(a) inconsistencies between the definition of a financial liability in IAS 32 and the definition of a liability in the 2018 CF and IFRS 2 *Shared-based Payment*. In the 2018 CF, IFRS 2 and IAS 32, an entity classifies a claim as a liability when it has an obligation to transfer cash or other assets. But under IAS 32, an obligation to deliver a variable number of its own shares would also be classified as a liability.

(b) the definition of 'the entity' and when an entity's shareholders are considered to be acting as 'the entity' through its governing body. This is important when deciding what is or not in the control of the entity (for example, if payments are at the ultimate discretion of the entity’s shareholders, does this mean the entity has an unconditional right to avoid payment?).

(c) measurement under IFRS 9 *Financial Instruments* 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.

(d) currently there is no guidance under existing standards about reclassifications between financial liabilities and equity and vice versa, and thus there is diversity in practice.

Financial institution preparers consider that there are application challenges in accounting for instruments with contingent settlement options under paragraph 25 of IAS 32, for example how to assess whether an event is beyond the control of the entity and/or the holder of the instrument and how to measure the liability component of such instruments.

Investors and analysts consider that there is generally a lack of sufficient information/disclosures about the claims in the financial statements. With only limited disclosures, they cannot get a full picture about the claims, and hence understand the economic consequences of the claims on the issuers' financial position and performance.

Standard-setting activity
Financial institution preparers believe that the challenges could be addressed by some amendments and clarifications to IAS 32, such as requiring additional disclosure of terms and conditions of instruments where these are not already provided and including additional guidance to deal with contingent settlement options under paragraph 25 of IAS 32.

Practitioners say that they are already familiar with the principles in IAS 32 and the application issues arise from a lack of guidance in certain areas. They consider that the IASB should develop guidance to address the application challenges under IAS 32.

HKICPA analysis and recommendation
Objective and scope
The HKICPA notes the objective of the FICE project is 'to articulate the principles for the classification of financial liabilities and equity instruments with a clear rationale, but without fundamentally changing the existing classification outcomes of IAS 32'. The HKICPA interprets this to mean that the IASB’s preferred classification principles have been reverse engineered to fit, or almost fit, the existing outcomes. This is an unusual approach because the principles should drive the outcomes, rather than the other way around. The HKICPA disagrees with the objective as stated although the HKICPA agrees that a clear rationale is required to support any classification requirements.

Challenges of applying IAS 32
The HKICPA agrees with the description of the practical challenges and their causes but also notes that there are several others that are not explicitly addressed as indicated by our practitioners.

Standard-setting activity

The HKICPA considers that the challenges identified in the DP and those highlighted by our stakeholders that we have set out above are important and warrant attention by the IASB. However, the HKICPA does not support the IASB's preferred classification approach for reasons explained in our responses to Questions 2 and 3. Instead, the HKICPA recommends starting with the definitions of liabilities and equity in the 2018 CF because they provide a conceptual basis for the IASB to develop IFRS Standards. Also, the HKICPA suggests the IASB should concentrate first on additional and improved disclosure of terms and conditions of financial instruments to urgently remedy the current lack of disclosures on equity instruments and improve the presentation of financial liabilities and equity instruments.

Question 2 – The IASB's preferred approach and classification of non-derivative financial instruments

Stakeholders' views

Financial institution preparers expressed the following concerns about the IASB's preferred approach to classification:

(a) The IASB's preferred approach might lead to changes in classification outcome for some financial instruments. For example, the classification of irredeemable fixed-rate cumulative preference shares would change from equity under IAS 32 to financial liabilities under the IASB's preferred approach. Financial institution preparers question why this is a better accounting outcome. They are also concerned that considering events at liquidation is inconsistent with the going concern basis on which financial statements are prepared.

(b) Additional effort would be required for the issuer to reconsider its past classification decisions. Accordingly, a careful weighing of potential cost and benefit should be performed by the IASB.

(c) The change in classification outcome of some financial instruments, for example, additional tier 1 (AT 1) instruments, would have a knock-on impact on the holders of those financial instruments and require them to revisit the classification and measurement of these financial assets. For example, an instrument may need to be measured at fair value through profit or loss under IFRS 9 *Financial Instruments* instead of being treated as an investment in subsidiaries under IAS 27 *Separate Financial Statements.*

(d) The IASB's preferred approach introduces new terminologies in the descriptions of the timing and amount features which are difficult to understand and apply, in particular, the notion of 'an amount independent of the entity's available economic resources'. For example, it is unclear how an amount could be considered as independent based on only a qualitative assessment. It is also confusing that the DP states that the entity's share price is dependent on an entity's economic resources when the entity's share price is also affected by market conditions. Even if the IASB provides lengthy guidance that helps to interpret these new terminologies, this may still not result in consistent application of the IASB's preferred approach.

(e) The timing feature currently focuses on liquidation, but for banks, the issue could be more related to 'resolution' instead of 'liquidation'. Therefore, it is recommended that the IASB takes into account the concept of 'resolution' in considering the timing feature.

Financial institution preparers agree that information about other features of claims should be provided through presentation and disclosure to help financial statement users to understand the economic substance of different claims.

Practitioners from large firms share the same concerns as financial institution preparers on the use of new terminologies and the lack of clarity in the description of the amount feature. They consider that uncertainty as to how the terminology should be interpreted could lead to new application issues and may open up structuring opportunities. One practitioner questions the relevance of classifying a claim as a liability based on an entity's obligation at liquidation. This practitioner considers that discounting the contractual amount of such an obligation from indefinite future to present would lead to an insignificant carrying amount that does not reflect the economics of the obligation and how commercial decisions are made.

Investors and analysts consider that given the rapid financial innovations, it would be difficult to predict what new claims would appear and how they should be classified in the financial statements. Therefore, it would be more important and useful to disclose the terms and conditions of the claims.

HKICPA analysis and recommendation

The HKICPA considers that a better articulation of IAS 32’s underlying principles may have advantages in improving understanding and application of those principles. However, the HKICPA shares the same concerns as its stakeholders about using new terminologies in the IASB's preferred classification approach, which is more likely to cause disruption and create new interpretive and application challenges.

Concerns with new terminologies

Particular examples of the articulation and new terminologies that are causing concerns and difficulties include:

(a) the focus on ‘liquidation’ in the timing feature when entities prepare their financial statements on a going concern basis. In reality, entities do not necessarily go straight into liquidation but may well pass through other forms of insolvency such as administration, receivership or, in the case of regulated financial institutions, ‘resolution’. In particular, the concept of resolution should be taken into account when considering financial institutions’ AT1 instruments. The holders of such instruments also participate in the losses that would arise if the financial institution is liquidated.

(b) the notions in the amount feature of ‘an amount independent of the entity’s available resources’ and ‘an amount that could exceed the entity’s available economic resources’. The DP uses the former term when defining a financial liability and for separate presentation requirements of financial liabilities. The HKICPA and its stakeholders are confused about the meaning of 'independent' used in the DP. In some cases, the DP uses the term to mean 'totally independent' of an entity’s available economic resources and therefore the instrument should be classified as a financial liability. In other cases, the term is used where there is only partial independence (for example, foreign currency written call options) but still leads to a financial liability classification. A logical interpretation of something being 'partly independent' is that it is not 'totally independent' and thus the instrument 'cannot be independent of the entity' available economic resources' (i.e. it is dependent on those resources) and its classification is equity. This confusion is particularly apparent when dealing with derivatives whose net amount partly depends on the entity's available economic resources.

Alignment with the principles in 2018 CF
The HKICPA considers that the amount feature should focus on obligations arising during the life of the entity (not at liquidation). The HKICPA thinks that a requirement to transfer economic resources / settlement only at liquidation should not result in liability classification, regardless of whether the amount is or is not independent of the entity's available economic resources. This is consistent with the going concern principle in the 2018 CF. The HKICPA considers that information about relative rankings of liabilities and equity instruments at liquidation is best conveyed through presentation and/or disclosure.

If the suggestion above is accepted and claims only at liquidation (for example, irredeemable cumulative preference shares) are not recognised as financial liabilities then for non-derivatives, the DP's proposals (updated for this suggestion) would be equivalent to the current IAS 32 requirement (obligation to pay cash or another financial asset). Generally, this requirement is sound and well understood under IAS 32. Accordingly, introducing new terminology would not be necessary.

IAS 32 has a second feature resulting in a financial liability classification (an obligation to deliver a variable number of equity instruments). However, this feature is contrary to the definition of a liability in the 2018 CF because an obligation to transfer a variable amount of equity is not a transfer of economic resources[1] and therefore, such an obligation, whether of a fixed amount or a variable amount, cannot be a liability. Aligning the definitions of liabilities and equity in IAS 32 with those in the 2018 CF would eliminate the current anomaly and all transfers of equity, whether of fixed or variable amount, would be equity.

Question 4 – Puttable exception

Stakeholders' views
Financial institution preparers generally agree that the exception should be retained for the same reasons set out in paragraph 3.37 of the DP. However, they think that it would be helpful to understand if any other proposals were considered that would have addressed all of the key concerns set out in paragraph 3.31 of the DP without the need for an exception, and, if so, why those proposals are not the IASB's preferred approach.

1 Equity instruments issued by an entity are not economic resources of the entity (paragraph 4.10 of the 2018 CF)

Practitioners from large firms mostly disagreed with the proposal to retain the exception largely because of the application issues encountered when applying the criteria in paragraphs 16A to 16D of IAS 32. For example, some funds have ‘Founders Shares’ or 'Management Shares', which legally may be the lowest subordinated claim. However, they are usually of a 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 is considered misleading as they are not considered to be the 'real equity' of the funds.

Practitioners also note that funds’ financial position is not evaluated by users of financial statements based on the equity/liability classification under the puttable exception. Instead the presentation of the statement of financial position provided by Example 7 in the Implementation Guidance to IAS 32 gives sufficient useful information to users of financial statements.

HKICPA analysis and recommendation

The HKICPA, in general, does not like exceptions to principles. The HKICPA would prefer not to retain the puttable exception. The need for an exception is indicative that the principles underlying the IASB’s preferred classification approach may not be fit for purpose.

The HKICPA notes that paragraph 3.37(c) of the DP states that 'the Board is not aware of any issues with the application of the puttable exception as set out in paragraphs 16A-16B and 16C-16D of IAS 32'. However, the HKICPA notes that there have been several requests made to the IFRS Interpretation Committee arising from application of paragraphs 16A to 16F of IAS 32.

The HKICPA suggests that the IASB establishes the extent to which the exception is used in practice, the application challenges arising from it and whether potential improvements to paragraphs 16A to 16D of IAS 32 can be identified before deciding whether to retain the exception.

The HKICPA considers that the disclosure requirements in paragraph 136A of IAS 1 *Presentation of Financial Statements* about puttable instruments provide useful information to users about expected future cash flows from these instruments. These disclosure requirements should be retained irrespective of whether the puttable exception is retained or not.

Question 5 – Classification of derivative financial instruments

Stakeholders' views

Financial institution preparers consider that the analysis of the individual legs of the derivative when assessing whether the individual legs are affected by independent variables is confusing as the proposed classification principle is whether the net amount is affected by a variable that is independent of the entity’s available economic resources. Instead of developing the IASB's proposal, they consider that disclosures on the potential outcome of different types of derivatives on own equity may be an effective way to provide information to investors.

Financial institution preparers also noted that in paragraph 4.42(a) of the DP, net-share settled derivatives to deliver a fixed number of an entity's 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 (as noted in footnote 50 of the DP) would be financial assets or financial liabilities. They think that these proposals would lead to an inconsistent outcome because the net result of both instruments is that the entity either receives or delivers shares depending on the movement of the share price.

Moreover, financial institution preparers have concerns about the removal of the foreign currency rights issue exception because it seems counterintuitive for entities that issue equity instruments in a foreign currency to have to classify derivatives on those equity instruments as financial assets or liabilities rather than equity if the same instruments would be equity in the functional currency.

Financial institution preparers suggest that the IASB should further analyse the possibility of accounting for all derivatives on own shares as derivative financial assets and financial liabilities within the scope of IFRS 9 to facilitate the accounting for derivatives.

A large firm practitioner commented that the DP does not address the fundamental question of why executory contracts to exchange equity in the future (i.e. derivatives over own equity) should be classified as equity prior to them being settled. The practitioner also notes that in practice most IAS 32 interpretive problems that relate to classifying derivatives on own equity are about the fixed-for-fixed condition. It would be preferable to retain the current IAS 32 position but provide a better explanation of 'fixed amount of cash' and 'fixed number of own shares' and circumstances in which variability of cash or number of shares is acceptable. For example, would a simple written call/warrant over the entity's own shares that is exercisable through an exchange of a fixed amount of cash in the entity's functional currency for a fixed number of shares that is adjusted only for anti-dilutive type events, for example, bonus issues of shares, share splits, etc result in equity classification? The practitioner thinks that retention of IAS 32 with improved application guidance is preferable to the proposal in the DP. If the model was finalised as proposed in the DP, the economic resources test will introduce a different set of interpretative questions (for example, what are available economic resources, what does dependent/independent mean, how to value economic resources in a private company etc). In effect the DP will replace one set of interpretative questions for another and so it would not be an improvement.

Some practitioners think that all derivatives over own shares should be treated as financial assets or liabilities at fair value through profit or loss, like other derivatives. They support this treatment both on practical grounds of eliminating interpretational complexity of which derivatives over own shares should be treated as equity instruments, and on conceptual grounds that the counterparty to these arrangements is a future equity owner and to classify the instruments as equity before they become equity owners is inappropriate. They consider that the gains and losses on remeasurement should be disclosed in a separate line item in the income statement.

These practitioners consider this approach would also overcome the need for a 'fixed-for-fixed' or 'independent of available economic resources' test.

HKICPA analysis and recommendation

The HKICPA considers that the proposed classification principles for derivatives over own equity are not an improvement to the current principles in IAS 32. The DP appears to be replacing one set of interpretational difficulties with another based on different principles.

Foreign currency rights issue exception

The HKICPA has concerns with the discussion in the DP about foreign currency and the foreign currency rights issue exception. The DP promotes the view that foreign currency is a variable that is always independent of an entity's available economic resources and, consequently, under the IASB's preferred approach a foreign currency instrument would be classified as a financial liability. The HKICPA questions whether foreign currency should always be treated as an independent variable. Many issuers operate in multiple jurisdictions and are required, by law or regulation, to raise funds in a currency other than their functional currency. Consequently, treating foreign currency as an independent variable has a harsh effect on those issuers. The HKICPA considers that there should be consideration of the economic and commercial reasons for entities raising funds in a foreign currency when determining whether it is a variable dependent on, or independent of, the entity's available economic resources.

Some practitioners have noted that foreign currency risk is not a feature of an instrument's contractual terms but of the circumstances in which the entity operates. Accordingly, if an entity issues a fixed number of own equity instruments the foreign currency risk should not matter. This would seem to be supported by the definition of a liability in the 2018 CF under which an obligation to transfer an entity's own equity cannot be a liability. Consequently, a foreign currency rights issue exception would not be required to achieve equity classification and the conversion feature in a foreign currency convertible bond would similarly achieve equity classification; hence removing the noted anomaly. The HKICPA sees merit in this approach and recommends that the IASB should explore this further.

The HKICPA normally does not support exceptions to principles. However, in this case the foreign currency rights issue exception is required until the IASB addresses the issues that gave rise to the creation of the exception in 2009. For example, the HKICPA considers that the removal of the exception contradicts:

(a) the IASB's previous conclusion that such transactions are transactions with owners in their capacity as owners that should be recognised in the statement of changes in equity in accordance with IAS 1 *Presentation of Financial Statements* (paragraph BC4H of IAS 32); and

(b) another IASB conclusion that classifying rights as derivative liabilities was not consistent with the substance of the transaction (paragraph BC4F of IAS 32).

Question 6 – Compound instruments and redemption obligation arrangements

Stakeholders' views

Financial institution preparers acknowledge that the IASB's preferred approach to compound instruments and 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 with better visibility of the obligation.

However, financial institution preparers are not convinced that written put options on own shares are similar to convertible bonds and thus should be treated similarly. In the case of a written put option on own shares, the entity has already issued shares, but 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 the 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.

A large firm practitioner also highlighted an important difference between a convertible debt and a written put option over own shares. In the case of a convertible debt, there is a liability for the funds borrowed at the issuance of the convertible debt. In contrast, a written put option may or may not be exercised in the future and only if exercised will result in an exchange of cash for a fixed number of shares. The issuer will only have the obligation to pay (i.e. a liability) at that time.

Financial institution preparers commented on the new guidance on accounting within equity for written put options on own shares. They note that 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. The DP notes that derecognition on issuance of a written put option does not mean that the equity instruments have been extinguished, but that it merely reflects the change in the characteristics of the equity instruments because of the presence of a written put option. However, it is not clear what, if any, implications this new type of derecognition would have.

Amongst large firm practitioners there are split views on whether measuring written put options over own shares (including over non-controlling interests (NCI)) on a gross basis should be retained. Those who do not agree with gross accounting do so on the basis that all derivatives over own shares should be accounted for as executory contracts and measured on a net basis.

HKICPA analysis and recommendation

Redemption obligation arrangements

The HKICPA agrees with the IASB's aim to achieve consistency between the classification of all arrangements that have the same settlement outcomes regardless of how an entity has structured the rights and obligations under those arrangements. However, the HKICPA agrees with its stakeholders about the differences in the settlement outcomes between written put options on own shares and convertible bonds, and therefore that they should not be accounted for in the same way. Consequently, the HKICPA disagrees with the examples in paragraphs 5.33 to 5.35 of the DP. The HKICPA recommends that the IASB reconsiders its approach for these instruments.

The HKICPA generally supports the IASB's proposals for redemption obligations by focusing on whether an entity has an unavoidable right to avoid a settlement outcome (as set out in paragraph 5.48 of the DP). However, the HKICPA doubts that the concepts from paragraph 5.48 could be easily embedded in IAS 32 because it is not intuitive that a standalone derivative to extinguish an equity instrument should be analysed for classification purposes in the same way as a compound instrument.

The HKICPA is supportive of the IASB's efforts to address the question of accounting for written put options over own shares, including over non-controlling interests (NCI) in an entity's consolidated financial statements, which has proved problematical under paragraph 23 of IAS 32. However, the HKICPA has concerns over the proposed accounting within equity. In particular the HKICPA:

(a) has concerns about the complexity of the debit entries in equity and the new concept that derecognition of equity is not an extinguishment of the shares;
(b) disagrees with the proposed use of other comprehensive income (OCI) for gains and losses on the redemption liability for fair value puts for the reasons discussed in question 7; and
(c) is disappointed by the lack of discussion of certain conceptual and application issues that were raised in the past related to written puts over NCI, including:
    (i) why changes to the redemption amount (especially for written puts at fair value) should be recognised in profit or loss under IFRS 9 rather than in the statement of changes in equity under IFRS 10 *Consolidated Financial Statements* and IAS 1 as transactions between equity holders.
    (ii) the treatment of profit allocation and dividends paid to NCI under IFRS 10 when the NCI have been derecognised.
    (iii) the implication on the calculation of basic earnings per share and diluted earnings per share under IAS 33 *Earnings per Share* when the NCI have been derecognised.
    (iv) whether the accounting should differ based on whether the written put forms part of a business combination or whether it was entered into separately.

The HKICPA recommends that the IASB reconsiders its proposals for accounting for written puts over own shares and NCI to simplify the accounting and resolve the various conflicts with other standards as indicated above.

Financial instruments with alternative settlement outcomes
The HKICPA considers that for instruments with alternative settlement outcomes that are contingent on an uncertain future event beyond the control of the entity, a distinction should be made between events that are in the control of the holder and those that are beyond the control of both the entity and the holder (for example, a change in control of the entity). If the settlement outcomes are within the control of the holder, the HKICPA supports the approach in paragraphs 5.10 and 5.21 of the DP. However, when the outcomes are contingent on an uncertain future event beyond the

control of both the entity and holder, the HKICPA and some of its stakeholders think the conditionality should be factored into the initial measurement of the non-derivative liability rather than, as suggested in the DP, included in the derivative representing the remaining rights and obligations. The DP's approach would mean that the liability would be measured at the full amount that the entity could be required to pay immediately. The HKICPA has sympathy with those stakeholders who support factoring the conditionality into the measurement of the non-derivative liability and think that this approach is conceptually stronger because it reflects the characteristics of the liability and how future cash flows of the entity could be affected. It also fits better with the measurement requirements in IFRS 9.

The HKICPA recommends that the IASB reconsiders its proposals for instruments with alternative settlement outcomes that are contingent on uncertain future events that are beyond the control of both the entity and the holder. It is essential that the measurement aspect of the conditionality is properly resolved, and conceptually sound guidance is produced. This is particularly important as concerns remain unresolved around the measurement of the liability component in certain 'non-viability' contingent convertible securities that are mandatorily convertible into a variable number of shares contingent upon a 'non-viability' event that is considered to be remote. The IFRS Interpretation Committee discussed a submission detailing these concerns in January 2014 but determined that the scope of the issues were too broad for it to address in an efficient manner.

Question 7 – Presentation of financial liabilities

Stakeholders' views

Financial institution preparers consider that the IASB's proposals of separate presentation of financial liabilities identified in paragraph 6.53 of the DP would introduce significant operational complexity because financial institutions do not generally track derivatives based on whether their net amounts are affected by dependent or independent variables. The IASB's proposals may lead to system changes or involve significant manual efforts. They consider that such separate presentation should be limited to embedded derivatives that are separated from the host and the amount of hybrid instruments that, as a whole, is not affected by a variable independent of an entity's available economic resources. They also suggested that the IASB considers providing an option for entities to separately present the carrying amounts of the financial liabilities, either in the statement of financial position or in the notes to the financial statements, depending on their size, nature and amounts.

Some investors agreed with the IASB's proposals to require presentation of income and expenses arising from financial liabilities with equity-like returns in OCI without subsequent recycling. They think that such income and expenses are not related to the core operation of the issuers and therefore, should not affect profit or loss. In addition, they agree that income and expenses recognised in OCI should not be subsequently recycled to profit or loss so as to avoid potential manipulation of earnings.

Practitioners do not support the expanded use of OCI. They think that an exception to present income and expenses arising from financial liabilities in profit or loss implies that the underlying principles of classification may not be appropriate. They also question whether presentation in OCI is consistent with the principles about the use of OCI in paragraphs 7.17 and 7.19 of the 2018 CF.

HKICPA analysis and recommendation
The HKICPA supports the IASB's preliminary view that there should be separate presentation in the statement of financial position of subclasses of financial liabilities that are not straightforward in their classification. Separate presentation provides useful information and could alleviate some of the concerns with the liability classification of more complex instruments. The subclasses warranting separate presentation should be those where disclosure of their terms and conditions is needed to assist users' understanding of their classification. The HKICPA would expect that these subclasses would potentially be the same as those identified in paragraph 6.53(a)(i) to (iii) of the DP but that they should be described using more familiar terminology than that taken from the IASB's preferred classification principles in the DP.

However, the HKICPA does not agree with presenting income and expenses of financial liabilities identified in paragraph 6.53(b) of the DP in OCI, including financial instruments that currently meet the foreign currency rights issue exception. The HKICPA considers that the proposals inappropriately expand the use of OCI without a strong logic. Presentation in OCI is not an appropriate solution to the issues identified in paragraph 6.12 of the DP, which essentially are about the effect of 'non-operating' items on financial performance. The HKICPA believes that if financial instruments have been properly classified as financial liabilities then gains and losses arising on such liabilities should not be in OCI. The HKICPA considers that to report these gains and losses in OCI would be the start of a slippery slope to including any 'non-operating' items in OCI—a position that the HKICPA does not support. The HKICPA considers that the gains and losses should instead be presented as a separate line item in the statement of comprehensive income in arriving at profit or loss. The HKICPA believes such presentation would be useful to users of financial statements in making their assessment of the impact of these instruments on an entity's financial performance.

Question 8 – Presentation of equity instruments

Stakeholders' views
Financial institution preparers generally agree that the attribution approaches have some benefits in providing information about distribution of returns among the different types of classes of equity. However, they have concerns about whether the benefits of the information provided by the attribution approaches would exceed the implementation costs. For example, attribution approaches (a) to (c) for derivative equity instruments require the fair values of equity derivatives to be determined, which could be difficult if those fair values are not observable and additional cost of preparing the information would be needed.

Some investors and analysts expressed concern about the reliability of the fair values of derivative equity instruments because measuring the fair value of such instruments involves the use of management assumptions and valuation models. They doubted the usefulness of information provided by attributing total comprehensive income based on those fair values. They generally preferred approach (d), i.e. a disclosure only approach.

Practitioners are of the view that the proposed attribution approaches would be complex, costly and not well understood by preparers, particularly, those in unlisted entities, and thus the quality and usefulness of the information would be questionable. One practitioner considers that the proposed attribution approaches are fundamentally flawed because equity instruments, by nature, have no claim on the entity's reserves until the entity declares dividends or is liquidated. It is also inconsistent with the going concern principle in the 2018 CF.

HKICPA analysis and recommendation

Separate presentation of equity instruments

The HKICPA agrees that better information about the different features of equity instruments (as set out in paragraph 6.56(a) to (c) of the DP) would be useful to users of financial statements. Of the choices provided in paragraph 6.58 of the DP, the HKICPA considers that improving disclosure requirements about equity instruments is the preferable approach.

Attribution of income and expenses to some equity instruments other than ordinary shares

The HKICPA has concerns that the various attribution methods detailed in the DP that could be used for different subclasses of equity in an enhanced presentation approach would introduce significant complexity, create confusion for users in understanding the information and, not least, increase costs for preparers.

Paragraph 6.63 of the DP contends that the attribution of comprehensive income to equity instruments other than ordinary shares would be similar to the presentation of NCI, i.e. the carrying amount is updated for the amount of total comprehensive income attributed to it and such changes in carrying amounts are presented in the statement of changes in equity. However, the presentation of NCI is not intended to reflect the relative interests of NCI. The HKICPA considers that the objective of showing 'a complete picture of how equity instruments affect each other's returns' is conceptually and economically different from existing guidance on attribution in relation to the presentation of NCI.

Under existing attribution guidance, the presentation of NCI simply reflects changes in the part of a group's net assets owned by the NCI or changes in the proportion of such net assets held by the NCI. It is not a separate measurement method for the equity instruments encapsulated in NCI. The allocation of comprehensive income to NCI and the owners of the parent is a consequence of the requirements of IAS 1 and the consolidation method set out in IFRS 10. It is notable that IFRS 10 only permits the use of existing ownership interests and excludes the possible exercise or conversion of potential voting rights and other derivatives.

Attribution approach for non-derivative equity instruments based on the existing requirements of IAS 33

While the HKICPA does not support using an attribution method, the HKICPA considers that an attribution method based on the existing requirements of IAS 33 could be applied in practice. However, the population of entities that would be required to apply this attribution method is broader than the population within the scope of IAS 33. Accordingly, there will be a lack of familiarity with the concepts of IAS 33 and thus risks misapplication of the attribution method.

Attribution approach for derivative equity instruments

As noted above, the HKICPA prefers a disclosure approach rather than a presentation approach involving attribution methods.

The HKICPA does not consider that any of the three attribution approaches discussed in paragraphs 6.74 to 6.86 of the DP provide a satisfactory answer from a cost-benefit perspective. A full fair value approach would appear to provide an understandable ‘measurement’ basis for the fair value of equity instruments other than ordinary shares (and NCI) and would align with the ‘measurement’ basis for the fair value of derivatives on own equity that are classified as financial liabilities or financial assets. However, the HKICPA considers that fair valuing all equity derivatives just for purposes of attributing net income is burdensome and costly especially for hard to value derivatives. The HKICPA also questions the relevance of allocating net income to equity derivatives using fair value information.

The HKICPA considers that the other two attribution methods (b) and (c) would also be complex and costly to apply as they require an entity to calculate the relative fair values of its own equity instruments.

Disclosure only

The HKICPA sees the advantage of providing information about the effect of derivative equity instruments on ordinary shares through diluted earnings per share and other disclosures. However, the HKICPA is unconvinced about extending the existing disclosures in IFRS 7 *Financial Instruments: Disclosures* about fair values to equity instruments other than ordinary shares. The HKICPA shares the same concerns as its stakeholders over the cost, difficulties and usefulness of fair valuing derivative equity instruments. The HKICPA understands that many users would prefer to do their own calculations rather than to have the values calculated by management with little detail on the assumptions and inputs used. A disclosure requirement to provide information about the terms and conditions of the instruments would be more effective in providing useful information to users.

Improving information provided to users of financial statements

The HKICPA suggests that the IASB improves information provided to users of financial statements by disaggregating equity using additional line items, subtotals and categories, for example, financial instruments that will or may be settled in the issuer’s own equity instruments (distinguishing between existing vs. potential shareholders) and improving the existing requirements and disclosures of IAS 33 as discussed in our response to Question 9.

Question 9 – Disclosure

Stakeholders' views

Financial institution preparers agree that disclosures are a key part of the project and welcome the IASB's discussions. However, they consider that further guidance on how to apply the proposed disclosure in relation to the terms and conditions of the claims is needed, for example, how banks could leverage on the existing Pillar 3 disclosure requirements under the Basel Committee on Banking Supervision in order to avoid unnecessary duplications or confusions due to overlapping disclosures.

Other stakeholders also generally welcome the proposed disclosures. However, some investors and practitioners have expressed the following views on the list of priority of claims on liquidation:

(a) Issuers, particularly multinational groups, may have to incur significant costs (including legal costs) in preparing the list. It is questionable whether the benefits of the information provided by the list could outweigh its preparation costs.

(b) It is questionable whether the list is useful without including non-financial liabilities and if the issuer does not have a going concern problem.

(c) The increased transparency of the priority of claims could lead to an increase in an issuer's cost of funding as credit investors would demand better returns if the relative ranking of the claim in the list is low.

Investors and analysts would like disclosures about the terms and conditions that may affect the priority of claims on liquidation and the use of assumptions when preparing the list. Some investors would also like disclosures about the voting rights of equity instruments.

HKICPA analysis and recommendation

The HKICPA supports improvement of disclosures about equity instruments. The HKICPA agrees that there is a significant gap between the information provided for equity instruments compared to that provided for financial liabilities. The imbalance in disclosures should be addressed by the IASB. However, as indicated above, this should not include fair value disclosure of equity instruments.

Disclosure of priority of financial liabilities and equity instruments on liquidation

The HKICPA supports providing a disclosure that provides a ranking of an entity's claims arising from its financial liabilities and equity instruments. The HKICPA is not convinced that the ranking necessarily should be one based on liquidation (even a hypothetical one). For example, for financial institutions one based on resolution may be more appropriate.

Furthermore, any ranking of priority, other than on a going concern basis, would be a contradiction with financial statements prepared on a going concern basis. This is particularly so if the information is provided on the face of the statement of financial position where it would be difficult, if not impossible, to reconcile with the existing IAS 1 requirement for the statement of financial position to be organised on a current / non-current basis. Similar issues would arise for those financial institutions that organise their statements of financial position based on the liquidity of their assets and liabilities as permitted by the exception in paragraph 60 of IAS 1. Consequently, the HKICPA recommends that any ranking disclosure should be provided in the notes to financial statements. This would be less disruptive than presentation on the statement of financial position.

The HKICPA acknowledges that providing any ranking of claims will involve practical challenges, particularly, defining priority within consolidated financial statements where the group operates in multiple jurisdictions with different contract and insolvency laws. Nevertheless, the HKICPA agrees that information about the priority of an entity's financial liabilities and equity instruments would be useful even if such information is prepared with some limitations. For example, when considering disclosure for an entity's consolidated financial statements it may be appropriate to frame the disclosure around significant subsidiaries or sub-groups in the same jurisdiction rather than one consolidated list which could involve arbitrary judgements of which claims under different laws took precedence.

The HKICPA considers that any ranking disclosure should use the carrying amounts in the statement of financial position and not fair value amounts. This would ensure that a user could easily reconcile the numbers between the disclosure and the statement of financial position.

Potential dilution of ordinary shares
The HKICPA agrees that additional information about the potential dilution of ordinary shares is warranted. The HKICPA agrees with the disclosure objective and the proposed disclosure in paragraphs 7.21 and 7.22 of the DP. The HKICPA agrees that the information discussed in paragraph 7.22 could be integrated with existing disclosures required by IAS 1 about outstanding shares. The HKICPA considers that the example in paragraph 7.23 of the DP is useful.

In addition, the HKICPA suggests that the IASB improves existing requirements of IAS 33 based on the shortcomings that the IASB has identified in paragraphs 7.13 to 7.15 of the DP, aligns the definitions in IAS 33 with the definitions in IAS 32 and IAS 1, and addresses issues that arise in practice (for example, the lack of transparency about the calculation of weighted average number of ordinary shares).

Contractual terms and conditions
The HKICPA agrees that additional information should be provided about the terms and conditions of financial liabilities and equity instruments that affect the amount and timing of cash flows, such as that discussed in paragraph 7.27 of the DP.

However, the HKICPA notes the challenges in preparing such disclosures. The aggregation issue described in paragraph 7.29 of the DP is difficult to solve, as aggregating at an inappropriate level could lead to important information being lost. Therefore, on top of providing a summary of terms and conditions in the notes to the financial statements, the HKICPA recommends that the IASB encourages entities to provide more details about individual instruments' terms and conditions on their websites to which users of financial statement could be referred. For example, any offering documents that contain the terms and conditions for issued instruments could be made available on the entity's website.

Question 10 – Contractual terms

Stakeholders' views

Economic incentives and compulsion that might influence the issuer's decision to exercise its rights

Financial institution preparers agree with the proposal in the DP 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. This is because different issuers may have different considerations and hence any such requirement would impair comparability of financial statements.

For the same reasons, investors and analysts generally agree that economic incentives and the effect of laws and regulations should not be considered. However, they requested disclosures about whether and how economic incentives and laws and regulations could affect the settlement outcomes, for example, disclosures about the likelihood of conversion into shares and the expected cash payment based on the conditions as at the reporting date. They consider that companies should also disclose management assumptions and observable data used in assessing the potential settlement outcomes.

Indirect obligations

Financial institution preparers considered that retaining and improving the indirect obligations requirements in paragraph 20 of IAS 32 would help to clarify some of the issues related to economic compulsion, for example, whether an entity is legally prohibited from exercising one of the settlement alternatives.

HKICPA analysis and recommendation

Economic incentives and compulsion that might influence the issuer's decision to exercise its rights

The HKICPA agrees that the concept of economic compulsion is challenging to apply in practice because of the highly judgmental nature of the assessment.

The HKICPA believes that a concept of constructive obligation (similar to that in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) could be applied to the classification of financial instruments. This concept is also discussed in paragraph 4.31 of the 2018 CF. When an entity is selling its financial instruments, it will, through its statements and actions, create a valid expectation that the holders will be paid; entities would never sell their securities without holders having this expectation. The application of a constructive obligation concept would catch obligations in situations where the entity does not have a realistic economic alternative. For example, in the case of callable step-up preference shares, where the cost of not calling the instrument would be much higher than the cost of capital. In addition, disclosures could be used to provide information where a 'constructive obligation' exists, such as details of the economic incentives for payment that exist at the reporting date, the reasons why payment has or has not been made and the effect this has on the statement of financial position. The HKICPA has not fully tested the 'constructive obligation' concept to financial instruments and whether it would achieve the desired classification outcome. However, the HKICPA recommends that the IASB explores this concept in its deliberations on economic incentives and compulsion.

Indirect obligations
The HKICPA agrees that the requirements in paragraph 20 of IAS 32 should be retained. Retention of the requirements is necessary to prevent structuring to achieve desired classification outcomes. It is a necessary anti-abuse provision.

The HKICPA recommends that the indirect obligations requirements could be improved by incorporating the notion of 'no commercial substance', which is found in paragraph 41 of IFRS 2 *Share-based Payment*, and reflect the IFRS Interpretation Committee's discussions in January 2014 on whether a possible settlement option is substantive. The consideration of the substance in the contractual terms is also discussed in paragraphs 4.60 and 4.61 of the 2018 CF. Incorporating such notion could ensure that when the terms and conditions of a financial instrument provide the entity with the choice between an equity or a liability settlement, the entity is required to consider whether one of the settlement alternatives:

(a) has no economic substance (for example, the equity settlement outcome is structured so that its value would always exceed that of the liability settlement outcome); or
(b) has no commercial substance (for example, the entity is legally prohibited from issuing the shares required for the equity settlement outcome).

Question 11 – Relationship between contracts and law

Stakeholders' views
Our stakeholders generally support retaining the approach in paragraph 15 of IAS 32, which focuses on the substance of the contractual arrangement.

Nevertheless, financial institution preparers consider that guidance is still required to address practical challenges arising from the interaction between the contractual rights and obligations and laws and regulations regarding innovative financial instruments such as contingent convertible bonds designed for banking capital requirements.

HKICPA analysis and recommendation
The HKICPA considers that the interaction between contractual rights and obligations and regulatory and legal requirements is an important issue. Contractual rights and obligations should be considered in the context of the law. They are inseparable from the legal requirements. Contracts arise under law and the law can impose features of a contract from which the parties are not at liberty to deviate but that does not make those features 'non-contractual'.

Currently, IFRS Standards are not consistent when dealing with contractual rights and obligations and regulatory and legal requirements. For example, within the financial instruments suite of standards IFRIC 2 *Members' Shares in Co-operative Entities and*

Similar Instruments takes into account legislative requirements for classification purposes while IFRS 9 and IAS 32 do not. Outside of financial instrument standards, IFRS 15 *Revenue from Contracts with Customers* and IFRS 17 *Insurance Contracts* require consideration of contract law and regulation.

Furthermore, paragraph 4.31 of the 2018 CF states that many obligations are established by contracts, legislation or similar means. The HKICPA understands this to mean that even if contracts would not establish an obligation, the obligation could arise as a result of legislation.

The introduction of new financial products, such as 'bail-in' and other 'non-viability' instruments as discussed in our response to Question 6, for financial institutions following the financial crisis highlights the challenges that arise in practice from the interaction between the contractual rights and obligations and legislation and regulation. When these interactions apply entities can face challenges in determining whether particular requirements stem from the contract or from related law or regulation. A contract might state that the entity is under the scope of specific legislation, include a general reference to legislation or replicate the wording of the legislation. The HKICPA has heard concerns about the potential different outcomes from essentially identical contracts where one contract incorporates the relevant law in its terms while another does not.

Accordingly, the HKICPA recommends that the IASB develops guidance to assist entities to address the challenges that rise in practice, particularly with 'bail-in' legislation. The HKICPA considers such guidance could cover the distinction between contractual and legal obligations and additional disclosures about legislation that are relevant for investors to understand the substance of the contractual arrangement of a financial instrument, which could be combined with disclosures about the terms and conditions of the instrument.

If the IASB were to develop its proposals as set out in the DP, the HKICPA agrees that the IASB should not reconsider the guidance in IFRIC 2.

~ End ~