ASC
ACCOUNTING STANDARDS COUNCIL
SINGAPORE

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(By online submission)

Dear Hans

RESPONSE TO DISCUSSION PAPER ON FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

The Singapore Accounting Standards Council appreciates the opportunity to comment on the Discussion Paper on *Financial Instruments with Characteristics of Equity* (the DP) issued by the International Accounting Standards Board (the IASB or the Board) in June 2018.

We commend the IASB for its efforts in attempting to address the existing conceptual and application challenges associated with the classification of financial instruments as either financial liabilities or equity instruments. The rules-based nature of IAS 32 *Financial Instruments: Presentation* is as much a cause of the challenges as the increasing complexity and sophistication of financial instruments being issued. There will be ongoing challenges amidst the continuing innovation in financial instruments that is to be expected from diverse investment preferences and capital regulatory developments.

In our comment letter to the IASB's 2015 Agenda Consultation, we expressed strong support for this project to improve the definitions and requirements in IAS 32 on the basis of sound concepts. We continue to encourage the IASB to forge ahead with this project with the aim of developing a standards-level solution that would achieve the project's objectives.

In terms of the IASB's preferred approach, we see merit in its fundamentals, namely retaining the binary distinction between financial liabilities and equity, developing a single set of classification principles without fundamentally changing existing classification outcomes that are well understood and provide useful information, and complementing the binary classification with new presentation and disclosure requirements.

We doubt the alternatives would provide a better solution; a fundamental review of IAS 32 is unlikely to be justified on cost-benefit grounds, while an approach of developing narrow-

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scope amendments and explanations to address specific application challenges is unlikely to future-proof IAS 32. That said, the challenge for the IASB's preferred approach lies in developing acceptable principles within the general confines of IAS 32, while balancing the benefits of limited changes to classification outcomes against the costs of applying new principles and the risks of new uncertainties emerging.

The classification principles under the IASB's preferred approach

We are supportive of classification principles that consider both timing and amount features of financial liabilities. The *Conceptual Framework for Financial Reporting* (the Conceptual Framework) defines equity as a residual interest, which we believe represents both interest at liquidation (i.e. akin to the timing feature) and interest in net assets (i.e. akin to the amount feature). The notion of equity representing a residual interest in net assets also underpins the widely-accepted puttable exception. Although the amount feature would change classification outcomes for particular perpetual and share-settled instruments, such changes cannot be totally avoided, if classification is to be guided by a single set of principles in place of the arbitrary and inconsistent rules in IAS 32.

We can appreciate applying the classification principles solely on the basis of contractual rights and obligations, which is consistent with the existing concepts in IFRS Standards for financial instruments. The classification of financial instruments in consideration of legal terms outside the contract would fundamentally change the scope of existing IFRS Standards for financial instruments. For financial instruments with alternative settlement outcomes, there is merit in a classification that is based on the notion of an unconditional right to avoid a liability classification outcome, instead of the likely settlement outcome or some aspects of economic compulsion. This approach would be similar to the existing concept in IAS 32, and the consideration of other concepts would fundamentally change the classification outcomes of IAS 32.

In addition, we see merit in applying the classification principles to the package of rights and obligations arising from derivatives and the underlying instruments for all liability/equity exchange derivatives – not only those that extinguish equity instruments. This approach would avoid different classification outcomes depending on how the derivative and underlying instrument are structured.

It follows that we see some merit in analogising redemption obligation arrangements to compound instruments. In some cases, the accounting outcomes are not immediately intuitive when classification is determined in consideration of the package of rights and obligations in an arrangement as a whole, but such a consequence is to be expected of substance-over-form accounting. That said, derecognition of the underlying instruments, which continue to represent an existing interest, would raise more questions about the accounting for the 'debit leg' within equity.

Nevertheless, the classification principles introduce various new concepts and terminologies, which would require clarification to reduce potential practice diversity arising from new interpretation and application issues. Besides, there is a need for more consistency in determining which exceptions in IAS 32 should be retained, or better articulation of the rationale for retaining some, but not other, exceptions. In particular, some of those

exceptions, such as the puttable exception and the foreign currency rights issue exception, would not be resolved by the classification principles, but the underlying issues remain.

Separate presentation and disclosures

We consider the additional disclosures about the features of financial instruments to be an important part of the IASB's preferred approach. The disclosures not only complement the information provided through classification, but also alleviate potential loss of information relating to the implications of economic compulsion and the legal terms outside of contracts.

We are supportive of separate presentation for financial liabilities of which amount is solely dependent on the entity's available economic resources, but not partly independent derivatives because doing so increases complexity and is not always practicable. We can understand the rationale for the separate presentation of related gains and losses in other comprehensive income, without subsequent reclassification. This is because if changes in the carrying amount of those liabilities are irrelevant to an assessment of financial performance, the same holds true for the cumulative amount to be reclassified from other comprehensive income.

However, we are doubtful whether an attribution of total comprehensive income to equity instruments other than ordinary shares can be justified on cost-benefit grounds. It is likely to be complex, but the resulting information may not have significant predictive value for the total returns from those equity instruments. On the whole, we think that a better balance may be achieved from disclosures about the fair value of those equity instruments, together with information about potential dilution of ordinary shares and priority of claims on liquidation.

Significant implications for particular entities

The IASB's classification principles will change the current classification outcomes for particular instruments that are commonly issued by entities in Singapore and other parts of the world. These changes have significant implications for particular affected entities, ranging from a deterioration in key financial ratios to a potential breach of covenants and legal requirements, with potential repercussions on the entities as a going concern and may also lead to financial difficulties and potential acceleration of payment obligations for the entities concerned. If the IASB decides to proceed with its classification principles, entities must be given sufficient implementation lead-time and transition reliefs to help them manage and ameliorate those implications.

Our comments on the specific questions in the DP are as follows:

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?

Challenges and the need for standard-setting activity

Generally, we accept the IASB's assessment that IAS 32 can be applied to the majority of financial instruments – having only features of either liability or equity – without difficulty, while resulting in appropriate classification outcomes.

However, we acknowledge the various conceptual and application challenges of applying IAS 32 to a growing number of financial instruments with a variety of features. There will be ongoing challenges amidst the continuing innovation in financial instruments that is to be expected from diverse investment preferences and capital regulatory developments. Therefore, we agree that standard-setting activity would be required to address the challenges.

Indeed, in our comment letter to the IASB's 2015 Agenda Consultation, we expressed strong support for this project to improve the definitions and requirements in IAS 32 on the basis of sound concepts. We continue to encourage the IASB to forge ahead with the project, and to address stakeholders' feedback on the DP to the extent possible, with the aim of developing a standards-level solution that would achieve the project's objectives.

Type of standard-setting activity

We are supportive of the IASB improving the classification requirements and outcomes of financial instruments through robust principles, while limiting unnecessary changes to the current classification outcomes that are well understood and provide useful information.

In particular, we doubt the alternative approaches would provide a better solution. An alternative approach is to fix the existing gaps in IAS 32 with narrow-scope amendments to address specific application challenges, and additional explanations for the rationale underlying specific rules. However, a major cause of the application challenges is arguably the rule-based, arbitrary and inconsistent requirements in IAS 32. This approach is expected to perpetuate the existing challenges and to not pre-empt further challenges that may arise from new and more complex financial instruments in the future.

At the other end of the spectrum, a fundamental review of IAS 32 is unlikely to be justified on cost-benefit grounds. IAS 32 is not fundamentally broken, and therefore, any standard-setting activity should achieve a balance on the relative costs and benefits of potentially pervasive and material changes to existing classification outcomes. Furthermore, it may not be practicable to develop classification principles that align with the principles in the Conceptual Framework, even if doing so would be an ideal outcome of a fundamental review. As communicated in our comment letter to the IASB's exposure draft on the Conceptual Framework, we recognised that the distinction between financial liability and equity would unlikely be satisfactorily addressed at the conceptual level, and that it might be better dealt with through more detailed standards-level guidance. Moreover, some of the associated challenges may be specific to financial instruments, and the IASB is not prevented from

specifying requirements that depart from aspects of the Conceptual Framework, such as the definition of a liability, in order to meet the objective of general purpose financial reporting.

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?

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?

In general, we see merit in the fundamentals of the IASB's preferred approach, namely retaining the binary distinction between financial liabilities and equity, developing a single set of classification principles without fundamentally changing existing classification outcomes, and complementing the binary classification with new presentation and disclosure requirements.

A single set of classification principles would have the following benefits: allowing the IASB to develop more consistent and robust requirements; the IFRS Interpretations Committee to reach a consensus on new application issues that may emerge in the future; entities to determine the appropriate classification of financial instruments for which there is no explicit

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guidance in IAS 32; and users to better understand the classification outcomes for a variety of financial instruments.

Nevertheless, the binary classification is inherently limited in its ability to capture all pertinent features of financial instruments. For example, classification alone would not provide adequate information about a variety of features, the interaction between different features in a financial instrument, and the interaction of features between different financial instruments.

Therefore, we are supportive of the IASB developing separate presentation and disclosure requirements about aspects of a variety of features without creating undue complexity. In particular, we consider improved disclosures to be an important part of the project. The disclosures would not only complement information provided through classification, but also alleviate potential loss of information relating to the implications of economic compulsion and the legal terms outside of contracts.

The classification principles under the IASB's preferred approach

On the whole, we can appreciate the principles in the IASB's preferred approach underlying the classification of financial instruments as either financial liabilities or equity. The resulting classification outcomes have the potential of providing information about the timing and amount features of claims that would help users of financial statements to assess not only funding liquidity and cash flows, but also balance-sheet solvency and returns.

In particular, we think that the classification principles are broadly aligned with the notion of equity being a residual interest. We believe that a residual interest represents both interest at liquidation (i.e. akin to the timing feature) and interest in net assets (i.e. akin to the amount feature).

More specifically, we believe that a consideration of the amount feature has the potential to provide more useful information. There is information value, particularly for holders of financial instruments, in classification outcomes that allow an assessment of whether the issuer would have sufficient economic resources to settle the obligation, even if settlement is due at liquidation only or the obligation is settled by delivering the issuer's own equity instruments.

Indeed, for financial instruments that are due for settlement by delivering the issuer's own equity instruments, there is a general acceptance of liability classification as an appropriate outcome, if the issuer's own equity instruments are used as currency. However, for financial instruments that are due for settlement at liquidation only, there is a deeply entrenched view supporting equity classification, even if the amount of obligation is independent of the issuer's available economic resources. If perpetual instruments are classified as equity, a concern is that the carrying amount of perpetual instruments would not be updated, and therefore, the reported and actual amounts of the obligations could be different.

That said, we note that the amount feature is not an entirely new concept for the classification of financial instruments in IFRS Standards. The fixed-for-fixed condition, which is one of the key issues that the amount feature is intended to address, is underpinned by the notion of

equity instruments representing a specified equity interest that is unaffected by variables other than the market price of the entity's own equity instruments. Similarly, the widely-accepted puttable exception is underpinned by the notion of equity representing a residual interest in net assets.

Although the amount feature would change classification outcomes for particular perpetual and share-settled instruments, such changes cannot be totally avoided, if classification is to be guided by a single set of principles in place of the arbitrary and inconsistent rules in IAS 32.

Nevertheless, we acknowledge that the amount feature would give rise to certain conceptual issues. For example:

(a) The Conceptual Framework states that financial statements are prepared on the assumption that an entity is a going concern. However, the entity would classify perpetual instruments as financial liabilities, even though they are due for settlement at liquidation only (and for an amount independent of the entity's available economic resources).

(b) The Conceptual Framework states that a liability must include an obligation to transfer an economic resource, and that an entity's own equity instruments are not its economic resources. However, the entity would classify share-settled instruments (with an obligation for an amount independent of the entity's available economic resources) as financial liabilities, even though the entity does not have an obligation to transfer economic resources.

These settlement features, namely settlement at liquidation and by delivery of own equity instruments, are arguably specific to financial instruments and uncommon for non-financial liabilities. Therefore, there may be a case for departure from the Conceptual Framework, if more useful information would result from liability classification for perpetual and share-settled instruments that contain the amount feature.

New concepts and terminologies

We note that the classification principles under the IASB's preferred approach introduce new concepts and terminologies that would increase complexity and raise new questions. There is a risk that practice diversity and structuring opportunities will emerge, if the IASB does not clarify those concepts and terminologies.

The timing feature

The timing feature places importance on the term 'liquidation' and its application. Although the term is currently used in IFRS Standards[1], there may be a need for clarification because its application is expected to be more widespread and increasingly complex, particularly with continuing innovation in financial instruments that is to be expected from diverse investment preferences and capital regulatory developments.

[1] For example, in the contingent settlement provisions and puttable exception in IAS 32, the going concern assumption in IAS 1 *Presentation of Financial Statements* and IAS 10 *Events after the Reporting Period*, the description of non-controlling interests in IFRS 3 *Business Combinations*, and the attribution of losses recognised using the equity method in IAS 28 *Investments in Associates and Joint Ventures*.

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For example, clarification may be useful as to whether liquidation could refer to the process of winding up in addition to the final stage before dissolution, and whether liquidation could include an insolvency-related arrangement whereby the entity may survive the process.

The amount feature

The amount feature introduces the new term 'available economic resources' and related new concepts, for example, 'independent' of or 'exceed' available economic resources, a 'portion' or 'proportion' of available economic resources. These terms and concepts raise new questions, for example:

(a) The term 'available economic resources' makes reference to both recognised and unrecognised assets and liabilities. It is unclear whether it would preclude any measures that do not include all unrecognised assets and liabilities (e.g. net asset value, total comprehensive income), or any measures that are not based on fair value (e.g. book value, liquidation value). On this note, the condition for puttable exception in paragraph 16A(e) of IAS 32 may provide a starting point for clarification, given that some financial instruments that do not contain the amount feature of financial liabilities will be settled at a specified time before liquidation. An inference from paragraph 16A(e) may be that a proxy for a residual interest in net assets includes the profit or loss, the recognised net assets measured at carrying amount, or the recognised and unrecognised net assets measured at fair value.

(b) The term 'available economic resources' makes references to assets after deducting all other claims against the entity (except for the financial instrument in question). There may be confusion as to how an entity should apply this description, if the entity has more than one class of claims that represent a residual interest in the entity.

(c) An amount is independent of an entity's available economic resources, if it is specified by reference to the entity's total economic resources or particular recognised or unrecognised assets (i.e. a portion of the entity's available economic resources). In contrast, the ordinary shares held by non-controlling interests are not independent of the group's available economic resources in the consolidated financial statements because those instruments depend on the subsidiary's (and thus a portion of the group's) available economic resources. Similarly, a derivative to exchange a fixed number of the parent's ordinary shares for a fixed number of a subsidiary's ordinary shares does not preclude equity classification in the consolidated financial statements. A clearer explanation should be provided for the different conclusion in the latter cases involving a portion (but not proportion) of the reporting entity's available economic resources in the consolidated financial statements.

(d) A financial instrument may contain an obligation for a fixed amount. If the financial instrument is a non-derivative instrument, it would have the amount feature of financial liabilities because the amount does not change as a result of changes in the entity's available economic resources. In contrast, the opposite would be true if the instrument is a derivative instrument because the amount is unaffected by a variable that is independent of the entity's available economic resources. Clarification is required as to whether the amount feature refers to an amount that is unaffected by the entity's available economic resources, or an amount that is affected by a variable other than the

entity's available economic resources. If the IASB considers the different concept or conclusion to be appropriate, a clearer explanation of the rationale should be provided.

Financial instruments with alternative settlement outcome(s) not controlled by the entity

We see merit in the principles underlying the classification of financial instruments with alternative settlement outcomes as financial liabilities, if the entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of financial liabilities.

In particular, we appreciate that the preferred approach would require financial instruments with similar obligations to be classified in a similar manner, regardless of how they are structured. For example, convertible bonds and puttable shares contain obligations of prima facie different nature. However, both instruments are similar, to the extent that they do not give the issuer the unconditional right to avoid a liability settlement outcome, and are expected to have similar settlement outcomes, ceteris paribus, if the market price of shares increases or decreases from the pre-determined exercise price.

Moreover, the preferred approach would address existing questions on IAS 32 about whether the effect of conditionality should be included in the measurement of the non-derivative liability component, or the derivative component representing the remaining rights and obligations. The inclusion of conditionality in the derivative component, while leaving the non-derivative liability component to reflect only the unavoidable obligation to transfer financial assets, has the potential to improve consistency and reduce complexity in classification, even if financial instruments with similar outcomes are structured differently.

Nevertheless, a classification based on the notion of an unconditional right to avoid a liability settlement outcome has its shortfall; the classification outcome may not reflect the likely settlement outcome or some aspects of economic compulsion. This may reduce the usefulness of information from the classification outcome and have undesirable accounting implications (refer to comments under Question 6). However, we recognise that a consideration of other concepts would fundamentally change the classification outcomes of IAS 32. Besides, doing so would raise more questions, for example, whether the likelihood of settlement outcomes should be considered only for financial instruments with alternative settlement outcomes that are controlled by the entity, what criteria should be used for determining the likelihood of outcomes, and whether and when reassessment would be required.

We further note that the DP has not addressed certain existing challenges in assessing whether the entity has the unconditional right to avoid a settlement outcome. For example, if the settlement outcome is contingent on an uncertain future event that is controlled by the entity's shareholders, there is uncertainty as to whether the shareholders are acting on behalf of the entity (as would be any decisions made by the entity under the control of its shareholders through participation in its governing bodies), or in their capacity as investors of the entity.

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?

We appreciate classifying derivatives on own equity in their entirety, and more specifically, such a derivative as equity if the instrument in its entirely does not have the features of financial liabilities.

In particular, this approach would be consistent with the existing classification requirements, which have largely resulted in appropriate outcomes. Furthermore, it would be consistent with the underlying rights and obligations for an exchange of financial instruments, and the existing requirements in IFRS 9 *Financial Instruments* under which derivatives are not separated into their individual legs.

In contrast to the alternative of asset/liability-only classification, this approach would reduce inconsistent classification in comparison with an obligation in a non-derivative equity instrument that is similar to the equity leg of the derivative. It would further avoid exacerbating the issue of recognising changes to the equity leg as income or expense.

Besides, it has the potential to address some of the existing issues about the fixed-for-fixed condition in IAS 32, for example:

(a) A need for clearer articulation of whether an adjustment to a fixed number of shares in exchange for a fixed consideration would necessarily violate the fixed-for-fixed condition.

(b) The inconsistent classification between gross-settled derivatives and net-share settled derivatives, in cases where such derivatives neither require a transfer of economic resources nor create an obligation for a net amount that is independent of the entity's available economic resources.

Distinction between asset/equity and liability/equity exchange derivatives

We can see merit in distinguishing liability/equity exchange derivatives from asset/equity exchange derivatives. However, we are not necessarily in favour of the distinction of

liability/equity exchange derivatives between an extinguishment of financial liabilities and an extinguishment of equity instruments.

The presence of a financial liability or an equity instrument that may or will be extinguished by a liability/equity exchange derivative imply a need for classification in consideration of the package of rights and obligations arising from both the derivative and the underlying financial liability or equity instrument. This approach has the benefit of avoiding different classification outcomes depending on how the derivative and underlying instrument are structured. It also has the potential to provide a basis for rationalising the existing gross-up accounting for certain derivatives such as written put options and forward purchase contracts, unlike other derivatives that are accounted for on a net basis.

We remain to be persuaded on the standalone basis for the classification of liability/equity exchange derivatives that extinguish financial liabilities in a similar manner as asset/equity exchange derivatives. Contrary to the DP, it is not always true that classifying the derivative and underlying liability separately would result in the same outcome as classifying the package of rights and obligations arising from the arrangement as a whole. For example, a simple bond and a standalone forward contract to settle the bond by delivering a fixed number of shares would be classified as financial liability and equity, respectively, in accordance with the DP. In contrast, an approach that considers the package of rights and obligations would result in the arrangement as a whole, which is akin to mandatorily convertible bond with a fixed conversion ratio, to be classified as equity in its entirety.

Partly independent derivatives

We can appreciate the classification of partly independent derivatives as financial liabilities. A consideration of any criterion that allows derivatives with one or more independent variables to be classified as equity would increase complexity of the classification assessment and reduce understandability of the financial statements.

That said, classification can only provide information about aspects of the independent variables, while separate presentation for the effects of dependent variables is not always practicable. Therefore, we are supportive of providing additional information about the independent and dependent variables in partly independent derivatives through disclosures only. Please refer to our comments under Question 7 for further details.

Variables that affect net amount of derivatives

We are supportive of the IASB providing additional guidance on assessing the independence of common variables that affect the net amount of the two legs of derivatives. We further encourage the IASB to consider extending the guidance to the assessment of the amount feature for non-derivative financial instruments.

That said, clarification may be useful on the following aspects:

(a) Whether the notion of 'time value of money' should be the same as that in IFRS 9, and if not, an explanation of why consistency would not be necessary.

(b) Whether the notion of ‘anti-dilution’ and ‘same economic position’ includes one or more of the various features such as maintaining the holder’s share in the number of issued shares, fair value of interests, and net assets.

(c) A derivative contains an independent variable if, for example, the occurrence of a contingent event would vary the amount of cash receivable or the number of equity instruments to be delivered. It is unclear whether an independent variable would be present in a derivative that is not fully protected from dilution, but mitigates the consequences of dilution by varying the amount of cash receivable or the number of equity instruments to be delivered.

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?

Compound instruments

We agree with the IASB’s preferred approach for compound instruments. The classification principles are largely carried forward from the existing requirements in IAS 32, which have generally resulted in appropriate outcomes.

Redemption obligation arrangements

Following from our comments on liability/equity exchange derivatives, we see some merit in classifying redemption obligation arrangements in a similar manner as compound instruments. It offers similar benefits, including consistent classification between arrangements that have similar obligations and outcomes but are structured differently, and the potential to provide a basis for rationalising the existing gross-up accounting for certain derivatives.

That said, the consequences of classifying the unavoidable obligation as non-derivative financial liability, and the remaining rights and obligations as derivative instrument, are not always intuitive. For example, a redemption obligation arrangement comprising ordinary shares and a written put option would be classified as a simple bond and a written call option instead (i.e. akin to a convertible bond). Likewise, the expiry of the written put option would

be accounted for in a similar manner as the exercise of the conversion option in a convertible bond. In some cases, the accounting outcomes are not immediately intuitive when classification is determined in consideration of the package of rights and obligations in an arrangement as a whole, instead of the structure of individual instruments, but such a consequence is to be expected of substance-over-form accounting.

While the DP attempts to address the accounting for the 'debit leg' within equity, potential issues could arise from derecognition of the underlying equity instruments. For example, in the case of a written put option on non-controlling interest, the following issues would have to be addressed:

(a) The accounting for the subsidiary's distributions, and attribution of the subsidiary's results, to the non-controlling interest that has been derecognised but continues to represent an existing ownership interest in the subsidiary.

(b) In the event that the written put option is not exercised, the accounting for any cumulative results of the subsidiary that have not been attributed to, and the effects of subsequently recognising, the previously derecognised non-controlling interest.

(c) In the case of a written put option in connection with a business combination (for example, a mandatory tender offer or an exit clause triggered by a change in control), the interaction between the accounting for business combination in accordance with IFRS 3 and the accounting for written put option as discussed in the DP. There may be questions as to whether the written put option is part of the business combination transaction, and the resulting implications, for example, relating to the accounting for goodwill or the interaction issues arising from the immediate derecognition of the non-controlling interest[2].

On the whole, the recognition of a contra-equity account may achieve a better balance in comparison with derecognition of the underlying equity instruments. Although the contra-equity account lacks substance, this approach may still provide some useful information through the non-derivative financial liability that represents an unavoidable obligation to transfer financial assets, together with the continuing recognition of the underlying equity instruments that represent an existing interest. Moreover, it eliminates the need to address the various issues that could arise from derecognition of the underlying equity instruments.

Financial instruments with alternative settlement outcomes controlled by the entity

In principle, we see merit in a classification based on the notion of an unconditional right to avoid a liability settlement outcome. More specifically, if the unconditional right is present in a financial instrument with alternative settlement outcomes controlled by entity, there is merit

[2] If the written put option is part of the business combination transaction, there may be implications for the initial accounting of goodwill and its subsequent accounting in the event that the written put option is not exercised. There may also be interaction issues associated with the requirement in IFRS 3 to measure other components of non-controlling interests (such as the implicit written call option) at fair value unless otherwise specified. If the written put option is a separate transaction, there may be issues arising from the interaction between derecognition of the non-controlling interest at fair value immediately after the acquisition date and the requirement in IFRS 10 *Consolidated Financial Statements* relating to changes in the proportion held by non-controlling interests.

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in classifying the financial instrument as a non-derivative equity instrument, and the remaining rights as a derivative financial asset.

Nevertheless, we recognise the IASB's observation that separating the embedded derivative would lead to a gross-up of both assets and equity. The effect would be more significant in cases where it is unlikely that the entity would choose the share settlement option and that the equity instrument would remain outstanding ultimately. We note that this observation may be an undesirable consequence of classifying financial instruments without consideration for the likely settlement outcome or aspects of economic compulsion.

To overcome the gross-up issue, the IASB may consider exploring the merit of not separating the embedded derivative from the equity instrument. Arguably, an unconditional right to avoid a liability settlement outcome must be accompanied by an ability to waive the right to equity settlement outcome and choose the liability settlement outcome. Indeed, paragraph 8.17 of the DP alluded to this point. In terms of accounting, there is no separation between an equity instrument, such as ordinary shares, and the underlying right to satisfy, in whole or in part, the instrument at some point in time. Therefore, in the case of financial instruments with alternative settlement outcomes controlled by the entity, it may be reasoned that the cash settlement option need not be separated and the financial instrument can be classified in its entirety as an equity instrument. Furthermore, it may be argued that the cash settlement option is part of the equity instrument, instead of an embedded derivative, because it has been considered in determining that the financial instrument as a whole is an equity instrument.

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?

Puttable exception and foreign currency rights issue exception

We see merit in retaining not only the puttable exception, but also the foreign currency rights issue exception, that are currently in IAS 32. This is because they are narrowly defined exceptions that would not significantly undermine the classification principles under the IASB's preferred approach, and the issues that have given rise to the need for those exceptions remain valid.

Moreover, there may be merit in considering whether particular existing disclosures about the redemption obligations for puttable instruments classified as equity, such as the expected cash flows on settlement of the financial instruments, ought to be extended to derivatives classified as equity under the foreign currency rights issue exception.

On this note, we do not support extending the foreign currency rights issue exception to the foreign currency conversion options embedded in foreign currency convertible bonds. The narrowly defined exception is limited to foreign currency rights that are offered pro rata to all of the existing owners of the same class of non-derivative equity instruments, which bear resemblance to dividends paid in shares and are essentially equity transactions with owners in their capacity as owners. They contrast with the conversion options embedded in foreign

currency convertible bonds, which were issued to holders as creditors who would become owners only after they have exercised the conversion option.

That said, the existing puttable exception have its limitations. In cases where an entity has more than one class of puttable instruments, the strict conditions for the exception (essentially, the instruments must represent the most subordinate claim to the net assets of the entity) may result in none of those instruments being qualified for classification as equity. An example is where the entity is required by law to issue the most subordinate class of instruments but not in a scale that can support the economic activities of the entity, or where the most subordinate class of instruments obliges the entity to pay a fixed amount in addition to a share in net assets at liquidation. The IASB may consider exploring whether and how those challenges should be addressed.

Furthermore, the IASB may consider exploring the merit of eliminating the exception in paragraphs 16C and 16D of IAS 32 by expanding the term 'liquidation' in the timing feature of the classification principles to include contractually specified liquidation. To the extent that financial statements are prepared on the going concern assumption, there may be little basis for different classification of a claim representing a residual interest at liquidation, depending on whether liquidation is contractually specified or an indefinite event.

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?

Separate presentation for financial liabilities with either timing or amount feature

Generally, we can appreciate the separate presentation of financial liabilities that meet the timing feature, but not the amount feature, of financial liabilities. Such financial liabilities have the same amount feature as equity instruments, which are affected by only changes in the entity's available economic resources.

In addition, we can understand the rationale for the separate presentation of changes in the carrying amount of such financial liabilities in other comprehensive income. The presentation of such changes in profit or loss may not provide relevant information about the entity's financial performance. It may be even counter-intuitive because of the accounting mismatch that arises from incomplete recognition of changes in value of the assets and liabilities of the entity.

If the IASB decides to proceed with separate presentation in other comprehensive income, the amounts so presented ought not to be subsequently reclassified to profit or loss. If changes in

the carrying amount of such financial liabilities are irrelevant to the assessment of the entity's financial performance, the same ought to be true for the cumulative amount to be reclassified from other comprehensive income. Moreover, this approach would be similar to the existing presentation requirements relating to the effects of changes in the entity's own credit risk, which are affected by changes in the entity's available economic resources.

For financial liabilities that meet the amount feature, but not the timing feature, of financial liabilities, we have not identified additional presentation requirements for the timing feature that would be necessary for an assessment of the entity's funding liquidity and cash flows.

Separate presentation for partly independent derivatives

We are not supportive of separate presentation for partly independent derivatives that meet the specified criteria in paragraph 6.34 in the DP (the Specified Derivatives), on cost-benefit grounds.

In principle, separate presentation of partly independent derivatives has the potential to improve information provided about an entity's financial performance. However, we have concerns about both the disaggregation approach and the criteria-based approach.

The disaggregation approach would be at odds with the principles of classifying and accounting for derivatives in their entirety. In addition, it introduces not only additional complexity, but also potential difficulty in isolating the effect of a change in particular variable because of interdependencies between variables. Moreover, it may be impracticable for some hybrid instruments, if such instruments are designated at fair value through profit or loss in their entirety (i.e. fair value option) because the entity is unable to measure the embedded derivative separately.

The criteria-based approach would have its challenges as well. Its scope and criteria may not be easily determined, given that a variety of independent variables may be included in partly independent derivatives. A broad scope would result in separate presentation of the effects of various variables that are otherwise recognised in profit or loss, and could lead to structuring opportunities by including a minor reference to a dependent variable. On the other hand, a narrow scope would significantly limit the benefits of separate presentation, and could reduce understandability of the financial statements because of perceived arbitrary distinction from other partly independent derivatives.

The criteria-based approach would also raise more questions for hybrid instruments that apply the fair value option. The inclusion of such hybrid instruments in the scope of separate presentation may not be practicable, particularly if the criteria-based approach adopts a broad scope and the entity is unable to measure the embedded derivative separately. Conversely, a scope exclusion would exacerbate the concerns about a narrow scope for the criteria-based approach, and reduce comparability between embedded derivatives that are separated and those that are not separated from the host contracts.

Furthermore, if the foreign currency rights issue exception is to be retained, there may be reduced need for separate presentation of the Specified Derivatives, particularly if separate presentation is prohibited for hybrid instruments that apply the fair value option. Specifically,

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a portion of the Specified Derivatives would be classified as equity applying the exception, which may represent a substantial portion of the population of the Specified Derivatives that are either a standalone derivative or an embedded derivative that is separated from the host contract.

That said, we recognise that separate presentation for the Specified Derivatives may alleviate calls for extending the foreign currency rights issue exception to the conversion options that are embedded in foreign currency convertible bonds. However, the assessment of the criteria in paragraph 6.34, such as whether the foreign currency is imposed by market forces, may be complex and highly judgemental.

On the whole, if the IASB decides to proceed with separate presentation for partly independent derivatives, the IASB may consider further developing a narrow-scope criteria-based approach – akin to an exception – that is built on the criteria in paragraph 6.34 but with the clarification necessary to avoid practice diversity. Since the exception would be narrowly defined, separate presentation should be extended to the embedded derivative of hybrid instruments that apply the fair value option, unless an entity determines that doing so would be impracticable. The separate presentation requirement should also be extended to non-derivative financial liabilities that otherwise contain no obligation for an amount independent of the entity's available economic resources, if not for a variability that meets the criteria.

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?

Attribution of total comprehensive income to equity instruments

We agree with the IASB on the need to improve the presentation and disclosure of equity instruments to provide more useful information about their different rights and obligations.

In principle, those improvements may include an attribution of total comprehensive income to equity instruments. However, the challenge lies in determining an attribution approach that could provide useful information, without undue complexity and costs. In particular:

(a) Different equity instruments have differences between their rights and obligations. A meaningful attribution of total comprehensive income may have to consider not only the relative amounts due at liquidation, but also other features such as restrictions on distributions and priority of claim on liquidation.

(b) Total comprehensive income does not completely capture all changes in value of the assets and liabilities of the entity. The amount attributed to equity instruments may not have significant predictive value for the returns that the holders would receive over the life of those instruments. Furthermore, if attribution is made on the basis of direct measurement for some, but not all, classes of equity instruments, there may be conceptual issues about attributing the unrecognised changes in value to some equity instruments, and consequently, under or over-attributing total comprehensive income to other equity instruments.

(c) The information resulting from an attribution of total comprehensive income is inevitably incomplete, to the extent that the attribution requirement does not apply to all claims involving equity instruments, such as equity-settled share-based payment transactions, and share-settled financial instruments that are classified as financial liabilities in their entirety.

Furthermore, we have the following concerns about the attribution approaches as discussed in the DP.

Non-derivative equity instruments (other than ordinary shares)

The classification principles under the IASB's preferred approach would result in all classes of non-derivative equity instruments having a residual interest in the entity's available economic resources. On the other hand, IAS 33 *Earnings per Share* attributes current-period profit or loss to ordinary shares and participating equity instruments as if the current-period profit or loss had been fully distributed. Therefore, we believe that further work would be required in determining whether the existing requirements in IAS 33 are fit for the purpose as envisaged in the DP. Specifically:

(a) The requirements in IAS 33 may not serve other attribution objectives, for example, of reflecting the distribution of residual assets on liquidation or total returns (including the residual return). In particular, an attribution that updates the carrying amount of equity instruments implies that its objective may be closer to reflecting the distribution of residual assets or total return, instead of current-period earnings. The attributed amounts invariably differ under those objectives, to the extent that the non-derivative equity instruments (other than ordinary shares) either do not have a pre-determined distribution formula, or have a distribution formula that differs from the formula for participation in the residual assets on liquidation.

(b) Applying the requirements in IAS 33, the current-period earnings would be fully attributed to ordinary shares and participating equity instruments, but not to derivatives because they generally do not represent an existing interest in the undistributed earnings. It is unclear how this outcome would interact with the attribution approaches for derivatives.

<u>Derivative equity instruments</u>

For all three approaches, the benefits from the attribution of total comprehensive income are unlikely to be justified by the costs of providing the information. The amount attributed to the derivatives may not have significant predictive value for the returns that the holders would receive over the life of those instruments.

Moreover, the attribution approaches for the derivatives and non-derivative equity instruments (other than ordinary shares) appear to be at odds with each other. The derivatives do not give the holders an existing interest in the returns until their conversion into non-derivative equity instruments. Yet, total comprehensive income is attributed to the derivatives with reference to the fair value of the underlying interest, and to non-derivative equity instruments (other than ordinary shares) based on the current-period earnings only.

More specific observations include:

(a) Fair value approach: This approach essentially attributes the unrecognised changes in value of the assets and liabilities to the derivatives, and consequently, under or over-attributes total comprehensive income to ordinary shares. Moreover, the direct measurement of derivatives appears to be at odds with the principle that the carrying amount of equity instruments should be measured indirectly based on the recognised changes in value of the assets and liabilities.

(b) Average-of-period approach: This approach essentially treats the derivatives as ordinary share equivalents based on their relative average fair value during the period. This approach has some merit, in that it takes into consideration the probability that the ordinary shares will be issued, and those derivatives that are anti-dilutive at the reporting date. Nevertheless, it will be costly to apply because of the need to determine the average fair value of all derivatives and ordinary shares.

(c) End-of-period approach: This approach may not accurately depict the distribution of returns during the period because the changes in carrying amount of derivatives will include catch-up adjustments that result from issuing such instruments at fair value. Moreover, it essentially requires direct measurement of all derivatives and ordinary shares, and changes in their carrying amount to be reflected through the attribution of total comprehensive income. This exacerbates the tension with the measurement principles for equity as described under the fair value approach.

On the whole, we think that a disclosure-only approach may achieve a better balance of costs and benefits. Disclosures about the fair value of equity instruments other than ordinary shares, together with information about potential dilution of ordinary shares and priority of claims on liquidation, could provide a starting point for further analysis about the distribution of returns among different equity instruments. Such information could be complemented by existing disclosures of diluted earnings per share and improved disclosures about dilutive

potential ordinary shares and their changes during the period. Nevertheless, disclosures about the fair value of equity instruments other than ordinary shares can be costly, and in some cases challenging. The IASB would have to perform further work to assess the relative costs and benefits of providing such information.

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 statements: (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 are generally supportive of the additional disclosures as discussed in the DP.

Priority on liquidation

We see merit in the presentation of financial liabilities and equity instruments in their order of priority on liquidation.

Information about the priority of claims on liquidation would be useful for assessing balance-sheet solvency and returns. However, users of financial statements currently have to perform their own assessments by making assumptions based on limited information because of the lack of disclosures required by IFRS Standards, which is far from ideal.

Nevertheless, we recognise that determining the priority of claims on liquidation may be challenging, particularly with the continuing innovation in financial instruments that is to be expected from diverse investment preferences and capital regulatory developments. This is because of the interactions between different terms of an instrument, between different instruments, and with instruments issued by other parties such as group entities. Furthermore,

complications may arise from instruments that have higher priority than ordinary share on liquidation, but are required to be written off on occurrence of specified default events.

In view of the interactions between claims, it may be better to present the priority of claims on liquidation in the notes to the financial statements to avoid cluttering the statement of financial position.

Moreover, presenting the information in terms of the fair value of claims may complement the information about their relative ranking, given that the priority on liquidation may not necessarily reflect the loss absorption on occurrence of default events. Nevertheless, this approach can be costly, unless the IASB decides in favour of fair value calculations for equity instruments under the attribution or disclosure requirements.

Potential dilution of ordinary shares

We are generally supportive of improving disclosures about potential dilution of ordinary shares and the effect of new issues of ordinary shares on the voting rights of existing shareholders.

There is information gap to be filled because of the current limitations of IFRS Standards. For example, the disclosures required by IAS 33 are not useful for particular assessments because IAS 33 defines dilution narrowly and considers only potential ordinary shares that are dilutive. There is also a lack of disclosures about the total number of potential ordinary shares, the number of potential ordinary shares that are currently antidilutive but may become dilutive in the future, and the changes in such potential ordinary shares during the period.

Improved disclosures about potential dilution of ordinary shares would help users of financial statements assess the distribution of returns among equity instruments and potential changes in the future. Such disclosures would be even more important, if the IASB decides against proceeding with the attribution requirements for equity instruments.

Contractual terms and conditions

We are generally supportive of additional disclosures about contractual terms that affect the timing and amount of cash flows from financial liabilities and equity instruments. Such disclosures should contain contractual terms that would help users of financial statements understand the timing and amount features of those instruments, including an expiration of options and contingencies that would change the conclusion of whether the entity has an unconditional right to avoid a liability settlement outcome.

The challenge would be to provide useful information about contractual terms that are both relevant to understanding entity-specific financial instruments and comparable across entities, while avoiding disclosure clutter. An aggregation of such information is necessary but challenging, if the entity issues a large number of financial instruments. For example, the approach of stratifying financial instruments, and requiring different disclosures based on the significance of possible effects on future cash flows, is expected to increase complexity and subjectivity.

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 can appreciate disregarding economic compulsion in the assessment of settlement outcomes that are controlled by the entity.

Although the consideration of economic compulsion would result in a classification that represents the likely settlement outcome, it represents a fundamental change to how financial instruments are classified under IAS 32. Moreover, we think that doing so raises more questions than it answers, for example, the criteria for determining whether the entity is economically compelled to exercise the liability settlement option, and whether and when economic compulsion would have to be reassessed subsequently.

Instead, we see benefits in developing guidance on the assessment of contractual terms that are non-genuine or without substance. Such guidance may include the requirements in paragraph 20 of IAS 32, or an existing notion in the *Conceptual Framework* of the entity having no practical ability to exercise an option, which is essentially an entity-specific aspect of the characteristic 'without substance'.

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 can appreciate applying the classification principles solely on the basis of the rights and obligations established by the contractual terms of financial instruments.

The consideration of law represents a fundamental change to the scope of IFRS Standards for financial instruments. It potentially extends the scope to encompass rights and obligations arising outside contracts, with consequences beyond the distinction between financial liabilities and equity.

Nevertheless, we recognise the risk of structuring opportunities, in that there may be different classification outcomes depending on whether a contract has incorporated the legal requirements. The IASB may consider further work on the significance of the risk in practice. A possible finding is that the risk may be relatively low, given that the contracting parties would reasonably expect the contractual terms to include critical terms imposed by legal

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requirements in order to establish a common understanding of their respective rights and obligations.

Furthermore, we are not quite supportive of specific guidance on, or exception for, mandatory tender offers. There should be a high hurdle for an exception that extends aspects of the scope of financial instruments literature, albeit one that is limited to the distinction between financial liabilities and equity. The IASB would have to perform further work to determine whether and why mandatory tender offers are sufficiently different from other legal requirements to justify an exception.

Other comments

Interactions with other IFRS Standards

We welcome the IASB's plan to consider potential interactions between this project and other IFRS Standards, and the brief discussions of possible consequences to other Standards.

In addition to the requirements that depend on the existing requirements in IAS 32, the IASB would have to consider those requirements that are related to aspects of the presentation and disclosure requirements as discussed in the DP, such as the attribution requirements for equity instruments other than ordinary shares and the disclosure requirements for potential dilution of ordinary shares. In the latter case, there is a need for cohesion and integration of related requirements, while reducing overlap of related requirements.

Significant implications for particular entities

We note that the IASB's classification principles will change the current classification outcomes for particular instruments that are commonly issued by entities in Singapore and other parts of the world. These changes have significant implications for particular affected entities, ranging from a deterioration in key financial ratios to a potential breach of covenants and legal requirements, with potential repercussions on the entities as a going concern and may also lead to financial difficulties and potential acceleration of payment obligations for the entities concerned. If the IASB decides to proceed with its classification principles, entities must be given sufficient implementation lead-time and transition reliefs to help them manage and ameliorate those implications.

We hope that our comments will contribute to the IASB's deliberation on the DP. Should you require any further clarification, please contact our project managers Siok Mun Leong at Leong_Siok_Mun@asc.gov.sg or Yat Hwa Guan at Guan_Yat_Hwa@asc.gov.sg.

Yours faithfully

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