AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

C/O KAMMER DER STEUERBERATER UND WIRTSCHAFTSPRÜFER
SCHOENBRUNNER STRASSE 222–228/1/6
A-1120 VIENNA
AUSTRIA

TEL	+43 (1) 81173 228
FAX	+43 (1) 81173 100
E-MAIL	office@afrac.at
WEB	http://www.afrac.at

December 15, 2018

Mr.
Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Hoogervorst,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on IFRS Standards Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity,* issued by the International Accounting Standards Board (IASB) in June 2018 (the 'DP').

Principal authors of this comment letter were Peter Bitzyk, Iryna Bura, Michael Hammer, Erich Kandler, Philip Kudrna, Katharina Maier, Aslan Milla, Roland Nessmann and Ernst Schönhuber. In order to assure a balanced Austrian view on the DP, the professional background of these authors is diverse.

Our detailed comments and responses to the questions raised in the DP are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact us.

Kind regards,

Romuald Bertl

DISCUSSION PAPER FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

GENERAL REMARKS

AFRAC welcomes and supports the initiative of IASB to clarify the distinction between equity and liability on the standard level, as proposed in the Conceptual Framework (revised 2018).

Acknowledging the intention of the new approach to distinguish between liabilities and equity in order to better reflect the economic substance of the underlying fact pattern, we notice some shortcomings and difficulties.

We welcome the continued stipulation, that equity – in accordance with the framework - is the residual after deduction of all liabilities from the assets.

We strongly support the Board's view regarding the requirement to maintain the exception for puttable instruments as stated in p. 3.32 – 3.36 of the DP. This is an important issue for parts of the Austrian financial industry as well as for other issuers of such instruments.

Nevertheless, we see some problems of the preferred approach in the DP:

We are concerned that the DP focuses solely on contractual arrangements without taking into account the existing legal framework. We believe that the same economic substance should lead to the same accounting consequences, regardless of whether this economic substance is caused by the legal framework, which allows little or no need for additional contractual regulations, or is stipulated solely in a contract. Therefore, we think that this question and the correct interpretation of the concept proposed should be reconsidered.

In principle, we agree with the result of the proposed distinction between equity and liability, which the Board proposes in the DP. Nevertheless, from the Austrian point of view, we want to point out those areas, where we expect a significant impact of the proposed new regulations:

1. In Austria, cumulative irredeemable preference shares (and similar financial instruments) have been issued which are currently classified as equity pursuant to the rules of IAS 32. These instruments would no longer qualify as equity under the proposed new regime, resulting in corresponding consequences on equity and key financial ratios at several big companies in Austria and, thus, in potential consequences on their financial stability. The regulatory ratios of financial institutions (banks) would not be affected, but there might be a potentially negative effect for financial institutions, which have issued AT1 instruments, caused by a decreasing equity ratio according to IFRS. Thus, we encourage the IASB to evaluate different options to provide transitional relief for preparers in order to prevent any collapses resulting from the immediate application of the new classification principles, such as longer transition periods or even some form of “grandfathering” of instruments issued prior to the coming into force of the new requirements. Additional information could be given for different categories of

equity, where required.

2. We understand the Board's conclusion that economic compulsion should not be a basis for the distinction between equity and liability from an operational standpoint, as this would raise new questions ("How compulsive must the economic compulsion be?" etc.). However, we believe that this question merits a new research project, as we believe that IFRS always intend to represent the economic substance of transactions. Ignoring the effect of economic compulsion does not seem to be in line with a faithful representation. In addition, other standards take account of economic or factual compulsion or obligations (e.g. legal or factual obligation in IAS 37, transactions under economic compulsion cannot be the basis for a fair value in IFRS 13, factual control in IFRS 10, etc.). Thus, we support a project to investigate the inclusion of economic compulsion into the distinction between equity and liability in the midterm.

   While we agree with the Board that the proposed approach would introduce clear principles for the distinction between equity and liabilities, particularly as compared to the current principles in IAS 32, we are concerned about the potential negative impacts of the application of the new criteria to some legacy instruments, as described above, particularly concerning the "amount" feature. We further observe that there is some uncertainty concerning the application of the feature, particularly as to reporting the assessment of claims which are due only in the case of liquidation of the entity. Given both aspects, the potential negative effects on some legacy instruments and the uncertainty concerning the application of the "amount" feature, we encourage the Board to assess possible ways to amend the proposed approach accordingly in order to ensure that the solution is indeed an improvement to the current IAS 32.

3. We agree partly that - at least for financial instruments with features of both equity and liability - additional information can result in a better insight into the economic situation of the reporting entity. However, such increased disclosure requirements have to be seen in the context of other initiatives, which aim at making disclosure requirements leaner and more to the point, in order to promote the readability of the report. We are of the opinion that the disclosure requirements in the DP should be reconsidered and limited: the scope proposed concerning the disclosure requirements could be - at least in our opinion – in conflict with the cost-benefit ratio, both from the preparer's as well as from the user's point of view.

In the following paragraphs, we want to answer to the specific questions posted in the DP. We only gave an answer, if we saw a relevant issue from our Austrian perspective.

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 problems 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?

AFRAC's response:

As stated in our general remarks above, AFRAC welcomes and appreciates the IASB initiative to clarify the distinction between equity and liability in conformity with the framework.

The challenges mentioned are valid. From our point of view a clear stipulation is missing that the application of the new requirements will be accompanied by appropriate transitional relief for preparers, such as longer transitional periods or even some “grandfathering” of legacy instruments. Otherwise, the transition from IAS 32 to the new proposed standard could have a significant and non-manageable impact on equity ratios of preparers with a huge potentially negative impact on financial market stability.

From our point of view a stipulation excluding the trading of own equity (incl. derivatives) by banks from the new requirements is missing.

Question 2

The IASB’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 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 of the DP.

The IASB’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?

AFRAC's response:

As already mentioned in our General Remarks, we do not agree:

In the context of lit a. we assume that the resolution of banks according to the BRRD (banking resolution and recovery directive) is an industry-specific form of liquidation: Thus, the assessment of a financial instrument as equity or liability has to be considered, whether payments are due at liquidation or at resolution.

In the context of lit b. we assume that the issue of economic compulsion has to be clarified. What happens in cases, where - from a purely legal point of view - the issuer has the legal right to cancel a payment, with or without being forced by inadequate economic resources, but will settle the payment in any case, knowing that every annulation of payments would destroy his/her standing (i.e. the issuer has a factual obligation to pay)?

As a result, we observe that an approach containing only the stipulation of lit a) together with a retained fixed-for-fixed stipulation under IAS 32, but accompanied by a clear rationale how to deal with economic compulsion could be the better and clearer solution as compared to the preferred approach suggested in the DP. In general, the current approach is well understood and does not require new concepts and terms, which always lead to uncertainty. According to our opinion the new approach misses two things:

- From our point of view, it should be clear that the issue of financial instruments in the functional currency of a group member can never be seen as an FX-transaction and, thus, can never result in the question whether it is a derivative.
- The existing stipulation regarding minority interests is also important for Austria, as several mutual banks are forced to issue such financial instruments because of legal requirements.

Question 3

The IASB'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?

AFRAC's response:

We do not agree: As already mentioned in our answer to Q 1 above, we have significant reservations regarding the “amount” feature in lit b.

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?

AFRAC's response:

We agree. As stated in DP 3.37f we think that this exception is commonly understood and – being accompanied by the disclosure requirements in para. 136A of IAS 1 – does not lead to an incomplete view on recognition and measurement of assets and liabilities.

From an economical point of view the omission of this exception could lead to a significant reduction of equity in some (co-operative) banks in Austria, which could potentially lead to negative consequences on financial markets.

Question 5

The IASB’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?

AFRAC's response:

We agree. Nevertheless, we want to point out that the solution to the problem shown in p. 4.42 lit (b) (i.e. foreign currency rights issues meeting the exception of IAS 32) should be reconsidered. We believe that an instrument should not be classified as a derivative, only because it is issued in a currency that is not the reporting currency of the group (but still the functional currency of the issuing entity). We believe this may cause counter-intuitive effects, especially if such rights are issued in international groups by local subsidiaries with functional currencies other than the reporting currency of the parent company. However, this topic seems to be of minor practical relevance from an Austrian point of view.

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?*

AFRAC's response:

AFRAC supports the Board's intention to clarify the treatment of compound instruments, particularly contingent convertible bonds, where some application issues arose in practice.

With regard to mandatorily convertible instruments that require the entity to deliver a variable number of its own shares, subject to a cap (and floor) (similar to some AT1 convertible instruments), AFRAC welcomes the guidance on the application of the preferred approach for classification on those types of financial instruments, and particularly the examples in para. 5.22.

AFRAC agrees that for those types of instruments the financial liability component would need to be identified in a first step, while the remaining rights and obligations would be assessed applying the classification principle for derivative financial instruments (para. 5.23).

However, it does not seem to be entirely clear how any remaining cap or floor needs to be classified. AFRAC, therefore, encourages the Board to be more explicit concerning the treatment of embedded caps and floors, with particular reference to features embedded in AT1 convertible instruments, and would also appreciate if examples on that matter could be provided.

Question 9

The IASB'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 IASB's preliminary view? Why or why not?

How would you improve the IASB'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 IASB's should consider when developing its preliminary views on disclosures?

<u>AFRAC's response</u>:

On the one hand we see the potential usefulness of the information required by the proposed approach. On the other hand, however, we see the need to balance any new disclosure requirements in the light of the cost-benefit ratio (for both the preparer and the user) as well as in the context of the overall attempts to reduce the existing disclosure overload.

Having said this, we think that the proposed requirements about priority on liquidation (para 7.4ff, esp. para 7.8 – 7.10) do not fulfil the cost-benefit balance. The same is true for para 7.13ff, esp. 7.22f, and the proposed disclosure of contractual terms and conditions of (all) financial liabilities and equity as proposed in para 7.26 – 7.29.

Question 10

Do you agree with the IASB'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?

AFRAC's response:

As already mentioned in our general remarks above, we propose a research project to evaluate whether to take economic compulsion into account, if applying the new concept. Economic compulsion is already taken into account in a number of standards such as IAS 37 (legal or factual obligation) or IFRS 13 (forced transactions not indicative of fair value). On the other hand, we accept the operational difficulties to draw distinct boundaries between equity and liability based on the economic compulsion. We see this as a shortcoming of the proposed approach and suggest to the Board to start further research work in this field in order to treat the problem of economic compulsion in a general way within the IFRSs as a whole, before making a new rule for the distinction between equity and liability which does not clarify this issue.

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?

AFRAC's response:

AFRAC agrees with the Board that rights and obligations that arise from statutory requirements imposed by law or government actions are not financial assets or liabilities (para. 8.27). AFRAC agrees that it would be a fundamental change to consider rights and obligations that arise from law within the scope of IAS 32 and that it would need extensive further work to assess the implications for other standards (para. 8.31).

However, the dividing line whether rights or obligations are within the scope of IAS 32 should be whether they arise from statutory requirements or result from a contract. AFRAC is concerned that the wording in para. 8.35 and 8.36 could be interpreted in a way even beyond this distinction, possibly resulting in a different assessment of some financial instruments than currently under IAS 32.

This might have an impact on all financial instruments, where the characteristics of the instrument are shaped by legal requirements (e.g. cooperative shares) or where legal requirements might have an impact on the contractual clauses (e.g. for some types of financial instruments subject to regulatory requirements, such as BRRD). We encourage the IASB to thoroughly assess the consequences on financial instruments in the market resulting from any change to current requirements. Some additional guidance would help to better understand the rationale and implications of the IASB proposals.