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International Accounting Standards Board
30 Cannon Street
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Comments on the Discussion Paper *Financial Instruments with Characteristics of Equity*

To the Board Members:

The Japanese Institute of Certified Public Accountants ("we" and "our") appreciates the continued efforts of the International Accounting Standards Board on this project, and welcomes the opportunity to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* ("DP").
The JICPA's comments in response to the DP are set out below.

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?

Comment:

(a) We agree with the description of the challenges identified and their causes for the reasons below.

- Conceptual challenges: A variety of features is used to distinguish liabilities from equity (e.g., the timing of a required transfer of economic resources, the amount of the claim, and its priority relative to other claims against the entity), but there is often no clear basis for selecting the distinguishing features. Furthermore, the IAS 32 definition of financial liabilities is not consistent with the definition of liabilities under the *Conceptual Framework*.
- Application challenges: Application of IAS 32 is subject to diversity in practice; many challenges have been notified to the IFRS Interpretations Committee, but numerous unresolved issues still remain.

(b) Distinguishing between financial liabilities and equity instruments is an issue of relevance to many entities, and making the distinction is important to enable users of financial statements to estimate the expected returns on their investments and compare financial position and performance among entities. We therefore agree that the challenges are pervasive enough to require standard-setting activity.

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?

Comment:

We agree with the IASB's preferred approach because we believe that an approach of employing the timing feature for assessments of funding liquidity and cash flows and the amount feature for assessments of balance-sheet solvency and returns means that features relevant to assessment of entities are used. However, if all claims with the timing feature are to be classified as liabilities without exception, we believe that puttable instruments, which are treated as exceptions in IAS 32, should not continue to be treated as exceptions.

Assuming, on the other hand, that there is a need to continue treating puttable instruments as equity, it would appear preferable to instead follow the approach of distinguishing liabilities from equity based solely on the requirements of the amount feature. From that perspective, therefore, we believe that the IASB's preferred approach should itself be revised.

In addition, we believe that deliberation on the following points is required:

- The requirement for the timing feature employs the concept of a contractual obligation at "a specified time other than at liquidation." In employing this requirement, therefore, it seems important to determine what point in time corresponds to "liquidation." However, even IAS 32 gives no clear guideline on what point in time is indicated by the concept "at liquidation." We believe that in order to make it possible to clearly distinguish claims with and without the timing feature in practice, it is necessary to more clearly define the "at liquidation" concept.
- The requirement for the amount feature employs the expression "the entity's available economic resources," but this is difficult to interpret and we believe that it risks causing confusion during application in practice. We therefore believe that this expression should be more clearly defined.

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?

Comment:
Please refer to our comments in response to Question 2.

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?

Comment:
We do not agree. If it is considered appropriate for such puttable instruments to be classified as liabilities, we believe that the IASB should apply its proposed approach and eliminate the exceptional treatment.

On the other hand, despite the fact that puttable instruments transfer economic resources at a time other than at liquidation, it may be considered appropriate to classify them as equity because they conform to the IASB *Conceptual Framework*'s definition of equity as a residual interest. In that case, we believe that, rather than the IASB employing its proposed approach and continuing with the type of exceptional treatment stipulated under IAS 32, the IASB should instead revise the proposed approach itself and develop an approach setting out an appropriate classification for the puttable exception referred to in paragraphs 16A-16B of IAS 32.

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?

Comment:

We agree with the approach to be applied to derivatives. However, foreign currency rights issues subject to the exception in IAS 32 would also be classified as assets or liabilities under this approach. We believe that the IASB should prepare for an exposure draft by discussing in greater detail whether information of more use to investors is in fact provided by an approach that results in foreign currency rights issues not being treated as equity simply on the basis of their foreign currency denomination.

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?

Comment:

We agree. However, as suggested in paragraph 5.37 of the DP, we believe that further discussion is required to consider whether this project alone should offer a conclusion on the accounting for NCI puts; such discussion should also cover questions relating to attribution to the NCI as required by IFRS 10.

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?

Comment:

We do not agree. We are concerned about the disadvantages cited in paragraph 6.44 of this DP, but supposing that OCI is to be used, we believe that the IASB needs to explain more clearly why it thinks that use of OCI would appropriately reflect an entity's financial position and financial performance. We also believe that consistency with the *Conceptual Framework* should be ensured. Furthermore, we believe that, if OCI is to be used, the amounts presented in OCI should be recycled, given that the revised *Conceptual Framework* specified the assumption that amounts presented in OCI would be recycled in a future period.

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?

Comment:

It appears that the concept of remeasurement using fair value following classification as equity—defined in the IASB *Conceptual Framework* as residual interest—is a new one. We therefore believe that the IASB should seek the opinions of users of financial statements before judging whether the benefits to users of providing such information outweigh the costs to the preparers of financial statements.

Question 9
The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments: (a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9). (b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22). (c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29). Do you agree with the Board's preliminary view? Why, or why not? How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29? Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

Comment:

We agree with the proposed disclosures. However, as suggested in paragraph 7.29 of this DP, if the IASB decides to finalize the disclosure requirement, we believe that overall consistency should be checked to ensure that there is no duplication with the disclosure requirements of other standards.

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?

Comment:

We agree.

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?

Comment:

We agree. However, there are cases in which it is difficult to distinguish between statutory and contractual obligations, such as when classifying financial instruments subject to bail-in clauses. We therefore believe that further discussion will be necessary when developing standards based on this DP, including consideration of the potential need to offer guidance regarding specific cases.

Yours faithfully,

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The Japanese Institute of Certified Public Accountants