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

8 April 2008

To: Members of the Hong Kong Institute of CPAs
All other interested parties

INVITATION TO COMMENT ON IASB DISCUSSION PAPER ON FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Comments to be received by 4 August 2008

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the IASB Discussion Paper which has been posted on the Institute's website at:
www.hkicpa.org.hk/professionaltechnical/accounting/exposuredraft/content.php.

The Discussion Paper is the first stage of the IASB's project to improve and simplify the requirements in IAS 32 *Financial Instruments: Presentation*. Stakeholders around the world have raised two broad classes of criticisms of the current requirements:

- the principles in IAS 32 are difficult to apply, and
- the application of those principles can result in inappropriate classification of some financial instruments.

The project is a modified joint project between the IASB and the US Financial Accounting Standards Board (FASB). Modified joint projects are projects in which either the FASB or the IASB have already independently been researching the topic, the Board that has already been working on the topic takes the lead role in the research stage of the project. The lead Board continues with their independent research to a discussion paper stage, both boards then publish that discussion paper for comment after which time it is anticipated that the project would become a joint project. The FASB published its Preliminary Views document *Financial Instruments with Characteristics of Equity* in November 2007. The FASB document describes three approaches to distinguish equity instruments and non-equity instruments: basic ownership, ownership-settlement, and reassessed expected outcomes. A summary of the three approaches and their possible implications are set out in the Appendix. The FASB document also briefly discusses three other approaches: the claims approach, the mezzanine approach and the loss absorption approach. However, none of those approaches is fully developed in the document.

The FASB has reached a preliminary view that the basic ownership approach is the appropriate approach for determining which instruments should be classified as equity. The IASB has not deliberated the proposals in the FASB document and does not have a preliminary view.

The goal of the Discussion Paper is to solicit the views of interested parties on whether the proposals in the FASB document are a suitable starting point for the IASB's deliberations. If the project is added to the IASB's active agenda the IASB intends to undertake it jointly with the FASB.

In accordance with the Institute's Convergence Due Process, comments are invited from any interested party. The FRSC would like to hear from both those who do agree and those who do not agree with the proposals contained in the IASB Discussion Paper.

Comments should be supported by specific reasoning and should be submitted in written form.

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To allow your comments on the IASB Discussion Paper to be considered, they are requested to be received by the Institute on or before **4 August 2008**.

Comments may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

Appendix

SUMMARY OF THE THREE APPROACHES FOR DISTINGUISHING EQUITY INSTRUMENTS FROM NON-EQUITY INSTRUMENTS AND THEIR POSSIBLE IMPLICATIONS

1) Basic Ownership Approach

Only instruments meeting the definition of a basic ownership instrument are classified as equity, all other instruments are non-equity (that includes perpetual instruments that are not basic ownership instruments).

A basic ownership instrument has both of the following characteristics:

- It entitles the holder to a claim to the company's net assets that has no priority over other claims on liquidation
- The entitlement is to a percentage of the net assets that remain after all higher priority claims have been satisfied.

A single instrument composed of a basic ownership instrument and a liability would be separated into two instruments for reporting purposes when the instrument requires a payment that does not meet the definition of a basic ownership payment (as defined above) and the basic ownership instrument remains after that payment has been made. This is the only situation in which separation into components is required or allowed under the basic ownership approach.

Under the basic ownership approach, significantly fewer instruments would be classified as equity than under IAS 32. For example, if an entity issues two classes of shares that are not equal in priority, only the class with the lower priority would be a basic ownership instrument even if both classes were labelled as "ordinary shares". All other instruments or components that have higher priority claims, such as preferred stock, would be classified as assets or liabilities even if perpetual. Also no derivative instruments would be classified as equity, this includes all share settled stock options. Under existing measurement requirements this would result in more instruments being remeasured at fair value with gains and losses being recognised in profit or loss.

2) Ownership-settlement Approach

Under the ownership-settlement approach, a company would classify instruments based on the nature of their return and their settlement requirements. Instruments that have no settlement requirements would be classified as equity. These include basic ownership instruments, other "perpetual instruments", and indirect ownership instruments settled by issuing related basic ownership instruments. An indirect ownership instrument is an instrument whose fair value moves directly with the fair value of a basic ownership instrument, and will be settled with that basic ownership instrument (ie share settled derivative transactions where the underlyer to the derivative is the shares in which the instrument will be settled).

Classification of instruments under this model considers all substantive features of the instrument, both stated and unstated, and disregards non-substantive features.

Instruments with both equity and non-equity outcomes must be separated into those components. Examples of different outcomes include both embedded obligations (ie mandatory fixed rate dividend streams) and settlement options that represent alternative outcomes for the instrument (ie put at a fixed price prior to liquidation, or share in the residual interest of the entity at liquidation). Such instruments need to be separated into their equity and non-equity components based on a maximum obligation approach (ie it is assumed the non-equity outcome will occur and that is measured first, the equity outcome is then the residual to the transaction price).

Classifications under the ownership-settlement approach would be broadly consistent with the classification in IAS 32. There are some differences including that more instruments would be separated into components with the result that more components of instruments would be classified as equity. Also, fewer derivative instruments would be classified as equity under this approach as only those instruments whose fair value changes in the same direction as the fair value of the basic ownership instrument and are ultimately settled with a basic ownership instrument would be classified as equity. IAS32 would classify derivative instruments whose fair value changes both directly and indirectly with the fair value of the underlying shares so long as the settlement represents an exchange of a fixed amount of cash for a fixed number of shares.

3) Reassessed Expected Outcomes (REO) Approach

The underlying principle of the REO approach is that instruments and components with fair value changes in the same or opposite direction as the fair value of a basic ownership instrument are considered equity or contra-equity. The REO approach focuses on an instrument's probability-weighted outcomes to determine separation and the classification of an instrument. Under this approach, the form of an instrument's settlement would not affect its classification.

The REO approach would classify many more instruments, and components of instruments, as equity than does IAS 32. However, some instruments that IAS 32 classifies as equity would be classified as liabilities under the REO approach, for example, all perpetual instruments other than basic ownership instruments. The REO approach requires the use of option-pricing models to separate and value instruments on an on-going basis. The model also requires all instruments or components of instruments other than basic ownership instruments to be remeasured at fair value with changes in fair value being reported in the profit and loss account. Hence only direct ownership instruments will not be remeasured through the profit and loss account despite a wider population of instruments being classified as equity.

4) Comparison of existing and proposed approaches

A comparison of the existing approach under IAS 32 and the proposed approaches is set out in a table on pages 20 to 25 of the Discussion Paper.