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

***Re: Comments on Discussion Paper***
***"Financial Instruments with Characteristics of Equity"***

Dear Mr. Hoogervorst:

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on Discussion Paper "Financial Instruments with Characteristics of Equity" (hereinafter referred to as the DP) published on 28 June 2018. Before drafting this comment letter, 7 members of the CAC participated in the IASB's outreach with users of financial statements held on 1 November 2018 at the ASBJ, and discussed actively with Mr. Takatsugu Ochi, a member of the IASB, and Mr. Kumar Dasgupta, a Technical Director at the IASB.

The Securities Analysts Association of Japan (SAAJ) is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members number 27,000. The Corporate Accounting Committee (CAC) is a standing committee of the SAAJ composed of 12 members, most of whom are users including equity and credit analysts, and portfolio managers, while a few others are academicians and public accountants. The CAC writes comment letters to accounting standard setters, including the International Accounting Standards Board (IASB) and Accounting Standards Board of Japan (ASBJ), and exchanges opinions with organizations including the ASBJ and Financial Services Agency.

## ***General Comments***

1. We welcome the IASB efforts to hear from the various stakeholders by publishing the DP to improve the information provided in financial statements on various financial

instruments issued by an entity and to address practical challenges when applying to IAS 32 *Financial Instrument: Presentation*.

2. However, we cannot decide with confidence how significantly the basic approach proposed in the DP to classify the certain financial instruments with the characteristics of equity, or the FICE, would increase useful information for users of financial statements. The DP proposes the approach to classify the FICE as either liability or equity according to the two criteria, the timing feature and the amount feature. We are not very sure this approach would effectively work as intended when classifying the various FICE issued in practice.

3. Therefore, we would like to express our opinion only to those questions on presentation and disclosure, which would directly impact the usefulness of the financial statements.

***<u>Question 7</u>***

**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?**

***<u>Comment</u>***

4. We basically agree with the preliminary view in paragraph 6.53(a) that an entity, applying the criteria-based approach, in the statement of financial position, present separately carrying amounts of:

(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

5. We also think that the following advantages of the criteria-based approach in the paragraph 6.25 would provide more useful information to users of financial statements to

assess the balance-sheet solvency in the following way;

(a) we expect income and expenses arising from a derivative financial asset or liability will be presented as a whole by applying the criteria-based approach. They, therefore, would reflect the effects of the change in all relevant variables on the fair value of the instrument, as well as interdependencies between the variables.

(b) compared to the disaggregation approach, the complexity and the cost would be greatly reduced for the preparers to apply, and for the users to understand the financial statements,

(c) disaggregation would become more consistent for the statement of financial position as well as for the statement of the financial performance,

(d) a derivative would be classified and accounted as whole, which is the consistent with the Board's preferred approach and the requirements in IFRS 9.

6. Having said that, we strongly disagree with the preliminary view in paragraph 6.53(b), which states that income and expenses arising from (i) through (iii) above should be presented in OCI, without subsequent reclassification, in the statement of financial performance.

7. We believe that the relative disadvantages of applying these presentation requirements using OCI in paragraph 6.44 would overweigh the relative advantages in paragraph 6.43. We doubt if the IASB should dare to make OCI even more complicated, by risking the breach of the default requirement in the Conceptual Framework as reiterated in paragraph 6.44(a), that income and expenses should be presented in profit or loss. In addition, as mentioned in paragraph 6.44(b), some economic gains or losses on claims against the entity will not be included in profit or loss without subsequent reclassification. We are concerned that such presentation without recycling would erase the important information from profit or loss about the increase in the amount of the future cash outflow even when the payment is made, as pointed out in an example of a share redeemable for its fair value in paragraph 6.47. We do not understand why the IASB dare to propose the presentation of the OCI without recycling, denying one of the key principles in the Conceptual Framework, the conceptual foundation of IFRSs.

8. We do not intend to blame the issuance of the FICE per se because we regard it as one of the key accomplishments by the development of financial engineering. However, the heavy issuance of the FICE would make an entity's capital structure extremely complicated. The sheer fact that the IASB is struggling to develop the accounting standard on FICE itself implies that such the financial instruments would make an entity's capital

structure overly complicated. Some members of the CAC doubt if it would be justified to make the capital structure too complicated by issuing a variety of FICE, not only from investors' point of view but also from an entity's capital management point of view.

9. We do not believe that accounting standards need to address the accounting mismatch arising from the issuance of the FICE. Rather, presenting accounting mismatch in financial statements as it is would make users of financial statements more attentive and encourage them to try to understand more rigorously the features of such financial instruments as well as the issuers' complicated capital structure. The costs of the accounting mismatch should be borne by the issuer of the FICE. We do not believe the IASB should pay the cost of the accounting mismatch, by breaching the principles of the Conceptual Framework.

10. In order to meet the objective of improving the information provided to the users of financial statements, it should be enough to disclose separately details of gains or losses arising from these financial instruments in the note, etc.

***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?**

***Comment***

11. We agree with the preliminary view that it would be useful to users of financial statements to expand the attribution of income and expenses to some equity instruments other than ordinary shares, when assessing the distribution of returns among equity instruments. Furthermore, we also agree with the preliminary view in paragraph 6.64, which says that "attribution of total comprehensive income to all equity instruments should be presented on the face of the statement of financial performance".

12. We also welcome the disaggregation of total equity and changes in equity between ordinary shares and equity instruments other than ordinary shares proposed in paragraph 6.62. We believe such disaggregation should improve the information about how the difference in the features of equity instruments would affect the distribution of returns

between equity instruments. Additionally, we encourage the IASB to consider how the presentation of the statement of financial position can be improved as to the distinction between ordinary shares and the other equity instruments. Specifically, we believe it would be useful to the financial statement users if ordinary shares and the other equity instruments are presented separately, in addition to existing classification between equity capital and reserves.

13. We also support the preliminary view in paragraph 6.68 regarding the attribution for non-derivative equity instruments including non-cumulative preference shares and participating equity instruments. We agree with the Board's view that such attribution should be based on the existing requirements for participating equity instruments in IAS 33.

14. The users of financial statements need to know how non-derivative instruments would affect the return attributable to the ordinary shares. We believe the information on such attribution should be greatly improved if the calculation of the basic earnings per share is presented on the face of the statements of financial performance according to IAS33, as stated in paragraphs 6.68-6.69. We strongly support the Board's view to enhance disclosure on earnings per share, one of the most fundamental valuation base of share price.

***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?**

***Comment***

15. We agree with the preliminary view to provide the information (a)-(c) above in the notes to the financial statements.

16. Information about the priority on liquidation is particularly important when classifying financial instruments as either equity or liabilities. We would welcome the disclosure of such information in a list of all financial liabilities and equity instruments in the order of their priority, as shown in paragraph 7.9. We expect the such disclosure should make users of financial statements understand more easily the exact order of the priority of the financial instruments issued by an entity, because they no more need to presume the priority based upon the limited information.

17. Similarly, we would welcome the disclosure of information about potential dilution of ordinary shares, as shown in the illustrative example in paragraph 7.23. The table in the paragraph provides a list at the end of each reporting period of all financial instruments that could dilute the ordinary shares. Such a table is very informative and would help the users of financial statements to assess the distribution of returns among equity instruments and how this may change in the future, as paragraph 7.25 points out. Furthermore, it would also help the users of financial statements to assess the effect of potential dilution if a similar list is disclosed regarding financial instruments such as share options and restricted stock units issued for performance-linked compensation.

18. We encourage the Board to deliberate how the disclosure could be enhanced in order to support the users of financial statements to estimate the future earnings per share, one of the most fundamental base of share price valuation. Should the more detailed and exact information about the potential dilution of ordinary share be provided, the users of financial information can estimate the shares outstanding in the future more accurately.

19. We believe the following information in paragraph 7.27 about terms and conditions are particularly useful if disclosed in the notes to financial statements; "terms and conditions that are relevant to determining the settlement amount" and "the timing of settlements, including the effect of any options and contingencies". If disclosed, these information would help users of financial statements assess "funding liquidity and cash flows" and "balance-sheet solvency and returns (measured on an accrual basis)" in paragraph 2.17.

20. Furthermore, the financial statements do not currently provide comprehensive disclosure about terms and conditions for financial instruments such as hybrid securities. The users of financial statements, therefore, need to look into the several information sources other than financial statements, including the prospectus and the analyst reports

issued by credit rating agencies. Because of this lack of disclosure, some members of the CAC believe that it would be very useful to users of financial statements if more information is provided about terms and conditions as a list in the notes. In their opinion, the list should include the terms and conditions such as “deferral of principal and interest payments” and “replacement capital covenants” for financial instruments classified as financial liabilities.

Sincerely yours,

Satoshi Komiyama
Chair
Corporate Accounting Committee