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Agenda ref **9A**

STAFF PAPER

January 2014

IFRS Interpretations Committee Meeting

Project	**IAS 32 *Financial Instruments: Presentation***		
Paper topic	Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event—Comment letters received		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

1. We received twelve comment letters on the IFRS Interpretations Committee's tentative agenda decision and those letters are set out below.

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23 September 2013

Mr Wayne Upton
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Dear Mr Upton,

IAS 32 Financial Instruments – Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

The Australian Bankers' Association (**ABA**) is pleased to respond to the IFRS Interpretations Committee's (**the IC**) tentative decision made at its July 2013 meeting in respect of mandatorily convertible instruments subject to a contingent non-viability event (Agenda paper 18).

The ABA works with its members to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services. The ABA works to ensure the banking system can continue to deliver the benefits of competition to Australian banking customers.

We make the following comments on the tentative decisions made by the Interpretations Committee:

a) The ABA agrees with the Interpretations Committee's view that such instruments could be compound instruments comprised of a financial liability, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and an equity component, which reflects the issuer's discretion to pay interest.

b) The ABA also agrees that as the contingent non-viability clause could occur immediately, as it is beyond the control of the issuer, the liability component should be measured at the full amount that could be required to be paid immediately (i.e. the equity component, as the residual, is measured at zero; referred to as View 3 in the July staff paper).

However, although we acknowledge that the basis on which the IC reached its conclusion is one valid interpretation of IAS 32 Financial Instruments: Presentation (IAS 32), we believe that there are other equally valid interpretations of IAS 32 which would support the classification of the distribution payment as an interest expense through the income statement when zero value is attributed to the equity component upon initial recognition of the instrument.

We believe that our alternative view is also appropriate, for the reasons that follow.

Due to the non-viability clause the instrument is classified as a financial liability in its entirety, and we consider the application of IAS 32 par 35 should be based on what is recognised in the financial statements upon initial recognition. As 100% of the instrument is attributed to the financial liability, the instrument could be viewed **wholly** as a liability which is supported by IAS 32 par 36 "dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond." [emphasis added]

We acknowledge the example in IAS 32 AG 37 which considers the treatment of discretionary dividends, however that example assumes a value has been ascribed and recognised as equity upon initial recognition in the financial statements (attributable to the discretionary dividend equity component). Our view is that if zero value is attributed to equity, then this should be reflected when considering IAS 32 par 35 (i.e. in substance treated as a financial liability in its entirety and the dividend should be treated as interest expense). This is also consistent with the accounting for transaction costs on such compound financial instruments which are proportionately allocated amongst the components (i.e. if zero value would be ascribed to the equity component then all transaction costs on the instrument would be recognised as part of the liability and ultimately recognised in the income statement as part of the effective yield).

Treating distribution payments on such instruments as dividends, when the full instrument is initially recognised as a financial liability, does not result in a faithful representation of the balance sheet and profit or loss statement, and is inconsistent with IAS 32 par 35 and 36.

While the example used for the IC was a relatively simple example, in practice such convertible instruments vary considerably across jurisdictions and are complex. Taking such a narrow view on the treatment of dividends without regard to the varying degrees of complexity across regions may result in not faithfully representing the economics of the specific transactions and various issuances. The IC's narrow interpretation does not align with the substance of the terms of such instruments.

Distributions on such convertible instruments in Australia, while being strictly at the issuer's discretion, also have a related "dividend stopper" feature (dividends on ordinary shares cannot be declared if no distribution is made on the convertible instrument). Accordingly the likelihood of the distributions being withheld is considered very remote. While we acknowledge that IAS 32 AG 26 disregards intent or history of making distributions in the classification of an instrument, the evidence remains that the discretionary nature of distributions on the instrument is not considered by investors to be a substantive feature, and in substance, the distributions represent payments of interest (i.e. the instrument is considered substantively to be a financial liability in its entirety).

The justification provided in the July IFRS staff paper does not provide a compelling argument as to why such distributions should only be treated as equity, particularly having regard for the alternative view which treats distributions based on how the instrument as a whole is classified. We believe the alternative view (i.e. distributions treated as interest expense) results in a more representational and faithful outcome as economically such instruments are effectively a debt instrument until the occurrence of a remote event (the contingent non-viability event).

In Australia, during 2012 and 2013 all of the major commercial banks issued very similar convertible preference share instruments as part of their preparation for Basel III, which contained non-viability clauses (i.e. a specific decline in Tier 1 regulatory capital ratios) – all of these banks have classified such instruments entirely as a financial liability and treated distributions as interest expense.

The removal of the distribution on such compound instruments from interest expense would change each bank's net interest margin 'NIM' calculation for statutory purposes.

As a result, each bank's true cost of funding would be distorted and net interest income would be considered misleading. In order to bridge this gap, and to assist investors, this would likely result in additional non-IFRS measures of each bank's financial results to be presented outside of their annual reports. As NIM is a key measure of a bank's performance, having alternate underlying and statutory measures due to the statutory accounts not reflecting what investors consider being economic reality is something we wish to avoid.

Accordingly, we encourage the Interpretations Committee to reconsider its tentative view that the distributions on such instruments must only be recognised in equity. We believe there is sufficient guidance in IAS 32 for an accounting policy to decide on the appropriate classification of the distributions based on the specific nature of the issued instruments and suggest removal of the sentence quoted below from the proposed wording for the agenda decision:

> *"Nevertheless, the Interpretations Committee noted that if the issuer pays any interest on the instrument, those payments relate to the equity component and, accordingly, would be recognised in equity."*

Yours sincerely,

Tony Burke

Accounting Standards Board
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September 17, 2013

(Via email to ifric@ifrs.org)

IFRS Interpretations Committee
30 Cannon Street
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United Kingdom

Dear Sirs:

Re: Tentative agenda decision on IAS 32 *Financial instruments: Presentation* – Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the IFRS Interpretations Committee's tentative agenda decision regarding classifying financial instruments that are mandatorily convertible into a variable number of shares upon the occurrence of a contingent non-viability event. This tentative agenda decision was published in the July 2013 IFRIC Update.

The views expressed in this letter take into account comments from individual members of the AcSB staff but do not necessarily represent a common view of the AcSB or its staff. Views of the AcSB are developed only through due process.

We disagree that IAS 32 is clear given the fact pattern submitted and we disagree with the conclusion reached by the Committee. We note the difficulty that Committee members seemed to express with applying the requirements of IAS 32 to the subject instrument and the carefully considered opposing views of practitioners consulted. We agree that the instrument described meets the definition of a financial liability. However, we disagree that the non-viability condition necessarily causes the instrument to be immediately convertible. We think that non-viability triggers are analogous to covenants in debt instruments that cause an instrument to be in default if and when breached. We think that most financial institutions have at least partial control over the adequacy of their Tier I capital and that the terms and conditions of these instruments are not uniform across jurisdictions. The issuer needs to evaluate the terms and conditions of any instrument it issues to determine the effect of the non-viability condition. We do not agree that the full face amount of the issue necessarily represents its fair value at the issue

date. We are concerned that the answer provided in the tentative agenda decision would have repercussions for debt instruments issued with covenants.

We would be pleased to provide more detail if you require. If so, please contact me at +1 416 204-3276 (e-mail PMartin@cpacanada.ca) or Kate Ward, Principal, Accounting Standards at +1 416 204-3437 (e-mail KWard@cpacanada.ca).

Yours truly,

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Director, Accounting Standards

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20 September 2013

Dear Sirs

Tentative Agenda Decision - IAS 32 Financial Instruments: Presentation - Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

We are writing in response to the IFRS Interpretations Committee's tentative agenda decision not to take the above item onto its agenda.

Although we acknowledge the technical analysis set out in the tentative agenda decision, we note that in practice there appears to be diversity in accounting for instruments with contingent 'non-viability' features that are similar to those included in the instrument that the Interpretations Committee discussed. If the approach set out in the tentative agenda decision were to be adopted by all entities with these types of instruments, it is possible that there would be some significant changes in practice.

Consequently, we believe that it would be appropriate for the Interpretations Committee to revisit its tentative decision and give consideration to taking this item onto its agenda and developing an interpretation.

Yours faithfully

Andrew Buchanan

Andrew Buchanan

Global Head of IFRS

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September 25, 2013

Mr. Wayne Upton
Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Mr. Upton:

Re: Tentative Agenda Decision: IAS 32 Financial Instruments: Presentation: Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

The Canadian Bankers Association[1] (the "CBA") appreciates the opportunity to comment on the International Financial Reporting Interpretations Committee's ("IFRIC") publication in the July 2013 IFRIC Update of the tentative decision not to take onto the IFRIC's agenda a request for an Interpretation of IAS 32 *Financial Instruments: Presentation* - Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. The issue addressed in the publication was how an issuer should classify a mandatorily convertible financial instrument in accordance with IAS 32, *Financial Instruments: Presentation* ("IAS 32"), in which the financial instrument did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments if the issuer breached a prescribed level for the Tier 1 Capital ratio (i.e. described as a 'contingent non-viability event').

We agree with the Committee's decision not to add this item to its agenda for the reasons provided in the tentative agenda decision.

We also agree that the instrument with the features described in the submission is a compound instrument and that the contingent conversion feature to deliver a variable number of shares represents a liability classified component pursuant to IAS 32 paragraphs 11 and 25, as noted in

[1] The Canadian Bankers Association works on behalf of 56 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 275,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

the agenda decision. However, we disagree with the accounting and measurement approach outlined that attributes the full settlement value to the liability component which is in fact, due to the contingency, an unlikely or remote occurrence at the time of issuance, and does not attribute any value to the equity component.

Consistent with View 2 in the publication, we believe that the appropriate application of IAS 32 paragraphs 11, 23 and 25 is to determine the value of the liability component based on the issuer's best estimate of the present value of the redemption amount and then to classify the residual to the preferred share equity component. IAS 32.23 calls for the liability component to be measured at fair value, which then leads us to IAS 39, *Financial Instruments: Classification and Measurement* ("IAS 39"), for guidance on fair value measurement. IAS 39.AG69 states that underlying the definition of fair value is the presumption that an entity is a going concern without any intention or need to liquidate. It therefore is inappropriate in our view to value the liability assuming the NVCC is going to be triggered. The existence of the contingency reduces the likelihood of the conversion occurring and therefore would result in the liability component value being minimal and the residual equity value being the predominant component.

The view presented in the proposed agenda decision results in the full settlement value being attributed to the NVCC liability. The proposed agenda decision cites support for the NVCC liability measurement being that the contingency could resolve immediately and therefore there lacks a time value component to equity. While we believe that expectations around the potential timing of a conversion are relevant to measuring the liability component, we do not believe that the theoretical possibility for conversion requires the entire instrument to be classified as a liability if that is not the expectation. The IFRIC's reference to paragraph IAS 32.BC12 doesn't appropriately address the nature of a contingency in the measurement of the liability feature. The view the IFRIC staff is putting forward for valuation of the liability component of a preferred share with an NVCC feature is akin to non-going concern valuation, which, as noted above, would seem reasonable only when the NVCC feature is likely to be triggered, and which is not consistent with the preparation of financial statements under the going concern assumption.

We also note that NVCC features are required in capital issuances in many jurisdictions to qualify as Basel Tier 1 capital, but the specific features of each NVCC feature may differ, which may impact the accounting conclusion reached.

We request the IFRIC board revisit the proposed agenda decision to reflect View 2 as the more appropriate application of IAS 32 to an NVCC instrument. We also request acknowledgement from the IFRIC board that NVCC instruments in different jurisdictions will contain different contingent conversion features that may impact the accounting conclusions reached with regards to a particular instrument.

Sincerely,

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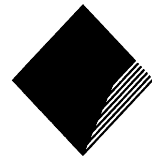

24 September 2013

Wayne Upton
Chairman
IFRS Interpretations Committee
International Accounting Standards Board
1st Floor 30 Cannon Street
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UNITED KINGDOM

Dear Mr Upton

Re: Tentative Agenda Decision Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

We wish to express our support for the comments put forward by the Australian Bankers' Association (ABA) dated 23 September 2013, on the issue of the tentative agenda decision made at its July 2013 meeting in respect of mandatorily convertible instruments subject to a contingent non – viability event (Agenda paper 18) by the IFRS Interpretations Committee for the following reasons:

- In Australia all of the major banks have issued Basel III compliant hybrid instruments which have as a key feature the non-payment of dividends and conversion to equity in certain stressed scenarios.
- It should be noted that during the GFC these banks continued to pay both coupons on their hybrid instruments (then under Basel II) and dividends to shareholders.
- All of these banks have classified their Basel III hybrid instruments as debt and recorded interest expense rather than dividends in the Income Statement.
- The removal of the distribution on compound instruments from interest expense would change each Bank's net interest margin 'NIM' calculation for statutory purposes and cause investors to add back the interest expense to derive an underlying NIM. As NIM is a KPI for Banks, having alternate underlying and statutory measures due to the statutory accounts not reflecting what investors consider economic reality is something we wish to avoid.

In light of the above and the arguments put forward by the ABA, we request the Interpretations Committee to reconsider its tentative view that the distributions on such instruments in all situations must be recognised in equity. We consider that the existing guidance is sufficient and results in information that is useful to the users of banks' financial statements.

Should you have any queries regarding our comments and feedback, please do not hesitate to contact David Huxtable at David.Huxtable@cba.com.au.

Yours sincerely

Michael Ford

Deputy CFO

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25 September 2013

Dear Mr Upton

Tentative Agenda Decision - IAS 32 *Financial Instruments: Presentation*: Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the July IFRIC Update of the tentative decision not to take onto the Committee's agenda a request for clarification of the classification as equity or as a liability of a financial instrument that has no stated maturity date, pays interest at the discretion of the issuer and is mandatorily convertible into a variable number of equity shares upon breach of the issuer's Tier 1 Capital ratio ('the contingent non-viability event').

We believe that the tentative agenda decision as currently drafted is not sufficiently clear about the two distinct issues relevant to this instrument (its classification and the measurement of any liability component to be recognised) and does not recognise that for each of these issues more than one valid view exists. Before proceeding, we believe the Committee should consider more explicitly these two questions and the alternative views.

Classification of the instrument

We agree with the statement in the tentative agenda decision that the instrument is a compound instrument due to the discretionary nature of interest payments (which are, as a result, an equity feature) and the contingent mandatory conversion into a variable number of equity shares (which is a liability feature).

We disagree, however, that the only appropriate characterisation of the liability component of the instrument is as a non-derivative liability akin to a demand obligation. We believe that consideration of this liability as a derivative (and, therefore, of the instrument as an embedded derivative with an equity host contract) would also be appropriate as the issuer's obligation to redeem the instrument can be characterised as a derivative that is an exchange of a fixed number of equity host contracts for a variable

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number of shares that are contingent on a future event. Such an instrument would fail the fixed-for-fixed criteria and therefore would be a financial liability.

Measurement of the financial liability component

On this issue we similarly believe that other valid views exist in addition to the analysis presented in the tentative agenda decision.

If the liability component is considered to be a derivative, then it must be measured at its fair value which will reflect the probability of the contingent feature being exercised in its fair valuation.

If it is considered a non-derivative (as in the tentative agenda decision) we do not consider the standard is clear about how such a non-derivative shall be characterised, specifically whether it is akin to a demand deposit that is not contingent (as in the tentative agenda decision) or a liability with a contingent feature. The characterisation is critical as it determines what the terms are that are subject to fair valuation.

Although we agree that one of the conclusions, as stated in the tentative agenda decision, could be that it is a non-derivative liability that is akin to a demand deposit and therefore fair valued assuming the contingent feature will occur is reasonable, we also believe a contrary view can validly be argued. The alternative view is that the analogy to the measurement of a demand deposit in IAS 39 is not relevant as the holder does not have the right to demand redemption. We believe it can be argued that measuring a demand deposit at the minimum amount that the holder can demand applies only when that amount is capable of being demanded, i.e. it is not contingent other than the passage of time and the holder's right to demand redemption. The financial instrument that the Committee is considering is not capable of being redeemed on demand unless the issuer is regarded as non-viable. Under this view, until the issuer is non-viable, the liability is not akin to a demand deposit and consequently is not fair valued assuming the contingent feature will occur. Its fair valuation would include the probability of the event occurring.

We believe that the Committee's agenda decision should more explicitly acknowledge these two questions and that there is more than one valid view for each.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0)20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

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25 September 2013

Dear IFRS Interpretations Committee members,

Tentative Agenda Decision – IAS 32 *Financial Instruments: Presentation* – Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, is pleased to submit its comments on the above Tentative Agenda Decision, as published in the July 2013 IFRIC Update.

The IFRS Interpretations Committee (the Committee) received a request "to address the accounting for a particular financial instrument that converts into a variable number of the issuer's own equity instruments in the event of the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument."

We disagree with the Committee's tentative agenda decision that its analysis of the existing IFRS requirements meant that neither an interpretation nor an amendment to a standard was necessary. Even though we agree that it is clear that the issuer's obligation to deliver a variable number of its own equity instruments in case of the contingent event occurring meets the definition of a liability, we believe that even then IAS 32 is open to interpretation regarding:

- whether there is a compound financial instrument, which relates to how to treat the related discretionary interest payments; and
- how that liability should be measured.

There are three different views of how to apply IAS 32 (all of which were discussed at the Committee meeting – Views 1 to 3 in Staff Paper 18) that can be supported by different parts of the standard, including its interaction with IAS 39 *Financial Instruments: Recognition and Measurement*. Appendix A sets out our rationale why we believe that those three views can be supported by IAS 32.

However, we agree with the objective of reducing the alternative views that can be reached by interpreting IAS 32 in its current form, in particular because the outcomes under those alternatives are very different and relate to an important aspect of financial reporting. Therefore, the diversity in practice is a significant concern. But we think that in order to

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achieve that objective, changes to authoritative guidance (either an Interpretation or changes to IAS 32) would be needed.

Appendix B sets out our considerations of what changes to authoritative guidance would be needed to reduce the diversity in views and improve the clarity of the requirements. We believe those improvements to the existing authoritative guidance can be done at a principle-level as limited amendments, without embarking on a major project on liability versus equity classification. We appreciate that the IASB's current project on the Conceptual Framework also addresses this aspect and that a major standards-level project would realistically take considerable time and could only start after the Conceptual Framework will have been completed. In contrast, we believe that a project to develop the amendments we consider in Appendix B could be undertaken, and completed, by either the Committee or the Board in the near term.

Should you wish to discuss the contents of this letter with us, please contact Tony Clifford at the above address or on +44 (0)20 7951 2250.

Yours faithfully

Ernst & Young Global Limited

Appendix A

This appendix sets out why we believe that three views of how to apply IAS 32 that were discussed at the Committee meeting (Views 1 to 3 in Staff Paper 18) can be supported by IAS 32.

Support for View 1

- View 1 is based on applying the requirements of IAS 32 in the sequence in which they are set out in the standard.
- First, the definition of a financial liability is applied. The fact that under the terms of the instrument the entity may be obliged (in case of the 'non-viability' event occurring) to deliver a variable number of its own ordinary shares to settle the instrument means that it meets the definition of a non-derivative liability (see IAS 32.11(b)(i) of the definition of a financial liability).
- Next, the guidance on the presentation as equity or a liability is applied, which is an elaboration of the definitions of a financial liability and equity. The instrument is only settled in the variable number of ordinary shares if the 'non-viability' event occurs. Because that contingency is outside of the issuer's control (similar to a debt-to-equity ratio; see IAS 32.25), the entity's ability to avoid settlement is conditional on the contingent event not occurring. Consequently, the entity does not have an *unconditional* right to avoid settlement. This confirms the assessment of the definition above and results in classifying the instrument as a non-derivative financial liability. These requirements also demonstrate that the classification as equity or a liability is based on whether an obligation to deliver cash[1] exists in terms of whether there is an *unconditional* right to avoid such an outcome. Consequently, the probability of delivering cash (or other financial assets, or otherwise settling the instrument in a way that would represent the settlement of a liability) cannot be taken into account in accounting for this liability (unless a feature is not genuine). Using a probability-weighted assessment would be inconsistent with the binary assessment of whether the right is unconditional (i.e. avoidable in all circumstances no matter how likely to occur). Without taking a probability weighting of the 'non-viability' event into account, the entire initial fair value of the instrument as a whole is classified as a liability because the contingent event could occur at any time, i.e. immediately.
- Consequently, the requirements for compound financial instruments do not apply because the assessment of the definition and the presentation requirements have resulted in classifying the instrument as a liability for the amount that is the initial fair value of the instrument in its entirety. The requirements for treasury shares are not applicable to this issue so next, the requirements for recognising interest, dividends, losses and gains are applied. IAS 32.35 and 36 require that the accounting for discretionary interest payments *follows the accounting* for the instrument that they relate to (instead of being subject to their own independent assessment for classification

[1] Or alternatively deliver other financial assets or otherwise settle the instrument in a way that would represent the redemption of a liability.

purposes). Consequently, even though discretionary, those payments must be recognised as an expense. In particular, IAS 32.36 sets out: "The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond." This is corroborated by IAS 32.40 about the presentation in the statement(s) of profit or loss and other comprehensive income of dividends classified as an expense.

In addition, View 1 cannot be rebutted based on the example in IAS 32.AG37 that the Committee cited in support of its view that an equity component exists. In that example, the financial instrument has a fixed term of five years. Also in that case the obligation to deliver cash in five years is a zero-coupon debt instrument, initially measured at the present value of the redemption amount, and the equity component represents the present value of the discretionary payments. That reflects the fact that because of the fixed term of the instrument the entity will definitely have the discretion over those five payments, and it is consistent with the measurement of the obligation to deliver cash at its present value (i.e. the two present values complement each other). In contrast, the instrument discussed by the Committee includes the 'non-viability' event contingency. This contingency has the effect that the entity's discretion over the 'interest' payments is also only contingent. The entity will have that discretion only if the 'non-viability' event does not occur before the decision on whether to make the respective payment is due, whereas if the contingency occurs earlier the entity never gets to exercise its discretion. Consequently, the feature that constitutes the equity component in the example of IAS 32.AG37 might, for the instrument discussed by the Committee, not come into effect because of an event beyond the control of the issuer. Because of that difference between relevant terms of the two instruments, the difference in the accounting outcomes does not constitute an 'inconsistency' that could call View 1 into question.

Support for View 2:

- View 2 assumes that the requirements of IAS 32 are *not* applied in the sequence in which they are set out in the standard.
- Instead, View 2 starts with identifying any discretionary payments, which by virtue of their existence give rise to equity. This is based on the example of IAS 32.AG37, which illustrates that discretionary payments constitute an equity component. View 2 applies the definitions of a financial liability and equity to the discretionary payments in isolation. Consequently, the discretionary payments represent equity because the entity has no contractual obligation to deliver that cash.
- The obligation to deliver a variable number of shares if the contingent 'non-viability' event occurs constitutes a financial liability (for the same reasons as under View 1, i.e. settlement by delivering a variable number of shares as a result of a contingency that is outside the issuer's control).
- Consequently, there is a compound financial instrument for the purpose of liability or equity classification.

- For the measurement of the liability component, IAS 32.32 is applied. This means the liability component is determined first "by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component." This means the 'similar liability' is a zero-coupon instrument type payment that is contingent on the 'non-viability' event because that contingency is an embedded non-equity derivative feature and therefore must be included in the terms of the 'similar liability'. The fair value of such a liability would require a probability-weighted assessment of whether and when the 'non-viability' event occurs because the contingency is not a 'demand' feature. IFRS 13 *Fair Value Measurement* requires using assumptions that market participants would use for pricing the item (see IFRS 13.22). Market participants would not treat this instrument as if it was 'on demand', as it contains a contingent 'non-viability' settlement term and not a counterparty call option, but take into account that the 'non-viability' event occurring immediately is only the 'worst case' scenario. Consequently, the measurement of the liability needs to reflect the probability-weighted assessment of when the 'non-viability' event might occur, which means it is a present value. In contrast, measuring the liability at an undiscounted amount as per the analysis of the Committee (i.e. View 3) would contradict IFRS 13 and IAS 39, which requires a financial liability to be measured at fair value on initial recognition (see IAS 39.43).
- However, View 2 depends on the interpretation that the requirements for compound financial instruments (IAS 32.28-32) are separate from the requirements of the IAS 32 regarding puttable features, put options, and contingent settlement provisions – all of which are based on a 'worst case' scenario for the purpose of liability versus equity classification, and disallow a probability-weighted approach. View 2 in substance overturns the liability classification for amounts for which the entity does not have an unconditional right to avoid settlement and that therefore fail the equity definition. View 2 also does not apply the requirements in IAS 32 in sequence because it characterises the instrument as a compound financial instrument only by first looking at the discretionary payments in isolation, and then applying IAS 32.28-32 to that instrument.

Support for View 3:

- The argument for View 3 is largely the same as that for View 2 – except that for the purpose of measuring the liability component of the compound financial instrument the 'worst case' scenario is assumed (i.e. immediate occurrence of the 'non-viability' event).
- View 3 avoids the inconsistency of View 2 regarding the use of a probability-weighted outcome to measure a liability with a contingent settlement provision, which means it avoids classifying as equity amounts for which the entity does not have an unconditional right to avoid settlement and that therefore fail the equity definition. Similarly to View 2, View 3 characterises the instrument as a compound financial instrument, thereby not applying the requirements in IAS 32 in sequence. In particular, View 3 and how it applies IAS 32.AG37 to the instrument cannot be reconciled with paragraphs 36 and 40 of IAS 32. Those paragraphs require that the accounting for discretionary payments follows

the accounting for the instrument that they relate to – but they could never apply if the fact that a payment is discretionary by itself meant that there was an equity component. View 3 illustrates this outcome taken to its extreme because it does not recognise discretionary payments as an expense even if the entire carrying amount of the instrument as a whole is classified as a liability.

Appendix B

This appendix sets out our considerations of what changes to authoritative guidance would be needed to reduce the diversity in views and improve the clarity of the requirements. This is a 'roadmap' that highlights which are the relevant principle-level issues that should be addressed by limited amendments to IFRSs. Because our suggestions in this appendix relate to principle-level issues, they go beyond only addressing aspects of the accounting for the convertible instrument addressed in Staff Paper 18 (in particular, some points are also relevant to the Committee's discussion in relation to Staff Paper 17 of the July 2013 meeting).

Use of assumptions: 'worst case' versus probability-weighted

- IAS 32 sets out many instances in which the classification of financial instruments as liabilities or equity is based on the *possibility* that the instrument might have to be redeemed when that possibility is not within the issuer's control. Examples are:
  - The parts of the definition of a financial liability that refer to "may" be obliged or be settled as well as the additional guidance in IAS 32.19 that refers to an *unconditional* right to avoid delivering cash (or other financial assets) and sets out that factors such as restrictions on the ability to satisfy those obligations and a counterparty's likelihood of exercising its right to redemption, even though they might result in no amount being redeemed, do not affect the classification of the instrument. This is corroborated by IAS 32.23 and in the application guidance (in paragraphs AG25 and AG27(b)).
  - Puttable financial instruments, which meet the definition of a financial liability irrespective of the probability of the put being exercised (notwithstanding the classification of some of those instruments as equity because of the explicit limited scope exception that was added to IAS 32 in February 2008 but which cannot be analogised to).
  - The requirements for contingent settlement provisions, which refer to an *unconditional* right to avoid delivering cash (or other financial assets or otherwise settling the instrument in a way that would represent the redemption of a liability).
  - The requirements relating to settlement options, which set out that a derivative instrument is not equity unless all alternatives would result in equity classification, which means the probability of each alternative occurring is irrelevant for classification purposes.
- We think that a principle could be explicitly established that for the purpose of the classification as equity or a liability, consistent with the irrelevance of the probability of settlement, the 'worst case' assumption must be used, i.e. that redemption occurs on the *first possible date* irrespective of the probability that it occurs on that date. The first possible date is the earliest date at which the entity could be required to redeem the instrument (or a part of it), which means that for redemptions that are contingent on future events it is assumed that the event occurs on the earliest date possible (which

could be immediately). That would clarify, by making it explicit, how contingent settlement provisions affect the assumptions for the timing of a contingent settlement. The existing guidance addresses (explicitly) only timing that is a fixed or determinable date or on demand (see IAS 32.AG27(a)).

Interaction between classification and measurement

- The Board or the Committee should consider clarifying the relationship between the assumptions used for:
  - the purpose of classification of a financial instrument as equity or a liability under IAS 32; and
  - the measurement of the financial liabilities that result from that classification.
- We think that a principle could be explicitly established that:
  - IAS 32 applies to the initial measurement of a financial liability, or a financial liability component of a compound financial instrument;
  - IAS 39 applies to the subsequent measurement of the liability; and
  - the measurement under IAS 39 must be consistent with the initial measurement under IAS 32 and the financial liability as it was identified under IAS 32, which means it must use the same assumptions.
- IAS 32 applies to the initial measurement of a liability, or a liability component of a compound financial instrument, because that initial measurement affects the classification of amounts that are presented as equity or as a liability. For example, measurement has an effect on the presentation as equity or a liability under IAS 32 for compound financial instruments because the measurement of equity as a residual amount means that it is affected by the assumptions used for the measurement of the parts of the instrument that were identified as a liability. In other words, the determination of the liability component has two dimensions, (i) the identification of the component and (ii) the measurement of what has been identified. This means that the *same assumptions* used for the purpose of identifying a financial instrument, or components of it, as equity or a liability under IAS 32 *must also be used* for the initial measurement of the identified liability (or liability component). That means, for example, that if a financial instrument (or a part of it) is classified as a liability because of a contingent settlement provision, the measurement of the liability uses the same assumption, i.e. it is based on the 'worst case' as well. This means any discounting is based on the assumption that the contingent event occurs on the earliest date possible (which could be immediately) – irrespective of how likely it is that the event occurs on that date.
- IAS 39 applies to the subsequent measurement of the liability that results from applying IAS 32 (which is already set out in IAS 32.23). The measurement under IAS 39 must be consistent with the initial measurement under IAS 32 and the financial liability as it was identified under IAS 32. Consequently, the subsequent measurement under IAS 39 must use the *same assumptions* that were used for classification as equity or a liability under

IAS 32. So in the example of a financial instrument (or a part of it) that is classified as a liability because of a contingent settlement provision, the subsequent measurement of the liability under IAS 39 would use the same assumption, i.e. it will continue to based on the 'worst case'. Hence, it would be valued as if a demand liability, as set out in IFRS 13.47.

- Unless the measurement under IAS 32 and IAS 39 is aligned with the assumptions for classification (in terms of identifying) as equity or a liability, the accounting for a financial instrument would implicitly involve different units of account, which creates inconsistencies in the accounting. For example, this is apparent from View 2 that was discussed at the July Committee meeting: that view applies fair value measurement using assumptions that are inconsistent with the criteria for classifying the financial instrument as equity or a financial liability, with the result, in substance, of overturning the liability classification for amounts for which the entity does not have an unconditional right to avoid settlement and that therefore fail the equity definition (see Appendix A). In other words, if the classification under IAS 32 is based on the 'worst case' assumption then the fair value of the related liability component cannot include market participants' assumptions about the likelihood of the 'worst case' occurring. Instead, the assumptions for fair value measurement purposes should follow those used when applying IAS 32 to identify the financial liability. This is not an inconsistency with IFRS 13 but instead is how IFRS 13 should be applied to the financial liability (as identified under IAS 32) that needs to be measured (and from which all other possible cases than the 'worst case' have been excluded).
- Consequently, clarifying the interaction between classification and measurement as well as between IAS 32 and IAS 39, and what assumptions must be used, could resolve a perceived conflict that until now causes confusion and diversity in practice.

Settlement in cash or other financial assets versus settlement in an entity's own equity instruments in a way that fails the equity definition

- We think that a principle could be explicitly established that for the purpose of the classification as equity or a liability, settlement in an entity's own equity instruments in a way that fails the equity definition is equivalent to delivering cash or other financial assets.
- This would align paragraphs 19 and 20 with paragraph 25 of IAS 32. We can see no reason why settlement of an instrument in an entity's own equity instruments in a way that fails the equity definition should result in a different outcome for classification as a liability or equity. For example, in the case of the other convertible instrument (addressed by Staff Paper 17) that the Committee discussed at its July 2013 meeting, one of the questions was whether IAS 32.20(b) could be applied even though that paragraph only refers to settlement in cash or another financial asset but not settlement in a variable number of equity instruments of the entity. If the principle mentioned above was established, the answer would be clear.

Sequence of applying the requirements:

- The Board or the Committee should consider whether the requirements of IAS 32 have to be applied in the sequence of the topical areas represented by the sections in that standard. If so, that should be explicitly established because that would improve the clarity of how the different requirements interact.
- For example, such a principle would clarify the following issues:
  - Whether the assessment of the financial instrument against the definitions of equity and a financial liability is performed (i) by first applying the definitions to the financial instrument as a whole or (ii) by assessing all possible deliveries and receipts of cash, other financial assets and equity instruments that could occur under the contract independently of each other, i.e. in isolation. This would clarify whether discretionary cash flows that relate to an instrument whose entire carrying amount is presented as a liability follow that classification and therefore are recognised as an expense (as set out in paragraphs 35, 36 and 40 of IAS 32). If the answer is alternative (i), the standard could be improved by emphasising that a financial instrument can be classified as a liability in its entirety as the result of applying the definitions even if it involves discretionary cash flows, and therefore the compound financial instruments requirements do not override the approach whereby the recognition of interest, dividends, gains and losses follows the presentation of the instrument that they relate to. Conversely, if the answer is alternative (ii), paragraphs 36 and 40 of IAS 32 should be amended. In addition, IAS 32.35 and the guidance on compound financial instruments should be revised to set out clearly that any discretionary cash flow represents an equity component, which might have a carrying amount of nil if the entire carrying amount of the related financial instrument is presented as a liability. This should also be clearly identified as an exception to applying the requirements in sequence.
  - Whether the guidance related to IAS 32.16(a) (i.e. IAS 32.17-20) can be used when evaluating the criteria set out in IAS 32.16(b). This is relevant for the question whether the guidance for settlement in cash or other financial assets (e.g. IAS 32.20(b)) also applies to instances where the obligation is always settled in shares (i.e. there is a settlement alternative in a variable number of shares instead of cash or another financial asset). This relates to our earlier point whether for the purpose of the classification as equity or a liability, settlement in an entity's own equity instruments in a way that fails the equity definition is equivalent to delivering cash or other financial assets. If so, that principle (i.e. that for the purpose of the classification as equity or a liability, settlement in an entity's own equity instruments in a way that fails the equity definition is equivalent to delivering cash or other financial assets) would have the effect that the sequence of applying the requirements for IAS 32 would be irrelevant for this question. Conversely, without that principle, the application of IAS 32 in strict sequence of the requirements would not allow applying the guidance for settlement in cash or other financial assets also to instances in which the obligation is settled in shares.

- Whether the analysis that determines whether there is a compound financial instrument under IAS 32.28 is performed only after taking into account contingent settlement provisions under IAS 32.25. This relates to our earlier point about whether the assessment of the financial instrument against the definitions of equity and a financial liability is performed (i) by first applying the definitions to the financial instrument as a whole or (ii) by assessing all possible deliveries and receipts of cash, other financial assets and equity instruments that could occur under the contract independently of each other. Alternative (i) would be consistent with applying the requirements in sequence whereas alternative (ii) would require an exception.

Other clarifications that should be considered are:

- The principle in IAS 32 is that a settlement option that could result in a settlement that fails the equity definition would not result in the entire instrument being classified as a financial liability if that option is within the control of the issuer. It reflects the definitions of equity and a financial liability because in such a situation the issuer has an unconditional right to avoid delivering cash[2] (by not electing that type of settlement). For non-derivative financial instruments that principle is reflected in IAS 32.AG25. It should be considered making it explicit that the requirements regarding settlement options for *derivative* financial instruments in IAS 32.26 are an exception to that principle because even settlement options of the *issuer* that could result in a settlement that fails the equity definition result in the entire instrument being classified as a financial asset or a financial liability. Making the exception explicit would help people distinguishing the consequences of settlement options for derivatives and contingent settlement provisions (i.e. issuer settlement options) for non-derivative instruments when applying IAS 32.
- The exception regarding when the possibility of an instrument being settled as a liability is ignored because a provision is not genuine (see paragraphs 25(b) and AG28 of IAS 32) could be clarified by providing more guidance on what 'not genuine' is. It is not clear how the abstract description of occurrence being "extremely rare, highly abnormal and very unlikely" relates to the debate about whether a feature is 'substantive' including the notions of 'economic reasons' and 'business reasons', as the Committee discussed at its July 2013 meeting for the other convertible instrument (addressed by Staff Paper 17). For example, would clauses that make settlement alternatives contingent on changes in taxation, law, or prudential regulation be considered as genuine? This should also clarify how the notion of 'not genuine' relates to the assessment of whether a settlement feature is substantive under IAS 32.20(b). Such a clarification should also include whether the 'not genuine' notion applies solely to contingent settlement provisions or whether it can be analogised to in applying any other requirement of IAS 32.

[2] And can also avoid delivering other financial assets or otherwise settling the instrument in a way that would represent the redemption of a liability.

National Australia Bank

National Australia Bank Limited
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AUSTRALIA

18 September 2013

Wayne Upton
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UNITED KINGDOM

Email: ifric@ifrs.org

Dear Mr. Upton

Re: Tentative Agenda Decision Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

National Australia Bank Limited (NAB) is pleased to respond to the IFRS interpretations Committee's (the Interpretations Committee) tentative agenda decision made at its July 2013 meeting in respect of mandatorily convertible instruments subject to a contingent non – viability event (Agenda paper 18).

National Australia Bank Limited (NAB) is one of the four major Australian banks. Our operations are predominantly based in Australia, New Zealand, the United Kingdom, the United States and Asia. In our most recent annual results we reported net profit after tax of A$ 4.1 billion and total assets of A$ 763 billion.

We have the following comments on the tentative decisions made by the Interpretations Committee:

NAB agrees with Interpretations Committee's view that such instruments are compound instruments comprised of a financial liability, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and an equity component, which reflects the issuer's discretion to pay interest.

NAB also agrees that as the contingent non-viability clause could occur immediately, as it is beyond the control of the issuer, that the liability component should be measured at the full amount that could be required to be paid immediately. (i.e. the equity component, as the residual, is measured at zero; referred to as View 3 in the July staff paper).

However, NAB does not agree with the Interpretation Committee's view that even when zero value is attributed to the equity component if the issuer pays any interest on the instrument, those payments still relate to the equity component and would be recognised in equity.

We disagree with this view for the following reasons:

- Whilst the instrument is strictly a compound financial instrument, due to the non-viability clause the instrument is classified as a financial liability in its entirety, the application of IAS 32 par 35 should be based on what is recognised in the financial statements upon initial recognition (as 100% of the instrument is attributed to the financial liability

component), this is supported by IAS 32 par 36 "dividend payments on shares ***wholly*** recognised as liabilities are recognised as expenses in the same way as interest on a bond."; [emphasis added]

- We acknowledge the example in IAS 32 AG 37 which considers the treatment of discretionary dividends, however that example assumes a value has been ascribed and recognised upon initial recognition in the financial statements (attributable to the discretionary dividend equity component). Our view is that if zero value is attributed to the equity component then this should be reflected when considering IAS 32 par 35 (i.e. in substance treated as a financial liability in its entirety and the dividend should be treated as interest expense). This is also consistent with the accounting for transaction costs on such compound financial instruments which are proportionately allocated amongst the components. (i.e. if zero value would be ascribed to the equity component then all transaction costs on the instrument would be recognised as part of the liability and ultimately recognised in the income statement);

- Treating distribution payments on such instruments as dividends, when the full instrument is initially recognised as a financial liability, results in an asymmetrical accounting outcome between balance sheet and profit or loss and is inconsistent with IAS 32 par 35, 36;

- Whilst the example used for IFRIC was a relatively simple example, in practice, such convertible instruments vary considerably across jurisdictions and are complex, accordingly taking such a definitive view on the treatment of dividends without regard for varying degrees of complexity across regions may result in not faithfully representing the economics of the specific transactions and various issuances;

- Distributions on such convertible instruments in Australia, whilst being strictly at the issuers discretion, also have a related "dividend stopper" feature (dividends on ordinary shares cannot be declared if no distribution is made on the convertible instrument). Accordingly the likelihood of the distributions being withheld is considered very remote. Whilst we acknowledge that IAS 32 AG 26 disregards intent or history of making distributions from impacting the classification of an instrument, the fact remains that the discretionary nature of distributions on the instrument is not considered by investors to be a substantive feature, and in substance, the distributions represent payments of interest (i.e. the instrument is considered substantively to be a financial liability in its entirety);

- The justification provided in the July IFRS staff paper does not provide a compelling argument as to why such distributions should be treated as equity, particularly having regard for the alternative view which treats distributions based on how the instrument as a whole is classified;

- We believe the alternative view (i.e. distributions treated as interest expense) results in a more representational and faithful outcome as economically such instruments are effectively a debt instrument until the occurrence of a remote event (the contingent non-viability event);

- In Australia, during 2012 and 2013 all of the major commercial banks issued very similar convertible preference share instruments as part of their preparation for Basel III, which contained non-viability clauses (i.e. a specific decline in Tier 1 regulatory capital ratios) – all of these banks have classified such instruments entirely as a financial liability and treated distributions as interest expense;

- The removal of the distribution on such compound instruments from interest expense would change the NAB's net interest margin 'NIM' calculation for statutory purposes.

As a result, the true cost of funding would be distorted and net interest income would be considered misleading. In order to bridge this gap, and to assist investors, this would likely result in additional non-IFRS measures of our financial results to be presented outside of the annual report. As NIM is a key measure of a banks performance, having alternate underlying and statutory measures due to the statutory accounts not reflecting what investors consider being economic reality is something we wish to avoid.

Accordingly, we strongly encourage the Interpretations Committee to reconsider its tentative view that the distributions on such instruments in all situations must be recognised in equity. We believe there is sufficient guidance in IAS 32 to decide on the appropriate classification of the distributions based on the specific nature of the issued instruments and suggest removal of the sentence quoted below from the proposed wording for the agenda decision:

"Nevertheless, the Interpretations Committee noted that if the issuer pays any interest on the instrument, those payments relate to the equity component and, accordingly, would be recognized in equity."

Should you have any queries regarding our comments and feedback, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at marc.smit@nab.com.au.

Yours sincerely

Stephen Gallagher
General Manager, Group Finance

Michael Laguda
Manager, Group Accounting Policy

IFRS Interpretations Committee
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24 September 2013

Dear Committee Members,

Tentative agenda decision: IAS 32 Financial Instruments: Presentation - Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

We are responding on behalf of PricewaterhouseCoopers to your invitation to comment on the above tentative agenda decision, published in the July 2013 edition of the IFRS Interpretations Committee Update. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms that commented on the tentative agenda decision. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We do not support the tentative agenda decision as drafted regarding the classification and measurement of an instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. The agenda decision concludes that, based on the analysis of the existing requirements in IAS 32, the guidance for compound instrument accounting is applied before the guidance for contingent settlement features and that the liability component must be initially recognised at the full amount that the issuer could be required to pay immediately. Any discretionary payments would be recorded in equity even though the equity component is measured at zero at initial recognition.

We agree that the requirements in IAS 32 support this view, but we also believe the words in IAS 32 support two of the other alternative views included in the Agenda Paper 18 on this topic, as set out below.

We are aware there is currently diversity in practice in accounting for instruments with non-viability clauses. We believe IAS 32 could be read in different ways to support views one, two and three in Agenda Paper 18 ('the Agenda Paper'). If the Committee feels that view three is the only appropriate answer, we suggest that the guidance in IAS 32 should be amended to be more explicit for the areas identified below.

Timing of when the contingent event could occur (to support View 2 in the Agenda Paper)

The draft rejection wording concludes that BC 12 of IAS 32 requires the issuer to consider that the contingent non-viability event could occur immediately because it is beyond the control of the issuer and there is no contractual minimum time period that must elapse before it could occur. We agree that BC 12 is clear that the issuer must assume the contingent event will occur in the recognition and measurement of the liability and thus the probability of the event occurring should not be factored into the analysis. However, the standard is unclear whether the expectation about the timing of when such event will occur should be included in the measurement.

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We believe a non-viability contingency can be viewed differently from a demand deposit or holder put option because in those cases, the instrument may be redeemed at the discretion of the holder at any time. However, where the contingent event is outside the control of both the issuer and the holder, redemption is not at the discretion of either party to the contract (or mandatorily converted) until the contingency occurs. The issuer could develop a reasonable expectation around the timing of when the contingency may occur (which in some cases may extend to several years). Factoring in the timing of the non-viability contingency would be more analogous to a written put option that is only exercisable at a future date and is recorded at the present value of the redemption amount in accordance with IAS 32 paragraph 23.

We believe the wording in IAS 32 should be clarified to require that an instrument with a contingent event as defined in paragraph 25 of IAS 32 should be measured using the guidance in IAS 39 paragraph 49 for instruments with demand features , if this is the Committee's view.

Order in which to apply guidance in IAS 32 (to support View 1 in the Agenda Paper)

There is no explicit guidance in IAS 32 specifying the order in which the guidance should be applied for instruments with both a contingent settlement feature and a liability and equity component. Agenda Paper 18 considers the example of a preference share with discretionary dividends in AG 37 of IAS 32 to demonstrate the principle of compound accounting. However, this instrument does not also have a contingent settlement feature. It is therefore not obvious that compound accounting should take precedence over the contingent settlement provision.

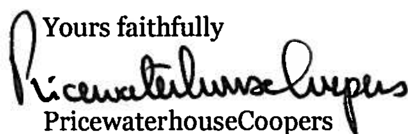
The draft agenda decision states that the instrument includes an equity component reflecting the issuer's discretion to pay interest, even though the instrument is measured entirely as a liability. If compound instrument accounting is applied before consideration of the contingent settlement provision, we agree the guidance in AG 37 applies. This view means any payments related to that component would be recorded in equity (regardless of whether the equity component is measured at zero).

However, based on the lack of guidance in IAS 32, we believe the contingent settlement guidance may be applied first. In taking this view, the instrument would be recorded entirely as a financial liability as laid out in view 1 in the Agenda Paper. No equity component would exist and the discretionary payments would be reflected as interest expense in profit or loss.

We believe the wording in IAS 32 should be clarified to require that compound accounting should take precedence over the contingent settlement provision, if this is the Committee's view.

If you have any questions in relation to this letter please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 207 804 2497) or Gail Tucker (+44 117 923 4230).

Yours faithfully



PricewaterhouseCoopers

Wayne Upton
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25 September 2013

Dear Mr Upton

Tentative agenda decision: IAS 32 Financial Instruments: Presentation - Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

Westpac Banking Corporation (WBC) is pleased to respond to your invitation to comment on the above tentative agenda decision, published in the July 2013 IFRIC Update.

WBC is one of the four major Australian banks with a current market capitalisation exceeding A$100 billion. We currently have on issue five different instruments with discretionary distributions that would be impacted by the tentative decision. Although not all of these instruments have 'non-viability' event features of the type described in the tentative agenda decision, they each have some form of contingent settlement feature that could result in them converting into a variable number of shares at any time due to circumstances that are outside of the control of both WBC and the holders of the instruments. WBC currently presents the distributions on these instruments as part of interest expense.

We have the following comments on the tentative decisions made by the Interpretations Committee:

We agree with the Committee's analysis and conclusion that such an instrument should be measured as a financial liability in its entirety, net of issue costs.

While we accept that the Committee's analysis and conclusion on the presentation of distributions in equity is one valid interpretation of IAS 32, we are of the view that presenting those distributions as an interest expense is an equally valid interpretation.

Paragraph 36 of IAS 32 provides relevant guidance on how interest, dividends, losses and gains should be treated based on the classification of the financial instrument as a financial liability or an equity instrument. This paragraph states that "dividends payment on shares wholly recognised as liabilities being recognised as expenses in the same way as interest on a bond".

With the financial liability component measured at the full amount of the proceeds received and no amount presented as an equity component, we believe it reasonable to conclude that the instrument is "wholly recognised" as a liability and thus the distributions should be recognised as an interest expense.

Further, although distributions on such convertible instruments are strictly at the issuer's discretion, they also have other features such as "dividend stoppers" (dividends on ordinary shares or other similar instruments cannot be declared if no distribution is made on the convertible instrument). Whilst we recognise that history and intent are ignored in classifying an instrument, the likelihood of the distributions not being made is considered very remote, in the normal course of business, when investors are considering investing in these instruments.

For all our instruments that would be impacted by this tentative decision, distributions are made or approved for immediate payment prior to the end of our financial year end or half year end. In presenting our accounts there is no contingency about if the distributions for the period being reported on will be paid.

These instruments are considered to be part of WBC's overall financing structure. The removal of the distribution on such instruments from interest expense would change our reported net interest margin 'NIM' for statutory purposes to exclude the impact of this part of the financing structure. NIM is an important measure of a bank's financial performance and excluding distributions on these instruments would make the measure less relevant and possibly misleading to the users of our financial statements.

If such payments were required to be treated as equity distributions we would adjust for them in our non-IFRS measurements reported to key decision makers and external stakeholders. Where possible we avoid making such adjustments to our statutory results as it adds complexity to our reporting and potential uncertainty on the quality of our disclosures.

We strongly encourage the Interpretations Committee to reconsider its tentative view that the distributions on such instruments must be recognised in equity.

Yours sincerely

Kitrina Shanahan
Group Financial Controller
Westpac Banking Corporation

12 September 2013

Wayne Upton
Chairman
IFRS Interpretations Committee
International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Mr Upton,

Re: Tentative Agenda Decision - Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US$5.1 billion and total assets of US$601 billion.

We have reviewed the tentative decision made by the Interpretations Committee at its meeting on 16 and 17 July 2013 in respect of the classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. Following our review, we bring the following matters to the Interpretations Committee attention:

We agree with Interpretations Committee's view that:

- such instruments are compound instruments comprising a financial liability (the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs) and an equity component (the issuer's discretion to pay interest); and
- the liability component should be measured at the full amount that could be required to be paid immediately because of the contingent non-viability clause that is beyond the control of the issuer and as such the equity component, as the residual, is measured at zero.

We do not agree with the Interpretation Committee's view that when the equity component is valued at zero and the issuer pays a coupon on the instrument those payments must be recognised in equity. While we acknowledge that the basis on which the Interpretations Committee reached its conclusion is a valid interpretation of IAS 32 *Financial Instruments: Presentation* (IAS 32), we believe that the classification of the coupon payment as interest expense through the Profit or Loss is an equally valid interpretations of IAS 32. The basis behind our view is set out below.

- Although strictly a compound financial instrument, the entire instrument is classified as a financial liability due to the non-viability clause. We believe that it is appropriate that the application of IAS 32 par 35 is based on what is recognised in the financial statements upon initial recognition. As 100% of the instrument is attributed to the financial liability component, the payment on the instrument would be classified as interest expense. This is further supported by IAS 32 par 36 "*dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond*".

- Treating distribution payments on such instruments as dividends, when the full instrument is initially recognised as a financial liability, results in an asymmetrical accounting outcome between Balance Sheet and Profit or Loss statement and is inconsistent with IAS 32 par 35 and 36.

- We acknowledge the example in IAS 32 AG 37 requires that the discretionary dividend on the instrument be recognised as a distribution of Profit or Loss, however that example assumes a value has been ascribed and recognised upon initial recognition in the financial statements (attributable to the discretionary dividend equity component). Our view is that if zero value is attributed to the equity component and there is no accretion of the principal to par through interest expense, then this should be taken into account when considering IAS 32 par 35 (i.e. in substance treated as a financial liability in its entirety and the dividend should be treated as interest expense).

In our view, the justification provided in the July IFRS staff paper does not provide a compelling argument as to why such distributions **must** be treated as equity, particularly having regard for the alternative view which treats distributions based on how the instrument as a whole is classified.

During 2012 and 2013, many Australian commercial banks issued very similar convertible preference share instruments as part of their preparation for Basel III. These instruments contained non-viability clauses (i.e. a specific decline in Tier 1 regulatory capital ratios) and a discretionary coupon. We believe the presentation of the distributions as interest expense in Profit or Loss results is more representative of the economics as such instruments are effectively debt instrument until the occurrence of a remote event (the contingent non-viability event). Our approach is in line with other Australian Banks that have classified such instruments entirely as a financial liability and treated distributions as interest expense.

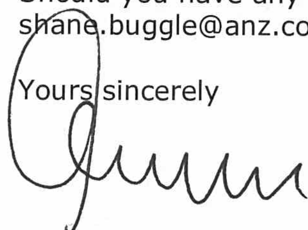
It is our view that should we be required to present the payment on the instrument as a dividend recognised as a distribution of Profit or Loss, the presentation of our true cost of funding and net interest income, a key measure of the organisations performance, is likely to be misstated. In order to meet the needs of the users of our financial statements we would need to present additional non-IFRS measures of our financial results to be presented outside of the annual report, which is not our preferred approach.

Accordingly, we encourage the Interpretations Committee to reconsider its tentative view that the distributions on such instruments in all situations must be recognised in equity. We believe there is sufficient guidance in IAS 32 to decide on the appropriate classification of the distributions based on the specific nature of the issued instruments and thereby suggest removal of the sentence quoted below from the proposed wording for the tentative agenda decision:

> *"Nevertheless, the Interpretations Committee noted that if the issue pays any interest on the instrument, those payments relate to the equity component and accordingly, would be recognised in equity."*

Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely



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Mr Wayne Upton
Chairman
IFRS Interpretations Committee
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Our ref MV/288
Contact Mark Vaessen

25 September 2013

Dear Mr Upton

Tentative agenda decision: ***IAS 32 Financial Instruments: Presentation—Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event***

We appreciate the opportunity to comment on the IFRS Interpretations Committee's (Committee) tentative agenda decision, *IAS 32 Financial Instruments: Presentation—Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event*. We have consulted with, and this letter represents the views of, the KPMG network.

Financial institutions are seeking to strengthen their capital bases and meet new regulatory capital requirements. An increasing number may issue financial instruments similar to the convertible instrument discussed by the Committee in order to achieve those objectives. Therefore, we believe it is important for the Committee to support a single view on the classification and measurement of such instruments so as to promote the imperative of achieving consistency in practice in this regard.

We hope this can be done without having to go through the full interpretation process and, if this is the case, we would agree with the Committee's tentative decision not to add this issue to its agenda. However, if the feedback that the Committee receives from other interested parties indicates that it may not be possible to achieve consistency in practice as to classification and measurement through an agenda decision, then we would recommend that the Committee instead consider developing an interpretation in accordance with its due process principles or, if this transpires not to be feasible, refer the matter to the International Accounting Standards Board for action.

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Also, we do not agree with certain aspects of the Committee's tentative decision, as follows:

- The tentative decision includes a general assertion about the measurement of financial instruments that appears to extend unnecessarily and potentially inappropriately beyond the particular scenario discussed.
- In our view, IAS 32 would not preclude the presentation of interest payments on the convertible instrument as expenses in profit or loss.

We provide our detailed comments on the Committee's technical analysis below.

Classification and measurement

We agree with the Committee's tentative conclusion that the convertible instrument is a compound instrument that is composed of the following two components:

- a financial liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs; and
- an equity component, which reflects the issuer's discretion to pay interest.

However, we are concerned that the tentative agenda decision makes inappropriately definitive statements concerning the measurement of the liability component that may preclude the use of judgement or have other unintended consequences for other fact patterns not specifically considered by the Committee. The tentative agenda decision states (emphasis added):

> *To measure the liability component, the Interpretations Committee noted that the issuer must consider the fact that the contingent non-viability event could occur immediately because it is beyond the control of the issuer and there is no contractual minimum time period that must elapse before the contingent non-viability event could occur. Hence the Interpretations Committee noted that the liability component must be measured at the full amount that the issuer could be required to pay immediately. The Interpretations Committee noted that this measurement is consistent with paragraph 23 of IAS 32, which sets out the requirements for an issuer's obligation to purchase its own equity instruments for cash or another financial asset, including those obligations that are conditional on the holder exercising its right; e.g. particular put options written on the issuer's own equity instruments. The Interpretations Committee noted that paragraph BC12 in the Basis for Conclusions on IAS 32 discusses the IASB's view that a financial liability must be measured at the full amount of the obligation if the occurrence of the contingent event is beyond the control of the issuer, irrespective of whether that event is within the control of the holder.*

Application of the statements above may not be appropriate and may not provide the only acceptable result or may conflict with other requirements of IFRSs in other scenarios where there is a contingently payable amount, for example:

- where the contingent redemption amount is greater than the issuance proceeds of the instrument and occurrence of the contingency is unlikely to occur in the foreseeable future (e.g. a non-derivative instrument that is issued for its initial fair value of 100 but is redeemable at 120 in the event of an improbable contingency);
- where the nature of the contingency that triggers redemption is such that the issuer would be able to reliably estimate its timing within a reasonably narrow range;
- an otherwise vanilla debt instrument that the issuer can be required to be prepay at a premium above its initial fair value on the occurrence of a contingent event (e.g. a debt instrument that is repayable at a premium in an event of default).

In the context of explaining the Committee's tentative analysis, we recommend that the agenda decision, rather than "noting" general propositions as to what an entity "must" do, instead identify the principles within IAS 32 that it believes are relevant to the particular case and how it expects them to be applied in the particular case.

Presentation of discretionary interest payments

We believe that the tentative agenda decision is unnecessarily prescriptive regarding the presentation of any discretionary interest payments. The tentative agenda decision states that 'consistently with paragraph AG37 of IAS 32, if the issuer pays any interest on the instrument, those payments relate to the equity component and would be recognised in equity.'

We do not believe that this is the only acceptable application of IAS 32 in this case. Paragraph 35 of IAS 32 states that interest relating to a financial instrument or a component that is a financial liability shall be recognised as an expense in profit or loss and that distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Paragraph 36 explains that the classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss and, thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond.

Paragraph AG37 of IAS 32 discusses the application of these principles to a compound instrument, being a preference share with a fixed redemption date and a feature allowing payment of discretionary dividends prior to that date. In that case, the issuance proceeds would be allocated between the present value of the redemption amount (a financial liability) and, assuming the usual case where the redemption amount equals the issue price, a positive residual amount (equity and reflective of the present value of expected dividend payments). Paragraph

37 explains that the accretion of interest on the discounted redemption amount would be an expense and any dividends paid before the fixed redemption date would be presented in equity, which is consistent with the allocation of initial proceeds. However, paragraph AG37 does not specifically discuss:

- compound financial instruments where the entire issuance proceeds or initial fair value is recognised as a financial liability; or
- dividends that are payable on an instrument which is already redeemable or contingently redeemable – i.e. might be redeemed immediately.

We believe that when all of the fair value of the consideration received for issuing an instrument is allocated to and recognised as a financial liability, IAS 32 is not clear about whether:

- discretionary payments are presented in equity because, in principle, discretionary payments are always an equity feature irrespective of whether any amount is allocated to equity (based on IAS 32.AG37); or
- discretionary payments are presented in profit or loss because discretionary payments on an instrument 'wholly recognised' as a liability relate to that liability and are recognised as an expense (based on IAS 32.36).

Therefore, in our view an entity should choose an accounting policy, to be applied consistently, to present the discretionary dividends in profit or loss or equity when the entire fair value of the consideration received on issuing an instrument with a discretionary dividend feature is allocated to and recognised as a financial liability and none is allocated to and recognised as equity.

For example, if an entity issues, for its par amount, a financial instrument with a feature allowing discretionary dividends at a specified monthly rate on the par amount, and which is redeemable at par at any time at the option of the holder, then we believe that it is reasonable for the entity to assert that any dividend payments relate to the par amount that is recognised as a financial liability, and thus to present those payments as an expense. The tentative agenda decision is inconsistent with such a position. We believe that there are issuers who have recognised discretionary interest payments as interest expense for several years based on the 'wholly recognised as liabilities' language in IAS 32.36. Also, any position taken on this matter is relevant to the question whether dividends on non-controlling interests (NCI) that are subject to a written put option are presented as expenses or equity distributions; the Committee has already been informed of diversity in practice in this area in the context of its project on NCI puts but has decided not to address that question in the NCI puts project.

We note that the focus of the agenda request was on the classification and measurement of the financial instrument, and not on the presentation of discretionary interest payments. We

therefore suggest remaining silent on the presentation of discretionary interest payments in the final agenda decision.

Please contact Mark Vaessen or Chris Spall on +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited