AUCKLAND CITY

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Review of IAS 32 and IAS 39

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Relevant Standards

IAS 32:*Financial Instruments: Disclosure and Presentation* IAS 39: *Financial Instruments: Recognition and Measurement* NZ FRS-31*: Disclosure of Information About Financial Instruments*

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Invitation to Comment (IAS 32)

The Board would particularly welcome answers to the questions set out below. Comments should indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? **The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability**. In addition, **the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash** or other financial assets, depending on the occurrence or non- occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be **classified as a financial liability**, **irrespective of the probability of those events or circumstances occurring (paragraph 22A).**

Classification of compound instruments by the issuer

The options in IAS 32 to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or by measuring the elements based on a relative- fair- value method are eliminated. Instead, any asset and liability elements are separated first and the residual is the equity element.
The objective of the proposed amendment is to conform the requirements in IAS 32 relating to the separation of liability and equity elements with the definition of an equity instrument as a residual and the measurement requirements in IAS 39.

IAS 32 paragraph 22A. An entity may issue a financial instrument (such as a bond or a share) that it could **potentially** be required to settle by delivering cash or other financial assets (or otherwise in such a way that the instrument would be **classified as a financial liability**, see paragraph 22C) depending on the occurrence or non-occurrence of **uncertain future events** or on the outcome of **uncertain circumstances** that are beyond the control of both the issuer and the holder of the instrument (such as a change in a stock market index, consumer price index, or interest rate, or the issuer's future revenues, net income, or consumer price index, or interest rate, or the issuer's future revenues, net income, or debt –to-equity ratio). Such a financial instrument **is a financial liability of the issuer** because the issuer does not have an unconditional right to avoid settlement of the obligation in cash or other financial assets (or otherwise in such away that the obligation would be classified as a financial liability).

Answer: Agree with the proposed amendments.
That classification of a financial instrument should be made without regard to the probabilities of different manners of settlement.

Question 2 -- - Separation of liability and equity elements (paragraphs 28 and 29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative- fair- value method should be eliminated and, instead, **any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?**

Answer: Agree with the proposed amendment.
That any asset and liability elements should be separated and measured first and then the residual assigned to the equity element

Reference IAS 32 Paragraphs 28 and 29 below

IAS 32 para 28.This standard does not deal with measurement of financial assets, financial liabilities and equity instruments and does not therefore prescribe any particular method for assigning a carrying amount to liability and equity elements contained in a single instrument. Approaches that might be followed include: (a) assigning to the less easily measurable component(often an equity instrument), the residual amount after deducting from the unstrument as awhole the amount separately determined for the component that is more easily measurable; and (b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts on a pro rata basis so that the sum of the components equals the amount of the instrument as a whole. The sum of the carrying amo unts assigned to the liability and equity comnponents on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole. No gain or loss arises from recognising and presenting the components of the instrument separately.

IAS 32 para 29.Under the first approach described in paragraph 28, the issuer of a bond convertible into common shares first determines the carrying amount of the financial liability by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into common shares may then be determined by deducting the carrying amount of the financial liability from the amount of the compound instrument as a whole. Under the second approach, the issuer determines the value of the option directly either by reference to the fair value of a similar option, if one exists, or by using an option pricing model. The value determined for each component is then adjusted on a pro rata basis to the extent necessary to ensure that the sum of the carrying amounts assigned to the components equals the amount of the consideration received for the convertible bond.

Question 3 -- - Classification of derivatives that relate to an entity's own shares (paragraphs 29C --- 29G)

Guidance about the classification of derivatives based on an entity's own shares is provided ,as follows:

- A derivative that is indexed to the price of an entity's own shares and requires net cash or net share settlement, or gives the counterparty a choice of net cash or net share settlement, is a derivative asset or derivative liability (not an equity instrument) and is accounted for as such under IAS 39.

- A derivative that is indexed to the price of an entity's own shares and gives the entity a right to require net cash or net share settlement instead of gross physical settlement is a derivative asset or derivative liability (not an equity instrument) unless the entity has an established history of settling such contracts through a gross exchange of a fixed number of the entity's own shares for a fixed amount of cash or other financial assets.

- Changes in the fair value of a derivative that is fully indexed to the price of an entity's own shares and will result in the receipt or delivery of a fixed number of an entity's own shares in exchange for a fixed amount of cash or other financial assets are not recognised in the financial statements.

- When a derivative involves an obligation to pay cash in exchange for receiving an entity's own shares, there is a liability for the share redemption amount.

The objective of the proposed amendment is to clarify the requirements affecting the classification of derivatives based on an entity's own shares and to promote the consistent application of those requirements.

29C. A derivative contract (such as an option, warrant, or forward) shall be classified as an equity instrument of the entity if, and only if, the contract will be settled by the exchange of a fixed number of an entity' sown equity instruments (other than derivatives) for a fixed monetary amount of cash or other financial assets. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of a derivative contract classified as equity are not recognised in the financial statements.

29D. A derivative contract is not classified as an equity instrument of the entity solely because it may result in the receipt or delivery of an entity's own equity instruments or because the value of the derivative contract is determined on the basis of the value of an entity's own equity instruments. A derivative contract (such as an option, forward, or total return swap) that requires settlement on a net basis in cash or other financial assets is a derivative asset or derivative liability even though its value may be determined on the basis of the value of the entity's own equity instruments. Similarly, a derivative contract that requires settlement on a net basis in an entity's own equity instruments is derivative asset or a derivative liability. Such contracts are not classified as equity instruments because they will not result in the receipt or delivery of a fixed number of an entity's own equity instruments in exchange for a fixed amount of cash or other financial assets at the maturity date.

29E. If a derivative contract has more than one settlement alternative (such as net in cash, net in an entity's own equity instruments, or by exchanging an entity's own equity instruments for cash or other financial

assets), the contract is a derivative asset or derivative liability unless the entity: (a) has an unconditional right and ability to settle the contract by exchanging a fixed number of its own equity instruments (other than derivatives) for a fixed amount of cash or other financial assets;(b) has an established practice of settling such contracts by exchanging a fixed number of its own equity instruments (other than derivatives) for a fixed amount of cash or other financial assets; and (c) intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets.
If these conditions are met, the contract is an equity instrument unless it may result in the entity delivering cash or other financial assets in exchange for receiving the entity's own equity instruments, in which case paragraph 29F applies. If the counter party can require an entity to settle a derivative contract on a net basis in cash or in the entity's own equity instruments, the contract is a derivative asset or derivative liability unless the counter party can require the entity to deliver cash or other financial assets in exchange for receiving the entity's own equity instruments, in which case paragraph 29F applies.

29F. When an entity enters into a derivative contract (such as a forward repurchase contract or written put option on the entity's own shares) that requires settlement by the delivery of cash or other financial assets in exchange for receiving the entity's own equity instruments, those equity instruments cease to meet the definition of equity instruments because the entity has an obligation to redeem them for cash or other financial assets. The obligation to deliver cash or other financial assets (for example, for the forward repurchase price, option exercise price, or other redemption amount) is a financial liability. When the financial liability is recognised initially under IAS 39, its cost (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with IAS 39. If the derivative contract expires without delivery of cash or other financial assets, the carrying amount of the financial liability is reclassified to equity.

29G. A derivative contract whose fair value fluctuates in part or in full in response to changes in one or more underlying variables other than the value of an entity's own equity instruments (for example, a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or a credit rating) is not an equity instrument of the entity even though the entity may be required or have the right to settle the contract in its own equity instruments. Such a contract exposes the entity to potentially favourable or unfavourable changes in a variable other than the value of its own equity instruments. Therefore, it is a derivative asset or derivative liability.

Answer: Agree with the proposed amendment
That the classification of derivatives based on a company's own shares as set out improves accounting for derivatives.

Question 4 -- - Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS32and IAS39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

Answer: We believe that consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments would simplify compliance.