International Accounting Standards Board
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Japanese Bankers Association

Comments on the International Accounting Standards Board's Exposure Draft *Financial Instruments with Characteristics of Equity–Proposed amendments to IAS 32* Financial Instruments: Presentation, *IFRS 7* Financial Instruments: Disclosures, *and IAS 1* Presentation of Financial Statements

The Japanese Bankers Association (the "JBA")[1] is pleased to provide comments on the Exposure Draft *Financial Instruments with Characteristics of Equity–Proposed amendments to IAS 32* Financial Instruments: Presentation, *IFRS 7* Financial Instruments: Disclosures, *and IAS 1* Presentation of Financial Statements (the "ED") issued by the International Accounting Standards Board (the "IASB").

The JBA appreciates the work of the IASB and would like to express our views based on comments received from member banks on several of the questions raised in the ED.

Answers to specific questions

Question 1—The effects of relevant laws or regulations (paragraphs 15A and AG24A–AG24B of IAS 32)
The IASB proposes to clarify that: (a) only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts (paragraph 15A); and (b) a contractual right or obligation that is not solely created by laws or regulations, but is in addition to a right or obligation created by relevant laws or regulations shall be considered in its entirety in classifying the financial instrument or its component parts (paragraph AG24B). Paragraphs BC12–BC30 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Regarding paragraph AG24B of IAS 32, we disagree with the proposal that, in classifying a financial

[1] The Japanese Bankers Association is an organisation that represents the banking industry in Japan. Its members are banks and bank holding companies operating in Japan.

instrument (a contractual right or obligation), "[t]he entity shall not disaggregate such a contractual right or obligation into contractual and non-contractual parts."

Paragraph 15A of IAS 32 requires that "[i]n classifying a financial instrument (or its component parts) as a financial liability, a financial asset or an equity instrument," an entity "shall not consider any right or obligation created by relevant laws or regulations that would arise regardless of whether the right or obligation is included in the contractual arrangement."

In this regard, paragraph AG24B of the Application Guidance on IAS 32 states that an entity "shall consider a contractual right or obligation, which is not solely created by laws or regulations but is in addition to a right or obligation created by relevant laws or regulations, in its entirety in classifying that right or obligation" and that the entity "shall not disaggregate such a contractual right or obligation into contractual and non-contractual parts." However, we believe that the IASB should not prevent an entity from separately classifying a contractual right or obligation, which is not solely created by laws or regulations but is in addition to a right or obligation created by relevant laws or regulations, especially when such a right or obligation can be reasonably disaggregated into two parts.

Additionally, we are of the view that the main purpose of paragraph AG24B is to provide guidance on classifying financial instruments in cases where contractual rights and obligations are added to those created by laws or regulations. Given this, the IASB should allow an entity to disaggregate a right or obligation into contractual and non-contractual parts and then provide adequate guidance on classification. Therefore, we recommend that the IASB reconsider the provisions of the proposed AG24B.

Question 3— Obligations to purchase an entity's own equity instruments (paragraphs 23 and AG27B–AG27D of IAS 32)
The IASB proposes to clarify that: (a) the requirements in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instruments also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments (paragraph 23). (b) on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would, therefore, be removed from a component of equity other than non-controlling interests or issued share capital (paragraph AG27B). (c) an entity is required to use the same approach for initial and subsequent measurement of the financial liability—measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right (paragraph 23).

(d) any gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraph 23).

(e)-(f) […]

Paragraphs BC62–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We oppose the proposal in Paragraph 23, which states that "[t]he redemption amount is discounted, assuming redemption will occur at the earliest possible redemption date specified in the contract. Therefore, the probability and estimated timing of the counterparty exercising their right to redeem have no effect on the initial or subsequent measurement of the financial liability."

This approach of uniformly assuming the earliest possible redemption, even for contracts with very low or practically no such probability of redemption being claimed, or those for which the timing of performance can be reasonably estimated, without reflecting such a possibility of estimation, could lead to financial statements that do not reflect actual economic reality and mislead investors. Therefore, we request the IASB to consider alternatives, such as off-balance sheet treatment of items for which there is virtually no probability of redemption occurring (disclosing such items in the notes to the financial statements if they are material) and adopting a fair value/amortised cost estimate that incorporates the probability of redemption occurring.

In addition, regarding clarification that the provisions in paragraph 23 on the obligation for an entity to purchase its own equity instruments should also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments, we disagree with the proposal in paragraph AG27B that "[t]he initial amount of the financial liability would […] be removed from a component of equity other than non-controlling interests or issued share capital."

As per BC63 to BC65 of the ED, we understand that this exposure draft aims to clarify that the requirements of IAS 23 also apply in cases where, for example, a variable number of the parent's shares might be transferred to settle the group's obligation to purchase the subsidiary's shares from holders of noncontrolling interests. Based on this understanding and in line with the aforementioned paragraph AG27B, it would be necessary to recognise a financial liability for the full redemption amount of a contract that includes, for example, an obligation to purchase an equity instrument issued by a subsidiary (such as a written put option or a forward purchase contract on non-controlling interests), and simultaneously to recognise the offsetting debit within the ownership interests of the equity holders of the parent instead of against non-controlling interests. This implies that, compared to the usual accounting treatment of the purchase of the non-controlling interest, the parent company would need to provide additional capital by the amount of the non-controlling interest in the period between the conclusion of the contract and its settlement. Such accounting treatment could have a particularly adverse impact on companies that use capital adequacy as a management indicator, especially in industries subject to capital adequacy regulations, such as the banking sector. We therefore

request the IASB to reconsider the proposal.

Question 4— Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)
The IASB proposes to clarify that: (a) some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A); (b) the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A); (c) payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37); (d) the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations (paragraph 11); and (e) the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring (paragraph AG28). Paragraphs BC94–BC115 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We oppose the inclusion of regulatory changes in the banking industry in paragraph AG28 as an example of assessing whether contractual terms are 'not genuine.'

In our view, the purpose of the IASB's proposal in the paragraph 25A (the initial and subsequent measurement of the financial liability […] arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event) is, as stated in BC 111, that the determination of whether the contractual terms is 'not genuine' is not based solely on the likelihood or probability of an uncertain future event occurring because an entity is required to make judgements in that assessment based on all the specific facts and circumstances ('extremely rare' or 'highly abnormal').

Therefore, it is considered that the proposed standard intends that the determination of whether a contractual term is 'extremely rare' or 'abnormal' based on its occurrence is not made on a formal basis, but rather on a comprehensive basis depending on the individual circumstances and nature of the contract. However, concerning regulatory changes in the banking industry, which is added in paragraph AG28 as an example of a contractual term that is very unlikely to occur but is a 'genuine,' no explanation is given as to the conceptual

basis of ‘rare’ or ‘unusual’ for the contractual term to be assessed as genuine, or which points (‘regulatory change in the banking industry’ or ‘regulatory change in any industry’) are considered to fall under ‘genuine.’ As a result, there is a concern that this could lead to an oversimplified judgement such as ‘any contractual term that refers to regulatory changes in the banking sector is genuine’ or ‘any contractual term that refers to regulatory changes is genuine.’ If the illustration in paragraph AG 28 were to be maintained, we request the IASB to add explanations about the concept of ‘rare’ and ‘abnormal’ and other relevant information.

Question 7— Disclosure (paragraphs 1, 3, 12E, 17A, 20, 30A–30J and B5A–B5L of IFRS 7)
The IASB proposes: (a) - (e) [...] The IASB proposes to require an entity to disclose information about: (a) the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments (paragraphs 30A–30B); (b) the terms and conditions of financial instruments with both financial liability and equity characteristics (paragraphs 30C–30E and B5B–B5H); (c) terms and conditions that become, or stop being, effective with the passage of time (paragraph 30F); (d) the potential dilution of ordinary shares (paragraphs 30G–30H and B5I–B5L); and (e) instruments that include obligations to purchase the entity’s own equity instruments (paragraph 30J). Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB’s rationale for these proposals. Do you agree with the proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We are generally opposed to the disclosure proposal in the ED, as we have significant concerns in terms of the disclosure burden on financial statement preparers and the limited benefits to investors despite the preparers’ costs.

The proposal in the ED could impose significant disclosure burdens on preparers in general. In particular, the disclosure of extensive and detailed information, such as priority of claims on liquidation and class-by-class disclosure of contractual terms/dilution, is expected to be especially burdensome for financial institutions because one of their main businesses is investment/fundraising. Such detailed disclosures would also be disproportionate to the granularity of the overall disclosed information and could cause confusion among investors as to ‘what information is really important, ’ thereby negatively impacting decision-making.

(End)