January 9th 2019

IFRS Foundation

International Accounting Standards Board

7 Westferry Circus

Canary Wharf

London

Re: Financial Instruments with Characteristics of Equity – DP/2018/1

Dear IASB members,

The Israel Accounting Standards Board welcomes the opportunity to comment on the IASB's Discussion Paper on Financial Instruments with the Characteristics of Equity published in June 2018.

Please find below our comments for some of the questions raised in the DP:

Question 1
Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes. (a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

We believe that the description of the challenges and their causes in the DP is adequate. However, we believe that there are other challenges that the Board did not identify and therefore not addressed in the discussion paper such as:

1. *Determination whether a shareholder's decision in the entity's organs is in his role as a shareholder or as an instrument holder*

   In practice, in many cases, shareholders of an entity also hold other financial instruments of the entity. Sometimes, those financial instruments give the entity the discretion (that right is established in the instrument's contract or other legal paper) if

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to pay cash on that instrument. For example, a bond that bears interest that was issued by an entity to its parent entity, and gives the entity the right to choose if to pay back the principal and interest of the financial instrument or to issue equity instruments. In those cases, a question arises whether shareholders make decisions regarding an entity's operating and financing activities as part of the entity's organs and its corporate governance or in their capacity as holders/ investors of the financial instruments. Another example is preferred shares held by controlling shareholders –which are redeemable by the entity under certain circumstances (such as IPO). The question arises whether it is within the entity's control or within the control of the holder of the preferred shares (as the controlling shareholders). Neither IAS 32 nor the DP address this issue.

2. *A definition of liquidation*

The Boards preferred approach to classification would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at ***liquidation****; and/or*

(b) ……

The DP does not include a definition of 'liquidation'. We believe, that in its discussion the Board should also consider the concept of 'deemed liquidation' (i.e. situations where all of an entity's resources are allocated to its common shareholders without legal liquidation of the entity).

Question 1 - ***continued***
(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

We agree that the application challenges in applying IAS 32 are pervasive enough to require standard-setting activity. However, we have concerns regarding the concept of the Board’s preferred approach, and the complexity in applying the preferred approach in practice by entities and other stakeholders.

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Question 2
The Board's preferred approach to classification would classify a claim as a liability if it contains: (a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or (b) an unavoidable obligation for an amount independent of the entity's available economic resources. This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50. The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure. Do you agree? Why, or why not?

We acknowledge the Board's approach in the discussion paper ('the DP') that the two key characteristics of financial liabilities are an issuer's obligation to transfer economic resources at a specified time prior to liquidation, and an issuer's obligation to transfer amounts independent of the entity's available economic resources. However, we recommend that the Board would try to integrate those principals into the existing guidance in IAS 32 instead of introducing a whole new approach and terminology. Introducing a new approach could potentially give rise to new unintentional challenges and lead to additional costs when preparing financial statements.

Question 3
The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains: (a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or (b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources. This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability. Do you agree? Why, or why not?

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Although we acknowledge that the two characteristics described in question 2 are important, we do not believe that the 'amount feature' would improve financial reporting. Thus, we recommend that the amount feature should be more closely aligned with the existing requirements in IAS 32. Our view is based on the following arguments:

- We note that one of the reasons that the FICE project was added to the Board's agenda is to address the accounting for complex financial instruments to which the requirements of IAS 32 were difficult to apply. We also note that the Board's approach in the DP was not to fundamentally change the current classification outcomes of IAS 32. However, introducing significant changes through the 'amount feature' would change the accounting for relatively simple and common instruments (e.g. irredeemable fixed-rate cumulative preference shares).
- We believe that additional information about an entity's returns could be adequately provided through presentation within equity and disclosures.
- It is unclear to us how the definition of a liability under the preferred approach conforms to the definition of a liability under the Conceptual Framework for Financial Reporting.
- The preferred approach creates inconsistency with IFRS 2.

Question 4
The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

We agree that the puttable exception would still be required under the Board's preferred approach.

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Question 5
The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows: (a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and (b) a derivative on own equity is classified as a financial asset or a financial liability if: (i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or (ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources. Do you agree? Why, or why not?

In our opinion, the proposed approach resolves some of the distortions created by the current model in IAS 32, but retains others. For example, a warrant that its exercise price is determined in a foreign currency is currently classified in accordance with IAS 32 as a financial liability. The outcome of that classification is that when the entity succeeds, there is an increase in the fair value of the warrant, and the entity is required to recognise an expense in profit or loss. That outcome is counter-intuitive. That outcome would not change according to the proposed model. Entities might issue such warrants as a result of investors' demands, economic environment etc. Another example is derivatives to deliver a fixed number of the entity's own shares for a fixed amount of cash when the number of shares changes only as a result of an anti-dilution provision. Those derivatives are currently classified in accordance with IAS 32 as financial liabilities and that classification would not change as a result of the proposed model.

Therefore, we believe that if the Board is seeking for a more conceptual solution, the Board should reconsider condition (a) for the classification of derivatives on own equity, ie separate classification of the derivative as a warrant and a speculation component. In the example of the warrant that its exercise price is determined in foreign currency, the separation would be between a warrant that its exercise price is determined in the functional currency and a swap for the exchange of the functional currency amount for the foreign currency amount. According to the proposed model, the warrant would be classified as an equity instrument and the swap would be classified as a financial asset/liability. The

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outcome would be that only the fair value changes of the swap (resulting from changes in the exchange rate) would be recognised in profit or loss rather than the fair value changes in the warrant as a whole (which is affected by both the entity's share price and the foreign currency exchange rate).

In our opinion, all warrants should be classified as equity instruments since they are subordinated to all other instruments, except ordinary shares.

We appreciate the opportunity to provide our comments.

Sincerely,
Dov Sapir, CPA, Chairman
Israel Accounting Standards Board

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