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17 December 2018

Hans Hoogervorst
Chair
International Accounting Standards Board
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Dear Mr Hoogervorst

Discussion Paper 2018/1 – Financial Instruments with Characteristics of Equity

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ('the IASB's') discussion paper *Financial Instruments with Characteristics of Equity* ('the discussion paper', 'the DP').

We welcome the DP given the importance of the liability and equity distinction in financial reporting and the IASB's acknowledgement of the interpretative issues that have arisen in applying IAS 32 *Financial Instruments: Presentation*.

We welcome the fact that the DP considers both classification and disclosure. The latter is an area that needs strengthening given that the advances in financial engineering have led to numerous instruments that are classified as equity but have very different rights to cash flows (during their life and at liquidation) and different degrees of dilution of current shareholders. Users of financial statements often lack information as to the terms of such instruments and how different equity instruments contribute to the capital structure of the entity.

We do not support the preferred classification approach in the DP. In our view, many of the difficulties in applying IAS 32 arise from applying the fixed-for-fixed rule, difficulties which we think will be replicated in the new 'amount' criteria in the proposed definition of a liability. This leads us to question more broadly whether contracts for the future receipt or delivery of equity instruments should be equity prior to the delivery or receipt of the equity instruments. We do not believe they should. We believe financial performance should be attributed to those holders of equity instruments that currently own a residual interest in the entity, not to those that hold instruments which may result in them being owners in the future. We acknowledge this is a departure from the classification model in the DP and in IAS 32 but we believe it has conceptual merit and would greatly reduce the amount of interpretative problems that arise with IAS 32, which we fear will still arise if the DP is finalised as a standard.

Further, we disagree that amounts due at liquidation are financial liabilities prior to liquidation. Like in IAS 32, we believe that such amounts should not be recognised as financial liabilities prior to liquidation as the financial statements are not prepared on a break-up basis, but on a going concern one. We disagree with this not only on conceptual grounds but also on the grounds that it will introduce complexity for subsequent measurement and will not be auditable.

We note the DP carries over the requirements in IAS 32 that future acquisitions of equity should be recognised as a gross financial liability with a debit in equity. We do not support this. In our view asset/equity and liability/equity exchanges should be classified on the same basis and so we do not support the notional grossing up of each of the legs of an arrangement that may result in the future purchase of equity.

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Further, the proposal to introduce remeasurement to OCI in some cases to overcome the concerns in IAS 32 about remeasurement to profit or loss does not solve the underlying cause of the problem (i.e. the recognition of a gross liability). Our preferred approach would be to treat such arrangements as a net obligation measured at fair value through profit or loss. This would avoid the counter-intuitive result that can arise with IAS 32 for arrangements to buy equity at future market price and also avoids the need to recognise the remeasurement of the gross obligation to OCI.

On balance, we believe the DP highlights appropriately the inadequacies in transparency of disclosures of equity instruments in IAS 32 and proposes disclosures that are worth pursuing irrespective of the classification model.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884 or Andrew Spooner in London at +44 (0) 20 7007 0204.

Yours sincerely

Veronica Poole
Global IFRS Leader

Appendix

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?

(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?

In our response to the Agenda Consultation we highlighted that the liability/equity distinction is a high priority and so we support the Board's effort to issue a DP in order to highlight and to overcome the current difficulties in applying IAS 32 *Financial Instruments: Presentation*. We particularly welcome that the scope of the DP includes disclosure given that IFRS Standards currently lack disclosure for different types of equity instruments. This problem is particularly important given that IAS 32 permits instruments with very different terms and conditions to be classified as equity without a requirement to explain what are the rights and obligations under these equity instruments.

We agree with the description of the challenges with IAS 32 though note there are two other challenges with IAS 32 that were not included in the DP which warrant consideration. The first is reassessment of the liability/equity classification after initial recognition, and the second is how to differentiate the entity from owners of the entity when determining whether the entity has an obligation.

It is not clear in IAS 32 whether an entity is required to continuously reassess the liability/equity distinction after the instrument is initially recognised when the terms of an instrument are unchanged (i.e. are unmodified). This question is relevant because if an entity was required to reassess classification after initial recognition the classification could differ from the classification determined at initial recognition. For example, this may be the case where the functional currency of the entity changes after the instrument was first issued (such that an instrument was classified as equity on initial recognition fails equity treatment upon a change of functional currency or it previously failed equity treatment but would meet the definition of equity upon a change of functional currency). This may also be the case where the term of an instrument that prevented equity classification expires prior to the maturity of the instrument. If an entity was required to reassess classification, the instrument would become equity at the date the term expires; in the absence of such a requirement, the non-equity treatment continues. Given the practices that have developed in this area we think this is an area worthy of consideration.

The other challenge in the application of IAS 32 that we would have liked to see addressed is the issue of differentiating the entity from its owners. This issue can cause difficulties when assessing whether an entity has an obligation to pay cash or another financial asset. In March 2010 the IFRIC noted that diversity may exist in practice in assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer's shareholders and, consequently, whether a financial instrument should be classified as a financial liability or equity. The IFRIC did not conclude further on the basis that the IFRIC recommended that the IASB address this issue as part of its project on FICE. Given the lack of guidance, the diversity in practice and that this was not included in the DP, we consider it worthy of consideration.

Should the DP move to the stage of an exposure draft, we draw to your attention the consequential impacts the proposals may have on other Standards which would need to be considered. The DP acknowledges that IAS 33 *Earnings per Share* would be impacted. We would add that consideration would need to be given to the impact on IFRS 2 *Share Based Payments* given the classification in IFRS 2 relies on the definition of an equity instrument; the impact on IFRS 10 *Consolidated Financial Statements* given the DP makes clear that contracts for the repurchase of non-controlling interest (NCI) are deemed a derecognition of the NCI; how

the disclosure requirements interact with the capital management disclosures required in IAS 1 *Presentation of Financial Statements*; and on the Conceptual Framework given the revised definitions in the Framework appear to conflict in some respects with the DP (notably the position taken on economic compulsion).

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 do not support the proposed definition.

We believe an unavoidable obligation to transfer economic resources prior to liquidation is a liability, and therefore we are supportive of part (a) of the definition. This is consistent with the Conceptual Framework and is mostly aligned with the definition of non-derivative liability in IAS 32:11 which in practice has generally worked well and is well understood. However, contrary to what is proposed in the DP, we believe an entity's own equity instruments are an economic resource if they are used as settlement of a financial liability, irrespective of whether the number delivered is a fixed or variable. We note that IAS 32 considers that a variable number of shares used in settlement of a fixed monetary amount is a financial resource, which is why such obligations are considered to be financial liabilities.

We understand why the IASB chose to include both (a) and (b) as it has the benefit of a universal definition of a liability that can apply equally to derivatives and non-derivatives (as opposed to IAS 32 which uses different definitions of liability to classify derivative or a non-derivative instruments). We acknowledge that having different definitions of a liability depending on whether something is a derivative creates interpretative problems as emphasis is placed on whether an instrument is a derivative, which is particularly challenging when a derivative may exist as part of a larger non-derivative instrument. Our concern is not that the DP proposes a universal definition of a liability, rather we disagree with the way that definition is expressed.

The part of the definition we have concerns with is part (b). Our fundamental concerns are that we believe that (i) amounts due only at liquidation should not be classified as liabilities prior to liquidation, and (ii) contracts for the future delivery of equity instruments should not be classified as equity until they are settled. This is elaborated below as well as included in our response to Question 5.

Amounts due at liquidation

The preferred approach in the DP will result in instruments that contain obligations for amounts payable only at liquidation to be classified as financial liabilities at initial recognition when the amount due at liquidation is independent of the entity's economic resources. We disagree with this proposal on a number of grounds.

Firstly, we consider that amounts payable only at liquidation are not financial liabilities until liquidation. To consider otherwise results in the statement of financial position as if it is prepared on a 'break-up' basis. This

is inconsistent with the going concern basis of preparation. IAS 32 considers that those amounts payable only at liquidation are not financial liabilities and we continue to support this treatment. We consider information about amounts payable at liquidation may well be useful to users, but this information can be conveyed within the disclosures to the financial statements, for example, in a capitalisation table, as opposed to recognition in the statement of financial position.

Secondly, the initial recognition as a liability of amounts that are payable only at liquidation will lead to the need to recognise in profit or loss the effects of subsequent remeasurement. We do not believe this would provide meaningful information to users. We acknowledge that at this stage the DP only deals with classification at initial recognition and not remeasurement. However, we believe consideration must be given to the measurement at initial recognition and subsequently in order to assess whether the classification is meaningful. If amounts due at liquidation are recognised as a liability prior to liquidation then changes in the timing (and/or amount) of that obligation will need to be remeasured through profit or loss (as is the case for all non-derivative financial liabilities accounted for under IFRS 9). For example, an increasing probability of paying a fixed obligation at liquidation will result in losses in profit or loss because of the acceleration of the unwind of the discount for the passage of time as liquidation becomes more likely. This measurement would be unavoidable given the amount due at liquidation is discounted as noted in paragraph 3.24(b) of the DP. This loss recognition will have the inadvertent effect of reducing net profit or loss and so potentially accelerating the liquidation. More fundamentally, we do not think it is practical for an entity to estimate, nor auditors to audit, the timing of an entity’s liquidation.

Contracts for the future delivery or receipt of an entity’s own equity instruments

We believe that contracts for the future delivery or receipt of an entity’s own equity instruments should not be classified as equity prior to their settlement (i.e. the point by which the entity delivers or receives the equity instrument). We would urge the IASB to deliberate the question whether the future delivery or receipt of equity is equity of the entity prior to that delivery or receipt. This question addresses a fundamental concept about whether the entity’s performance is attributed to only those owners of equity that have funded the entity and hold an instrument representing a residual interest in the entity, or whether it also extends to those holders that have a right to receive equity in the future, or have a right to deliver their equity interest back to the entity. In our view, the counterparty to an instrument that has the right to receive equity from the entity in the future is not a holder of an equity interest as they do not hold a residual interest (they do not have rights to the residual interest in the entity should the entity be liquidated prior to their instrument being settled); conversely, the holder of an instrument that may put their interest in the equity of the issuer to the entity in the future is the holder of an equity interest in the entity until they cease to hold the residual interest.

Our alternative approach to the definition of equity ensures that all obligations to deliver or receive equity instruments are treated consistently as financial assets or financial liabilities until they are derecognised (upon which equity is either issued or repurchased). This applies irrespective of whether the obligation is a derivative or a non-derivative instrument. In other words, a non-derivative instrument that is settled by delivering a variable number of equity instruments equal to a fixed amount is as much a liability as a derivative over own equity (such as an option that may result in the delivery of equity instruments). This approach has the benefit that profit or loss is only ever attributable to those holders of instruments that do not carry an obligation of the issuer to pay cash or another financial asset, nor the receipt or delivery of equity instruments, i.e. those holders of the residual interest.

We believe our approach has the following benefits:

- There is no distinction, and potential arbitrage, between the definition of liability for derivatives and non-derivatives, as in IAS 32.
- It avoids the need to have an ‘amount’ criteria (as expressed in part (b) of the definition in the DP) and the corresponding interpretation challenges we expect to arise such as what economic resources are included in the calculation and what ‘independent’ means. Similar interpretative challenges arise with the ‘fixed-for-fixed’ rule in IAS 32 but would be avoided using our approach.

- It avoids the challenge of trying to determine an approach to attribute comprehensive income to derivatives over own equity which the DP acknowledges the IASB was unable to conclude on. Under our approach, such attribution to comprehensive income is not necessary because contracts for the future delivery or receipt of equity are not equity instruments prior to settlement.
- It results in grouping together of all instruments that will result in the future receipt or delivery of equity instruments and reporting them in the same line in the statement of performance. In IAS 32, and with the DP, some derivatives over own equity are fair valued in profit or loss, some are not fair valued at all (as they are equity), and in the case of the DP some are fair valued through OCI (e.g. certain net cash settled derivatives where the amount is dependent on the entity's economic resources). We question whether such a complex approach would be understandable to users of financial statements.

We acknowledge that compared to IAS 32 and the DP, our approach would lead to more executory contracts for the receipt or delivery of equity instruments (such as derivatives over own equity) being fair valued through profit or loss whereas in IAS 32 and the DP these instruments may be classified as equity. For other contracts, such as liabilities settled by 'shares to the value of' our approach would yield no difference to IAS 32. Given the change in the accounting treatment for many derivatives over own equity that our approach would introduce, our preference is that the fair value gains and losses associated with those instruments would be included in a separate line in or below finance costs, through a requirement in IAS 1 *Presentation of Financial Statements.* We believe that this is justified by the fact that the nature of these gains and losses is more akin to financing because the future receipt or delivery of equity instruments are financing the capital structure of the entity.

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?

Consistent with our response to Question 2:

- we support part (a) of the definition, that is consistent with IAS 32 and the Conceptual Framework, noting that equity instruments delivered or received to settle a financial instrument, whether it is a derivative or non-derivative, are deemed an economic resource of the entity.
- we do not support part (b) of the definition because we believe (i) amounts due only at liquidation should not be classified as liabilities prior to liquidation, and (ii) contracts for the future settlement of equity instruments should not be classified as equity until they are settled.

A detailed explanation of our views for non-derivatives is included in our response to Question 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?

Yes, we agree. The conditions that led to the exception being introduced in 2008 are still applicable. These conditions will continue to apply in the case where part (a) of the proposed definition of a liability in the DP (and included in IAS 32) applies.

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?

We agree that derivatives over own equity should be classified as a single instrument and so the two legs of the instrument should not be assessed and classified separately. We note that the DP takes this view for asset/equity exchanges, but not for liability/equity exchanges. We believe this is inconsistent and we do not support this. We believe that a consistent approach should be followed for both, i.e. in both cases, the instrument should be classified in its entirety. We elaborate on this further in our response to Question 6.

Consistent with our response to Question 2 we do not support the classification of some derivatives over own equity as equity. Such instruments represent a right (or obligation) to receive or deliver equity instruments in the future; they are executory instruments and not funded instruments where the entity has received consideration and given the holder of the instrument a residual right in the entity. Our preferred approach is that such derivatives should be fair valued through profit or loss. We acknowledge that our proposals would result in the measurement at fair value of instruments that met the definition of equity under IAS 32. We nevertheless note that the practicalities of fair valuation of these instruments for the issuer is the same for holders of these same instruments (i.e., at fair value through profit or loss).

Should the Board continue with an approach where some derivatives over own equity are classified as equity, as opposed to our preferred approach described in our response to Question 2, our preference would be to limit equity classification to those arrangements which are either exclusively gross physically settled or where the issuer has the right to gross physically settle. We do not support cash settled derivatives over own equity being remeasured through OCI without recycling; we do not support net share settled instruments being classified as equity.

The DP justifies the introduction of OCI measurement as a response to some concerns that the recognition of changes in the value of an equity instrument in profit or loss is counterintuitive, also drawing comparison with changes in the fair value of own credit (recognised in OCI, following the amendment to IAS 39). We do not believe these concerns are valid for the following reasons. If an entity writes an option over its own equity that results in the instrument being measured at fair value, increases in the value of the entity's equity will generate losses. We believe this faithfully represents a loss to the entity (and the current shareholders) as the consideration it will receive on issuing equity is less than the fair value of equity delivered. We do not consider this counterintuitive. Further, we do not think it is comparable with the own credit issue. The basis for excluding changes in the fair value of own-credit risk in profit or loss was the

inability of the entity to realise the gain or loss. This is not the case for derivatives over own equity as resources are either received or paid in exchange for the delivery or receipt of equity instrument and so the gain or loss will be realised.

We note the DP includes guidance on settlement alternatives for non-derivatives in paragraph 8.4, but it does not include guidance where settlement alternatives are included in derivatives over own equity. It could be inferred that if the issuer has the choice, and if one of those choices is net share or gross share settlement, then the instrument would be classified as equity, but it is not clear. Similarly, it could be inferred that if the counterparty can require the issuer to settle net in cash then it would be classified as a financial asset or liability, but it is not clear. Such an approach would differ to some extent to the approach in IAS 32 that only permits equity treatment if it is gross physically settled without any settlement alternatives.

Question 6

Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not?

Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

(a) Do you think the Board should seek to address the issue? Why, or why not?

(b) If so what approach do you think would be most effective in providing the information, and why?

We do not support the proposed approach in the DP as we believe:
- Asset/equity exchanges should be classified consistently with liability/equity exchanges.
- A forward purchase or written put over own equity is not equivalent to a purchase of equity funded by borrowings and therefore the accounting for the latter should not drive the accounting for the former.
- The debit recognised in equity under the preferred approach in the DP should not result in derecognition of equity.

These points are elaborated below.

The DP retains the 'gross obligation' treatment in IAS 32 for instruments that result in the repurchase of own equity instruments. The DP differs only in that it would require subsequent remeasurement to OCI rather than profit or loss in some cases. This is justified in the DP as a means to overcome some of the concerns with the current requirements in IAS 32. We believe introducing a subsequent measurement to OCI does not address either the conceptual or practical concerns.

We believe that asset/equity and liability/equity exchanges should be treated consistently. In other words, an obligation to deliver economic resources in exchange for receiving equity should be classified the same way as an obligation to deliver equity in exchange for receiving economic resources. This approach would be aligned with the classification of derivatives more generally where IFRS prohibits the separation of the legs of a derivative into an asset (for the inflows) and a liability (for the outflows). Consistent with our views expressed in response to Question 2, we believe asset/equity and liability/equity exchanges are future receipts or delivery of equity and therefore should only be accounted for as equity upon that receipt or delivery, and not before.

The approach in IAS 32 and replicated in the DP accelerates equity derecognition by presenting the equity as if equity has been acquired but not yet paid for. We do not support this, as in the case of derivatives over own equity, it 'grosses up' the two-legs of the executory contract treating them as if they are non-executory, i.e. as if the entity borrowed cash and used that cash to acquire its own shares. Nowhere else in IFRS Standards are derivative contracts separated out into their two legs and we do not believe there is a sound enough basis for doing so here.

Grossing-up of derivatives introduces two accounting problems: (i) whether the gross obligation should be accounted for in the same way as other liabilities under IFRS 9 or remeasured differently because the amount is linked to the delivery of shares, and (ii) whether the debit in equity represents the derecognition of equity. The DP has addressed both of these areas but not in a way we support.

With respect to the measurement of the gross obligation, we note that the DP proposes remeasurement to OCI to overcome concerns that in some cases remeasurement to profit or loss may be seen counterintuitive. Measurement to OCI will apply for 'fair value puts' or 'fair value forwards' where the strike or contracted forward price is equal to the fair value of the shares to be delivered at the time of delivery. In our view these arrangements are in substance liquidity contracts, rights or obligations for the holder to deliver shares back to the issuer for their then market price. These arrangements provide the holder with security that the shares can be sold back to the issuer. Other than the benefit for the holder to have liquidity in selling shares back to the issuer they do not have value (i.e. there is no intrinsic value), yet the accounting in IAS 32, and in the DP, produces profit or loss volatility (OCI volatility in the case of the DP). We do not think this is appropriate as it portrays the entity as having gained or lost from acquiring its shares at future market price when in fact it has done neither. Consistent with our proposed approach for classification, we believe such contracts should be fair valued through profit or loss. Fair valuation will appropriately reflect only the liquidity benefit, to the extent that there is any, to the holder and will not result in gains or losses arising from changes in the fair value of the issuer's equity instruments. This logic could be extended to instruments where the only obligation contained in the instrument is for the entity to acquire its equity at fair value, e.g. puttable shares. In substance, the value of the put option inherent in the instrument is the value of the liquidity benefit only.

With respect to whether the debit to equity represents derecognition, we do not support the proposal in the DP that the debit in equity is derecognition of equity in all cases. Such an approach extends the analogy of treating forward purchase and written puts over own equity as if they are debt-funded share buy backs at the date the derivative is entered into. We do not support this treatment as it accelerates the purchase of equity prior to it actually occurring, noting that in the case of written put options the repurchase may never occur as the option may lapse unexercised. This leads to a number of concerns: firstly, it can increase basic EPS by decreasing the denominator even though the number of ordinary shares outstanding is unchanged, and secondly, in the case of non-controlling interests (NCI) it treats the number of shares subject to the contract as being acquired so presenting those shares as not being owned by the NCI even though the NCI's rights to dividends and the net assets of the subsidiary are unchanged. Ultimately, whether the NCI is deemed to be acquired is a matter for IFRS 10 and should not be determined by whether a derivative is notionally split.

A further complication arises with the derecognition of the equity (i.e., recognition of the debit in equity): when written put options lapse unexercised, the entity is required to depict that at maturity of the option the entity has issued equity (either parent's or subsidiary's) even though such transaction has not occurred. This accounting treatment in effect reverses the "derecognition" of equity that was recorded when the instrument was first recognised. In the case of a written put over NCI, the entity will be required to recognise the NCI as a purchase of NCI (a transaction between shareholders) when the put is entered into; and then on expiry, if the option is unexercised the entity will have to recognise a sale of NCI, i.e. in effect reversing the purchase of NCI that did not actually occur. In our view this is unnecessarily complex and does not faithfully depict the current ownership interest of the NCI during the period the option remains outstanding.

One of the justifications in the DP for treating written puts as gross obligations is to ensure the same classification of a liability in the case when an entity issues equity and writes a put option over equity, with the liability that is recognised when an entity issues a convertible bond. The argument being that the combination of an issue of shares with a written put is economically the same as a convertible bond. We disagree with this logic as we believe the instruments are economically different. For example, a convertible bond that is convertible at maturity at say year 5, is not the same as the issue of shares with a written put that is exercisable at year 5. In the former, the entity has a fixed claim for the principal of the convertible debt until such time, at year 5, when the holder can convert into equity and then have a residual interest in the entity. In the latter, the holder already has a residual interest in the entity and only has a fixed claim at year 5. Depending on the financial health of the entity during the 5-year period, the holder is not in the same economic position.

In addition to our general comments on liability/equity arrangements, we also disagree that forward purchases or written puts over own equity that are exclusively net share settled (or where the issuer has a choice of net share settlement) should be recognised as a gross obligation with a debit in equity at initial recognition. In this case, as the entity is not obligated to pay the gross amount, the recognition of the gross obligation results in overstating liabilities (and understating equity) which will need to be fully or partially reversed when the instrument is actually net share settled.

Question 7

Do you agree with the Board's preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

The presentation of balance sheet solvency and returns described in paragraphs 6.53 and 6.54 are a product of the proposed classification model in the DP. Given the proposed model requires liability recognition for amounts that are discretionary other than at liquidation, we can see why the Board would prefer to split these out from liabilities where there is no discretion. However, the Board's preference for separate presentation further highlights to us that such instruments are different in nature and that they should not both be classified as financial liabilities (see our response to Question 2).

Similarly, the Board have proposed a classification model whereby some derivatives over own equity are remeasured to OCI, not profit or loss, hence the need for separate presentation on the statement of financial position of those instruments versus others. As explained in our response to Questions 2 and 5, our preference would be that such instruments are measured at fair value through profit or loss. Therefore we do not believe that further disaggregation in the statement of financial position is warranted, rather they should be grouped together in a single line (and remeasured in a single line in profit or loss, as outlined in our response to Question 2).

We believe the complexity of the proposed presentation requirements arises because different instruments are measured as equity or financial liabilities depending on the degree to which the 'amount feature' is partly or fully independent on the entity's economic resources. Our proposed approach does not rely on the amount feature, nor does it permit FVTOCI, hence our classification approach and the presentation that follows is simpler.

An example of this complexity is highlighted in the request for feedback on how to present instruments with embedded derivatives that would require bifurcation if the instrument was not wholly measured at fair value through profit or loss. One of the advantages of applying the fair value option to financial liabilities is to avoid the need to calculate the fair value of the embedded derivative. We do not therefore consider it reasonable

to require the separation of embedded derivatives for presentation purposes (Alternative A) when they are not separately recognised as doing so would eliminate much of the benefit of applying the fair value option. Our preference therefore is Alternative B.

Question 8

The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

(a) a full fair value approach (paragraphs 6.74–6.78);
(b) the average-of-period approach (paragraphs 6.79–6.82);
(c) the end-of-period approach (paragraphs 6.83–6.86); and
(d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25.

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

We agree with the observations in the DP that the current focus in IFRS Standards is disclosure of instruments that are financial liabilities, and not those that are equity. We believe the imbalance should be addressed given the rights of equity instruments can vary considerably. Overall we support the approach in the DP to attribute total profit or loss and OCI between ordinary shares (as in IAS 33) and other equity instruments. This will enhance the information provided where an issuer has multiple classes of equity instruments.

We note that the Board was unable to decide on a proposed attribution approach for equity instruments that are derivatives. Our preferred approach in accounting for derivatives over own equity as financial assets and liabilities would result in them being excluded from the attribution approach as they would not be equity instruments. Instead, the gains or losses on such instruments would be recognised in profit or loss and so would be included in the allocation of comprehensive income between the non-derivative equity instruments as proposed in the DP.

If the Board does not pursue our preferred approach for the classification of derivatives over own equity, and therefore some derivatives over own equity were classified as equity, our preferred allocation approach would be the fair value approach given that it best represents the cumulative gain or loss that is borne by some equity instruments and not others. We are conscious that to fair value such instruments could be argued as being onerous if this was solely required in order to attribute total comprehensive income for disclosure purposes. This reinforces our preferred classification approach that they should be fair valued for recognition and measurement purposes, and not solely for attributing comprehensive income.

We observe that much of the attribution approach ties in with IAS 33 *Earnings Per Share*. IAS 33 is a standard that has not kept up with the current classification approach in IAS 32 and is showing its age. For example, IAS 32 treats a conversion option the same irrespective of whether it is embedded in a debt instrument (such as convertible debt) or a standalone derivative over own equity; yet, IAS 33 has two different methods for calculating dilutive EPS by applying the if-converted method to the former and the treasury stock method to the latter leading to very different results. This is one example where IAS 33 could

be improved considerably. Should the Board continue with this project, we consider that the EPS impact of the liability/equity classification outcomes should be assessed against the outcomes in IAS 33 to determine whether the approaches in IAS 33 remain relevant or whether IAS 33 needs updating. We fear that IAS 33 could become less relevant as the liability/equity model (and attribution approach) deviates further from the original basis for IAS 33.

Question 9

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).
(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).
(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

We support improvements to disclosure. We note that when IFRS 7 *Financial Instruments* was issued it removed the disclosures requirements previously contained in IAS 32, some of which the DP proposes to reintroduce, e.g. disclosure of the contractual terms and conditions of instruments. The focus of IFRS 7 has been on financial assets and liabilities, with nothing included on equity instruments. We support re-establishing a balance.

Priority on liquidation

We agree with the DP that information on priority on liquidation would be useful. Paragraph 7.6 of the DP proposes this could be included on the face of the statement of financial position or in the notes to the financial statements (like in a capitalisation table). We would favour the latter for the following reasons:

- Consistent with our previous comments regarding liquidation in response to Question 2, because the financial statements are prepared on a going concern, we prefer the current approach in IAS 1 of listing assets and liabilities either as current/non-current or in order of liquidity. The capitalisation table would supplement this in the notes to the financial statements so users would understand the priority on liquidation. Disclosure in the notes to the financial statement would not mix up concept of amounts due on a break-up basis with the timing of cash flows assuming the entity continues as a going concern.
- Offering a choice of disclosure on the face of the statement of financial position or in the notes to the financial statements will lead to mixed practice and a lack of comparability.
- Including the information in the notes to the financial statements allows the terms and conditions of the instruments to be explained along with the priority on liquidation given the liquidation priority is often one of the key terms and conditions. This will avoid repetition in the financial statements.

Potential dilution of ordinary shares

We believe the information in IAS 33 has become less meaningful due to the advances in financial engineering and the fact that the standard has not been updated to be aligned with the requirements of IAS 32. In addition, IAS 33 has some flaws that could be rectified as part of this project to ensure that the EPS disclosure is more meaningful. For example, as included in our response to Question 8, IAS 33 retains two different dilutive calculations, the 'if-converted' and the 'treasury stock' method for calculating the dilutive effect convertible options depending on whether they are issued as part of a convertible debt or as standalone instruments even though IAS 32 requires them to be classified the same way.

We support the disclosure proposed in the DP as it illustrates the potential for dilution, as opposed to simply the dilutive effect at the period end (as required by IAS 33). Understanding the potential for dilution, i.e. how many shares are potentially issuable and under what circumstances is important in understanding potential changes to the entity's capital structure. For example, an issuer may have potential ordinary shares where the conversion is contingent on a future event. Under IAS 33, the period end is assumed to be the end of contingency period, and so if the event is assumed not to have occurred at the period end, the instrument is considered as not dilutive and the potential dilutive effect is not disclosed. Similarly, a conversion option may be deemed out of the money at the period end, so is not dilutive when applying the treasury stock method, and so is not included in dilutive EPS even though in future periods should the value of ordinary shares change it has the potential to be dilutive.

Contractual terms and conditions

We support greater disclosure of the terms and conditions of financial instruments. However, there is a risk that such disclosures extend to all financial instruments, including financial assets, or financial liabilities such as trade payables. We do not believe this should be the focus. Rather, we believe the focus should be on disclosure of terms and conditions of those instruments that the entity uses as its capital structure (and those instruments that it uses to manage its capital structure such as derivatives over own equity). The capital management disclosures in IAS 1 could be extended to include this to avoid duplication.

We note the DP acknowledges that should the Board pursue their proposal they would consider the information that is already required by other Standards. We support this, particularly given the capital management disclosures as noted above, and the liquidity disclosures already required by IFRS 7.

We agree with the DP that aggregation of instruments based on their terms and conditions could prove challenging. If the Board were to pursue introducing a capitalisation table it would make more sense that the significant terms and conditions of the items listed in that table, which may be aggregated if they are similar, as noted above, are included with that table so users of financial statements understand the terms of the instrument together with how those terms impact the seniority relative to other instruments in the table.

Question 10

Do you agree with the Board's preliminary view that:

(a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?
(b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

We agree with the Board's proposed approach in this respect.

The impact of economic incentives and indirect obligations contained in IAS 32 are largely well understood and have not led to requests to the IASB for interpretation. We note that this approach could be considered inconsistent with paragraph 4.29 of the revised Conceptual Framework for Financial Reporting that states

that "[a]n obligation is a duty or responsibility that an entity has no practical ability to avoid." Irrespective, our preference is to retain the approach in IAS 32, which is carried over into the DP, where classification is based on the substance of the contractual terms.

We agree that economic incentives that may influence the issuer's choice whether to pay should be ignored when classifying an instrument as a liability or equity. This is consistent with IAS 32:AG26. If the Board were to move away from this approach into a more probability weighted approach, we expect this would create new reclassification and measurement issues, in particular because it would lead to the the need to re-estimate the likelihood that economic incentives will affect the entity's probability of making a payment. An entity may have economic incentives to pay dividends on ordinary shares given investor expectations, but we do not believe these should convey on obligation of the entity.

Similarly, with respect to indirect obligations, the guidance in IAS 32:20 reduces the risk of structuring opportunities whereby an entity can claim they have no obligation to pay cash even though the delivery of cash is a much cheaper alternative than the obligation to deliver equity. Enhancements in disclosure of terms and conditions of instruments classified as equity should assist users in understanding indirect obligations contained in instruments.

Question 11

The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

Differentiating between contractual and statutory obligations has been challenging in practice in certain jurisdictions. We support the IASB in acknowledging this issue and recognise that to move away from the current approach will no doubt be challenging. However, we do think the Board should consider if guidance could be provided that distinguishes where the boundary for the contracts stops and legal obligations (not subject to contract) start. We note that IFRS 17 *Insurance Contracts* takes a different approach by including legal provisions in the determination of a liability. Given the similarities between issued financial instruments and insurance contracts we think it would be helpful to clarify how and when statutory provisions impact the determination of a financial liability.

In practice, we have seen in a number of jurisdictions examples where under law the entity is required to distribute a specified percentage of profits to ordinary shareholders. In some cases these distribution requirements are specified in the contract, in other cases they are not specified and are merely enforceable because the instrument is governed by the law in that jurisdiction. The issue becomes more complex when instruments issued in those jurisdictions include additional obligations to pay a percentage of profits over the statutory minimum; the difficulty arises in determining whether the financial liability represents the excess over the statutory minimum or all the amounts that the entity is required to pay. Similarly, banking resolution regulation may not be included in the contractual terms of an instrument as it applies in law to holders of instruments resident in the issuing jurisdiction; whereas in other cases the banking resolution regulation is included in the contract so investors of the instrument residing outside of the issuing jurisdiction are treated equally to those that are residents in the issuer's jurisdiction. This may result in the latter being deemed a contractual term whereas the former is not.

We acknowledge that issuing guidance in this area would be challenging given that IFRS Standards are applied across multiple legal frameworks. A possible approach is to develop a principle whereby statutory obligations are those that arise from law and are generally not specific solely to the entity but to other entities at the same time. In contrast, a legal requirement could be considered integral to the contractual terms of an instrument (and therefore reflected in determining whether it is a financial liability) if that term would continue to apply throughout the life of the instrument despite subsequent changes in law.