



## FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Issued 7 January 2019

ICAEW welcomes the opportunity to comment on the Financial Instruments with Characteristics of Equity consultation paper published by IASB in June 2018, a copy of which is available from this [link](#).

ICAEW appreciates the IASB's efforts to address the challenges arising in practice from the application of IAS 32 *Financial Instruments: Presentation*. It is clear that significant work has taken place in order to develop the preferred approach outlined in the discussion paper, and this will no doubt prove useful in the future. However, we are concerned that the IASB's preferred approach is overly complex, such that the ongoing costs of application are likely to exceed any benefit of a more robust conceptual underpinning to accounting in this area.

Overall, we are not convinced that the new approach would result in a significant improvement in the accounting for financial instruments with characteristics of equity compared to IAS 32. In our view, making targeted improvements to IAS 32 would appear to be the most efficient way forward at this stage, relying mainly on the existing Conceptual Framework.

This response of 7 January 2019 has been prepared by the ICAEW Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

© ICAEW 2019

All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
  - the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.
- Where third-party copyright material has been identified application for permission must be made to the copyright holder.

For more information, please contact: [frf@icaew.com](mailto:frf@icaew.com)

## KEY POINTS

### SIGNIFICANT WORK TO DATE

1. ICAEW appreciates the IASB's efforts to address the challenges arising in practice from the application of IAS 32 *Financial Instruments: Presentation*. It is clear that significant work has taken place in order to develop the preferred approach outlined in the discussion paper, and this will no doubt prove useful in the future.
2. That said, at this stage of the project we would have expected a discussion paper to include discussion of the pros and cons of all the various approaches considered by the IASB as well as different options for taking this project forward into an Exposure Draft. We accept that, due to the complexity of some of the issues under discussion, it may have been difficult for constituents to follow the full debate over time. The IASB may have considered it most helpful to move straight to a discussion paper outlining their preferred approach. However, in our view, greater discussion on the various options could have been beneficial, particularly in light of our concerns with the preferred approach, as outlined below. While many constituents are likely to support an approach with similar outcomes to IAS 32, providing them with an opportunity to consider other outcomes may have provided better evidence of this support.
3. We acknowledge there have been issues raised with the Interpretations Committee, and that IAS 32 is not a perfect standard with a strong conceptual underpinning. While many of the older application issues have been resolved or relate to instruments which are increasingly less common in the banking industry, there remain issues in other industries, such as private equity. Also, as capital requirements evolve, particularly for banks, there are new issues emerging, such as how to address instruments with bail-in features which aim to help resolve as a going concern. However, as noted in paragraph 29 below, it is not clear whether the discussion paper addresses features that impact instruments prior to a winding up. It may be that further consideration will be required for emerging instruments, whether or not IAS 32 is replaced.

### COMPLEXITY OF THE PREFERRED APPROACH

4. Overall, we believe that the preferred approach is too complex, so that the ongoing costs of application, including those for users trying to interpret the results, are likely to exceed any benefits of a more robust conceptual underpinning for accounting in this area. In particular:
  - a) It introduces new terminology which is difficult to understand and, in our view, would be challenging to apply in practice both at transition and on an ongoing basis (see questions 2 and 6 for further detail).
  - b) It uses concepts in a way that is not consistent with the Conceptual Framework. For example, the interrelation of the 'amount' feature with the concept of financial statements produced on a going concern basis, which results in some instruments being classified as liabilities even though there is no amount payable other than at liquidation; and use of the term 'derecognition' in relation to own shares in a written put option (see questions 2 and 6 for further detail). We consider that such inconsistency goes beyond minor amendments to the definitions of liabilities or equity that might be expected given the Conceptual Framework was finalised in advance of this project.
  - c) It results in certain outcomes which are more complicated to account for and understand compared to IAS 32. For example, the proposal for written put options results in three entries (DR: own shares, CR: liability, DR/CR: asset/liability or equity) with some movements taken to OCI rather than two entries (see question 6 for further detail).
  - d) It introduces a new type of liability that expands the use of OCI which, in our view, is not well understood (see question 7 for further detail).
  - e) It introduces a complicated analysis of reserves based on IAS 33 *Earnings Per Share*, which currently only applies to listed entities, for all entities (see question 8 for further detail).

- f) It introduces complex, judgemental measurement for liability components which are initially recognised at little or no value but then could be remeasured if circumstances change so repayment seems more likely (see question 2 for further detail).
5. The preferred approach also has implications for other standards, for example, IFRS 9 *Financial Instruments* where a holder can only measure instruments at FVOCI if they are equity for the issuer, and IFRS 2 *Share-based Payments*, which requires consideration of whether the award is based on the price of an equity instrument. However, the discussion paper does not appear to consider the interrelation of the concepts outlined in the preferred approach with other IFRSs. The merits of consistency with the preferred approach or otherwise, will need to be considered. Addressing the impact on other standards and the Conceptual Framework will mean additional work for the IASB.
6. Overall, we are not convinced that the preferred approach would result in such a significant improvement in the accounting for financial instruments with characteristics of equity compared to IAS 32 to justify the effort of finalising and implementing the changes.

## A HALF-WAY HOUSE

7. In developing the preferred approach, the IASB has sought to clarify the rationale for distinguishing liabilities from equity instruments in order to help explain many of the existing classification outcomes arising from the application of IAS 32. In addition, the IASB has sought to address some of the application issues that exist in practice. Indeed, the discussion paper notes that, under the preferred approach the classification outcomes for the majority of financial instruments would not be expected to change.
8. We can sympathise with the IASB's reason for tackling the project in this way, particularly when the application of IAS 32 does not present significant classification challenges for the majority of financial instruments in practice. However, this approach appears to represent a half-way house between going back to first principles in order to develop a solution, and developing targeted improvements to IAS 32.
9. We do not find this to be a satisfactory outcome. Even when no change to the classification outcome is expected, the complexities with the approach would result in significant implementation cost and effort (as well as standard setting effort to align with the Conceptual Framework and other standards) in order to reach the same outcome as under IAS 32. While transitional provisions could be used to reduce the implementation effort, we believe the complexity of the preferred approach could remain an issue.
10. Additionally, where it appears that there are changes in classification, we are not convinced that the outcomes would result in more useful information. For example, we do not agree with the removal of the foreign exchange rights exemption (see question 5) or that certain cumulative preference shares should be classified as liabilities (see question 2).

## NEXT STEPS

11. In light of our reservations noted above, we recommend that the IASB does not pursue the preferred approach outlined in the discussion paper. We believe it is likely that the costs of implementation to all parties, including to the IASB in developing an accepted standard and making consequential amendments to other standards, seem likely to exceed any benefit. In fact, the benefit of producing what may be perceived as a better, more principled standard would be lost if it is overly complex to apply and the results are more difficult for users to understand. We acknowledge that some of these concerns may be alleviated as the terminology and concepts became more familiar (see our response to questions 2 and 3), but even those well versed in the nature of capital instruments and their accounting issues are finding it difficult to understand and apply the approach outlined in the discussion paper.
12. Nevertheless, the discussion paper identifies some solutions to certain specific issues in IAS 32 which could be helpfully developed. For example, the suggestion of additional disclosures on the terms and conditions of financial instruments has some merit. Also improved disclosure on areas of significant judgement could be explored further (see question 9).

Additional guidance on how to deal with contingent settlement options and the order in which to analyse components could represent an improvement to IAS 32 (see question 6). Aligning the treatment of foreign currency contractual terms with the treatment in IFRS 9 could also be explored (see question 5).

13. While we would support the IASB going back to first principles to develop a solution, we do not believe that this is a high priority. For example, if the IASB did choose to develop proposals that have a simpler conceptual basis, it could result in equity being more limited than under IAS 32, with all derivatives on own equity measured at fair value through profit or loss. Such an approach would also have its own challenges since more changes in own share price would be recognised in profit or loss. We thus fully appreciate the difficulties and the amount of time the IASB has already devoted to this issue. It may be that developing a widely supported, more conceptually pure basis would prove a very difficult task.
14. In our response to the IASB's 2015 Agenda Consultation, ICAEW classified the 'financial instruments with characteristics of equity' project as high priority in order to complete the revised Conceptual Framework, rather than to address any fundamental problems with IAS 32. However, in our view, there are other more pressing matters for the IASB to address in 2019, for example, the accounting implications of IBOR reforms. Making targeted improvements to IAS 32 would appear to be the most efficient way forward at this stage, relying mainly on the existing Conceptual Framework.

## ANSWERS TO SPECIFIC QUESTIONS

### 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?**

15. The discussion paper identifies two general challenges. Firstly, the conceptual challenge of identifying a clear rationale for distinguishing liabilities from equity. Secondly, the application challenge of developing principles which balance the benefits of the information provided in the accounts with the cost/complexity of their application. We agree that these are challenges to be considered when looking at how to address the issues arising from IAS 32.
16. However, while we do not disagree with the description of these challenges and their importance to users of financial statements, we do not believe they will be resolved by the preferred approach outlined in the discussion paper. As discussed below, we are concerned that the preferred approach is overly complex and that the costs may exceed any benefit of a clearer conceptual underpinning to the requirements. In addition, we are not convinced that some of the different classification outcomes expected under the preferred approach would result in more helpful information.
17. That is not to say that no standard-setting activity should occur. We could support the IASB going back to first principles to develop a new standard that may result in different outcomes to IAS 32. This would involve developing a consensus for classification changes, including the effect on profit or loss, and setting out the impact on the Conceptual Framework and other standards. However, we do not believe that this is a high priority. Rather, we believe the discussion paper identifies some solutions to a number of current issues in IAS 32 which could be developed in the short term. For example, the suggestion of additional disclosures on the terms and conditions of financial instruments has some merit. Also improved disclosure on areas of significant judgement could be explored further. Additional guidance on how to deal with contingent settlement options and the order in which to analyse components could represent an improvement to IAS 32. We also believe that it would be helpful to provide guidance on the application of key principles of IAS 32.

18. In addition, there are further challenges that are not addressed in the discussion paper. The interaction with other standards will need to be considered, for example IFRS 9 *Financial Instruments* classification by the holder of the instrument (including availability of FVOCI) or accounting treatment under IAS 27 *Consolidated and Separate Financial Statements*. For example, certain investments in subsidiaries that are currently classified as equity under IAS 32 form part of the investment in a subsidiary in the financial statements of the parent. If these are classified as liabilities or compound instruments, this will change the parent's financial statements, introducing volatility due to the change in classification by the subsidiary and could have a real economic impact with regard to funding subsidiaries.
19. As capital requirements evolve, particularly for banks, there are new issues emerging, such as how to address instruments with bail-in features which aim to help resolve as a going concern. However, as noted in paragraph 29 it is not clear whether the discussion paper addresses features that impact instruments prior to a winding up. It may be that further consideration will be required for emerging instruments, whether or not IAS 32 is replaced. Other challenges not sufficiently addressed include consideration of the linkage between different types of financial instruments and the impact of foreign currency as discussed further in our response to question 5.

## 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?**

20. We have a number of concerns with the preferred approach. In particular, the introduction of new terminology and concepts which, in our view, are difficult to understand and would be challenging to apply in practice both at transition and on an ongoing basis. These may also lead to new structuring opportunities, as discussed in paragraph 29 below.
21. It is especially difficult to understand part (b) of the preferred approach (referred to as the 'amount feature') which states that a financial instrument is classified as a liability when it is 'independent of an entity's available economic resources.' Paragraph 3.21 of the discussion paper states that the 'amount' of a particular financial instrument is not the fair value of the financial instrument and that the assessment of the amount 'depends on whether the amount specified in the contract (the contractual pay-off) changes in response to the available economic resources'. However, in many of the examples provided in the discussion paper, the amount seems to be tied to the entity's share price, which suggests fair value.
22. While in theory the entity's share price is a proxy for its available resources, it is not clear that this always applies in practice. An increase in share price is not necessarily closely related to the amount of cash or other economic resources available to the entity, particularly in the short-term. While the discussion paper suggests that an entity should not need to determine its available economic resources to assess whether the amount of a financial instrument is independent of its available economic resources, it is not clear that such a determination would be operational. It seems unlikely to be possible or meaningful to identify all of an entity's recognised and particularly unrecognised assets in order to make such a determination.
23. Generally speaking, we do not believe that the IASB has articulated the concept of an 'amount independent of the entity's available economic resources' or clearly explained how it



would be applied in practice. This is important so that any resulting standard can be readily applied to simple transactions, which represent the majority for most companies, but can also deal appropriately with more complex transactions.

24. It is also unclear whether the concept of 'liquidation' (which applies to both the timing and the amount feature) also includes other insolvency arrangements, such as administration and other consequences of default, such as restructuring or solvent liquidation. While standards are not intended to be industry specific, bank resolution regimes in a number of jurisdictions make it virtually impossible for a bank to go into liquidation and therefore the application of the concept is unclear.
25. Furthermore, we are concerned that the concepts outlined in the preferred approach are not used in a way that is consistent with the Conceptual Framework. In particular the interrelation of the proposed 'amount' feature with the going concern basis of accounting (see below), and the use of the term 'derecognition' (discussed further in question 6). The 'amount' feature itself does not seem to represent a good conceptual basis for establishing a liability in the absence of also meeting the 'timing' feature. Fixed amounts paid on a winding up do not seem to represent liabilities.
26. For example, under the preferred approach, irredeemable fixed-rate cumulative preference shares are treated as a liability because there is an obligation 'independent of the entity's available economic resources' even though there is no amount payable other than at liquidation. This is a significant change in outcome compared to IAS 32. Yet this is not a problematic financial instrument, in terms of classification under IAS 32. Moreover, we struggle with accepting that this instrument is a liability. We do not believe this provides relevant information for an assessment of balance-sheet solvency and returns since no amounts will be paid except at liquidation, and financial statements are prepared on a going concern basis.
27. We also note that under the preferred approach irredeemable non-cumulative preference shares that require a fixed amount to be paid at liquidation would be considered a compound instrument with a liability component, the fixed amount payable at liquidation discounted back to nil or an insignificant amount on a going concern basis. We have trouble accepting that an amount payable only on liquidation contains a liability component in financial statements prepared on a going concern basis. In addition, the subsequent measurement of these liabilities is not addressed in the discussion paper. If, in accordance with IFRS 9 the liability is re-measured either on an amortised cost or fair value basis, as the likelihood of liquidation becomes more (or less) probable, this would seem to be a change from existing practice and introduces issues which require further consideration. For example, what discount rate should be applied, how should judgements be made as to the likelihood and amount of any payment on liquidation and how does this outcome relate to paragraph 5.21 of the discussion paper which suggests that any conditionality is not included in the non-derivative financial liability? This accounting may make the financial statements less understandable or even misleading, particularly where the instrument could actually suffer loss in a liquidation.
28. In our view, any amount payable on a preferred share on liquidation is not a liability but a preferred interest in the residual interest in the assets of the entity after deducting its liabilities. The amount due to the preference shareholders on liquidation is limited by the value of the entity's net assets. Also, as an entity moves toward ceasing to be a going concern, recognising amounts that could exceed the value of the entity's net assets through profit or loss is unlikely to provide useful information.
29. A more common example of how the 'amount feature' might work, which is not set out in the discussion paper, is a preference share that is callable by the issuer. While there is no obligation for the instrument to be called, an increasing coupon may create 'economic compulsion.' However, as a result of a fixed amount being paid at liquidation, the liability component would have a significant fair value reflecting the likelihood of the call option being exercised. The liability is created as a result of the situation on a winding up and not as a result of the call option. This outcome could be avoided by not having a fixed amount payable on a winding up. Basing classification on a contractual term that may not be particularly relevant to the economics and pricing of an instrument, such as what happens on

a winding up, will create structuring opportunities and does not seem an improvement to existing IAS 32.

### 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?**

30. As discussed in our response to question 2, we have a number of concerns with the preferred approach outlined in the discussion paper.

### 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?**

31. Yes, we agree that the puttable exception is required under the IASB's proposed preferred approach. Although the IASB has sought to develop a more robust conceptual underpinning to the classification of financial instruments with characteristics of equity, the conditions that give rise to the need for the exception are not resolved by the preferred approach and would, therefore, need to be retained.

### 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) 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?**

32. We agree with the preliminary view that a derivative on own equity should be classified in its entirety as an equity instrument, a financial asset or a financial liability ie, that the individual legs of the exchange would not be separately classified.

33. However, following on from our concerns outlined in our responses to questions 2 and 3, we are not convinced that the preferred approach to the classification of derivatives on own equity will be an improvement over IAS 32. Indeed, we are concerned that it will introduce further complexity and lead to outcomes which may provide less useful information.

*Removal of the IAS 32 foreign currency rights exception.*

34. In 2005, the IFRIC decided to recommend that the IASB amend IAS 32 to permit a conversion or stand-alone option to be classified as equity if the exercise price was fixed in

any currency. However, the IASB decided not to proceed with the proposed amendment. In 2009, the IASB amended IAS 32 to ensure that a rights issue denominated in a foreign currency is classified as equity. This resulted in interested parties questioning why derivative financial instruments that meet the exception introduced in 2009 should be classified differently to conversion options in foreign currency convertible bonds, which are classified as financial liabilities. Whilst the approach preferred in the discussion paper would align the treatment of the foreign currency bond and the rights issue so that both have a derivative component that, if certain conditions were met, could have movements recognised in OCI, we do not think this is the better solution. It does not address the challenges that the functional currency concept does not always work particularly well in the context of consolidated financial statements of an international group.

35. We consider that the rationale for the amendment to IAS 32 remains and alignment could be better achieved by changing the treatment of the foreign currency convertible bond. Under IFRS 9, the holder of a financial asset assesses and accounts for the instrument in accordance with its terms. It is unclear why the same principles should not apply to the issuer as well as the holder. As a result, the classification assessment should be based on the terms of the instrument itself, rather than considering the functional currency of the issuer. In certain jurisdictions, entities have to raise capital in their non-functional currency due to limited liquidity in the markets for their functional currency. Having a different treatment for the same instrument, except the currency in which it is issued, is likely to cause more effort for users to understand, than if the same treatment is applied. It will also reduce comparability between companies with the same instrument, depending on the functional currency of the issuer. Foreign currency bonds are frequently hedged into the functional currency by currency swaps, which causes further complications since the economic exposure is the same as a functional currency issuance.
36. We also note that the proposal set out in paragraph 6.34 of the discussion paper would require movements in derivatives recognised as a result of the instrument being denominated in a foreign currency to be recognised in profit or loss, unless the foreign currency condition is imposed by an external factor, such as law, regulation or market forces. Such a scope restriction could result in those entities that originally requested the rights issue exemption not meeting the conditions, since the use of foreign currency is not necessarily required by law or regulation and it may be difficult to demonstrate that the issuance is required by 'market forces'. However, the resulting shares would be equity of the issuer once the shares are issued.
37. The discussion paper is also unclear as to whether the classification of an instrument would alter with any change in an entity's functional currency. For example, would an instrument which is denominated in a foreign currency and which is classified as a liability, be reclassified as equity if the functional currency of the entity changes to that currency in which the instrument is denominated?
38. Reconsidering the treatment of foreign currency terms and aligning their treatment with IFRS 9 could be an improvement to IAS 32 that the IASB should pursue.

#### *Derivatives*

39. In accordance with the discussion paper, in the case of net share settled derivatives, those settled by delivery of a fixed number of own shares in exchange for receiving a variable number of its own shares for a value equal to a fixed amount in the entity's functional currency would be classified as equity. However, a derivative to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares would be a compound instrument. This might be appropriate accounting for options where shares are delivered depending on whether the option is in or out of the money. For other derivatives, such as swaps, the entity either receives or delivers shares depending on the movement of the share price. There might be no extinguishment of own equity instruments. It is not clear conceptually why these instruments should be classified as a redemption obligation arrangement when they are just as likely to lead to own shares being received.



40. We also question whether the amount feature results in the same outcome as IAS 32 when there is a derivative to deliver a variable number of shares that represent a fixed proportion of the entity's issued shares (paragraph 4.58(a)). The discussion paper indicates the potential asymmetric dilution in this circumstance, where the holder of the option is entitled to receive 25% of the shares in issue for a fixed amount of functional currency it would not meet the amount condition notwithstanding that the option holder can be put in a better position than equity holders since, regardless of share price changes, the equity holders remain entitled to 25% of the shares. IAS 32 could be improved by better explaining how 'fixed for fixed' works in such situations.

### 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.***

41. We have a number of concerns with the IASB's preferred approach in relation to compound instruments and redemption obligation arrangements.
42. In particular, similar to our response to question 2, we are concerned with the introduction of new terminology and concepts. For example, the discussion paper introduces the concept of a 'package of contractual rights and obligations' ('for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the underlying non-derivative equity instrument that will or may be extinguished together'). However, it is not clear how this concept relates to other standards, for example, IFRS 9 IGB.6 which addresses when transactions should be aggregated and treated as a derivative. The concept of a 'package' does not require the instruments to be entered into at the same time. This could result in a broader application than that applied under IAS 39/IFRS 9 which may create issues in its application.
43. Overall, we find the preferred approach for compound instruments to be overly complex and believe it would result in outcomes which are more complicated to develop and difficult to understand. For example, we do not agree that convertible bonds and written put options on own equity instruments should result in the same accounting. While we agree that the written put option should be recognised as a liability, we believe the debit should be recognised as a debit in equity rather than 'derecognising' the shares. This is because the entity will continue to pay dividends on the shares while they exist, rather than interest, the holder of the shares retains the voting rights and, in the event of insolvency before the option is exercised, the holder is not in the same position as the holder of a convertible bond. It is not clear what this derecognition represents or whether it is consistent with IFRS 9 and the Conceptual Framework.
44. Furthermore, we consider that the additional entry suggested by the preferred approach to recognise the fair value of the conversion option in equity is confusing, particularly if the written put option is exercised and settled by delivering cash. It is not clear why the fair value would be relevant. What is the information content of the carrying amount of the conversion option being reclassified within equity? Rather, we prefer the existing IAS 32 treatment of written put options, which does not result in the attribution of a fair value to the option.

***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?***

45. The discussion paper notes that the IASB has discussed potential ways to provide information about alternative settlement outcomes, including: separation of embedded

derivatives from the equity host instrument; and through presentation and disclosure, such as attribution within equity.

46. We recommend that the IASB does not pursue the possibility of separating the embedded derivative from the equity host for the financial instruments in question here for the reasons noted in paragraph 5.46(b).
47. In our view it would be more helpful, at this stage, to make specific improvements to the current version of IAS 32 for such instruments, for example, providing additional guidance on how to deal with contingent settlement options and to explain the order in which to analyse the components of such financial instruments.

### **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?***

48. As discussed in our responses to questions 2 and 3, we have concerns with the preferred approach to classification, particularly in relation to the proposed 'amount' feature. Following on from this, we do not support the proposal that income and expenses arising from certain financial liabilities are presented in OCI, which is also based on the 'amount' feature. In our view this will introduce a new type of liability that expands the use of OCI, which is not well understood. We understand that the IASB would like to avoid the recognition of gains and losses on financial instruments that contain an obligation for an amount that is affected by changes in the entity's economic resources in profit or loss. However, we consider that such an outcome should result in careful consideration of the underlying principles, rather than the increased use of OCI.
49. The Conceptual Framework states that 'the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period' (CP 7.17). We do not believe that this use of OCI amounts to an 'exceptional circumstance'. The existence and effect of such an instrument can be reflected through presentation and disclosure, rather than creating a further disconnect between profit and loss and the balance sheet.
50. With regards to the proposal to require separation of embedded derivatives from the host contract for the purposes of the presentation requirements, we are not convinced by either option outlined in paragraph 6.38. As noted in paragraph 6.40(b), one of the reasons for allowing an entity to designate a hybrid instrument as a whole at fair value through profit or loss is to reduce the costs and complexity of separation. To require separation merely to reflect a component in OCI rather than profit or loss seems unlikely to meet a cost/benefit test. However, if the IASB decides to pursue this matter, we would favour approach A, albeit with our strong reservations regarding the use of OCI as already discussed.

### **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?***

51. While some users may believe that expanding the attribution of income and expenses to some equity instruments other than ordinary shares would provide useful information we are not convinced that an attribution mechanism can be developed that would in fact provide useful information or be cost effective. Furthermore, we are concerned that the proposed attribution approach outlined in the discussion paper is overly complex. For example, currently profit is attributed using the requirements of IAS 33, whereas the proposed attribution approach in the discussion paper covers total comprehensive income and therefore is different from EPS. Also, such an approach is unlikely to be readily applicable to unlisted entities that are currently outside the scope of IAS 33.
52. It might be more appropriate for the IASB to update IAS 33 in order to address the issues raised in the discussion paper, such as the issue that potential ordinary shares are considered dilutive only if they decrease earnings per share which results in less information about potential ordinary shares which are anti-dilutive. Improvements to disclosures are likely to be more understandable and cost-effective than fundamentally changing the presentation in the primary statements.
53. With regards to an attribution approach for derivative equity instruments, we would favour the option outlined in part (d) of this question ie, not requiring attribution. We note that the discussion paper identifies significant disadvantages with the other options.

## **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?***

54. In principle we agree that information about the priority of financial liabilities and equity instruments on liquidation would be useful. However, we question whether providing this information is feasible in practice. For example, it is not clear from the discussion paper how this would work in consolidated financial statements. We anticipate that there would be

significant challenges in determining priority in large complex group structures. More fundamentally, we wonder whether providing this information might be potentially misleading. For example, it would be providing information about financial liabilities, rather than all liabilities such as tax. Also, it is unlikely to be reflective of the balance sheet at the point of liquidation. Such a stressed situation is likely to be very different from the current reporting date position. Overall, we are unsure whether this requirement, which could be costly to implement, will in fact be helpful for users of the financial statements

55. We do not agree with the proposals for the disclosure of information about potential dilution of ordinary shares as outlined in the discussion paper. Such an approach would require the application of IAS 33 by unlisted companies, which in our view would not be desirable. In addition, we believe it would be difficult to implement in practice and may result in information that is difficult for users of the financial statements to understand. It might be helpful for the IASB to explore other options here, for example, a simple disclosure showing the potential maximum or minimum number of shares that could be issued by the entity.
56. While we broadly agree with the aim of providing better information on the terms and conditions of financial liabilities and equity instruments, we believe this needs further consideration. In our view, this type of information will be beneficial for users of financial statements. However, the information on the terms and conditions for such companies is likely to be difficult to summarise in a meaningful way and runs the risk of cluttering the financial statements with unhelpful information. Furthermore, it is important to consider what information on terms and conditions is already publicly available for certain types of entities (for example, through SEC requirements and Pillar 3 requirements for banks). Overall, we believe there may be some merit to improving disclosures around terms and conditions where these are unusual or complex. However, we suggest further work is needed. For example, it may be helpful to consider how this type of information could be linked to the requirements around the disclosure of key judgements and estimates in IAS 1 *Presentation of Financial Statements* ie, to make clear which terms and conditions might be materially significant.
57. Very broadly, we believe the IASB should consider how disclosures around financial instruments could be targeted to provide better information on judgemental areas. One challenge not fully explored in the discussion paper is how detailed information on financial instruments can be summarised in a helpful way. This may be something to take forward as part of the IASB's Disclosure Initiative project along with consideration of how existing and proposed disclosures, including those of regulators, might helpfully be aligned.

### **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?**

58. Yes. We agree with the Board's view that 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. While it might be useful to understand this characteristic of a financial instrument, we believe it would be difficult to implement and measure in practice, for example, economic incentives attached to a financial instrument may come and go over time as market variables change.
59. We also agree that the requirements in paragraph 20 of IAS 32 regarding the treatment of financial instruments with indirect obligations should be retained. In our view, this characteristic of a financial instruments is better addressed through disclosure. Indeed, it may be helpful for the IASB to consider how the disclosure requirements for such financial

instruments might be improved across all relevant standards. For example, to provide better information about financial instrument with multiple outcomes.

**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?***

60. Yes, we agree with maintaining the approach outlined in IAS 32 which considers the contractual terms of a financial instrument. Introducing other considerations, such as regulatory and legal requirements would lead to inconsistency with IFRS 9.