IASB Discussion Paper DP/2018/1
'Financial Instruments with Characteristics of Equity'

FRC Response

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Contents

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1 General comments

1.1 We agree that there are significant challenges in applying the requirements of existing standards, notably IAS 32 'Financial Instruments: Presentation'. However, we are very disappointed in the Discussion Paper, and do not consider that it provides an adequate basis for an IASB Exposure Draft.

1.2 We, and many of those with whom we have discussed the Discussion Paper, have found it dense and inaccessible, and some may submit only brief responses as a consequence. The Discussion Paper may therefore not promote a sufficiently fruitful dialogue between the IASB and a wide group of its stakeholders to justify developing the proposals to an Exposure Draft.

Fundamental concerns

1.3 Our most fundamental concerns are the following:

(i) The Discussion Paper rejects a fundamental review of the principles that should be used to determine the distinction between liabilities and equity, but instead seeks to find a rationale that supports the requirements of existing standards and practice, with a few exceptions that the IASB deem comfortable.

(ii) The Discussion Paper proposes that some claims that do not contain a present obligation to transfer economic resources should be reported as liabilities, because the distinction between liabilities and equity includes consideration of an 'amount' test. We believe that this is an unnecessary departure from the Conceptual Framework and results in heterogenous items being classified as liabilities, which cannot be readily understood.

(iii) In some instances, the analysis in the Discussion Paper places an emphasis on 'settlement outcomes' rather than reporting the claims on the entity's economic resources that exist at the reporting date. Please refer, in particular, to our response to Questions 2 and 6 in Appendix C.

(iv) Although we agree that enhanced disclosures would improve the usefulness of financial statements, we are disappointed that the

Discussion Paper fails to develop disclosure requirements that can be implemented in a way that it is practicable for preparers and will provide information that is readily understandable by, and useful to, users of financial statements. Please refer to our response to Questions 7 and 9 in Appendix C.

(v) The proposed attribution of income and expenses to different classes of equity instruments lacks an objective and the significance of the resulting information is unclear. Please refer to our response to Question 8.

Structure of this response

1.4 Sections 2–3 of this response expands on the points made in (i) and (ii) of the preceding paragraph.

1.5 There are three Appendices to this response, as follows.

- Appendix A draws attention to some basic considerations and summarises an alternative approach. The objective of this Appendix is not to advocate that approach but to highlight conceptual issues that need to be fully addressed in a comprehensive review and illustrate that viable alternatives merit serious evaluation.
- Appendix B compares the classification outcomes that would result from the alternative approach summarised in Appendix A and ‘the Board’s preferred approach’ advocated in the Discussion Paper.
- Appendix C responds to the specific questions raised in the Discussion Paper.

Points of agreement

1.6 There are some fundamental points on which we agree with the approach advocated in the Discussion Paper. These are:

- Consistently with existing practice and the Conceptual Framework, financial statements should reflect a binary distinction between liabilities and other claims.

- The binary distinction will not achieve the provision of sufficient information to meet all the reasonable needs of users, and therefore must be supplemented by disclosure and presentation requirements.

- More specifically, any solution must ensure that financial statements provide information about (i) whether a claim contains an obligation to transfer an economic resource, and (ii) whether any claim is for an amount that depends on the future performance of the entity.

1.7 We suggest that the IASB, after considering its agenda priorities, should either:

- undertake a fundamental review of the concepts and practices that are relevant to the classification of claims; or

- undertake a project to address and rationalise the disclosure and presentation requirements in respect of equity and liability instruments in existing standards.

2 Scope of the project

2.1 Paragraph 1.12 of the Discussion Paper notes that the Board considered two different approaches to the project:

(a) a fundamental review of the underlying concepts for distinguishing between liabilities and equity and of the requirements of IAS 32 unconstrained by existing concepts and requirements; and

(b) a narrow-scope review of the requirements of IAS 32 to address particular application challenges without reconsidering the underlying concepts in IAS 32.

2.2 The approach adopted in the Discussion Paper is that of a narrow-scope review, supplemented by proposals for enhanced presentation and disclosure.

2.3 We advocated a fundamental review of the debt/equity distinction in our responses to the 2008 IASB Discussion Paper 'Financial Instruments with Characteristics of Equity' and the IASB's 2015 Agenda Consultation. It remains our view that a fundamental review of the underlying concepts is necessary. This might provide a secure principles-based standard rather than a proliferation of rules.

2.4 In support of the decision to adopt a narrow approach to the project, the Discussion Paper suggests that:

(i) *'for most financial instruments, applying IAS 32 provides useful information to users of financial statements and creates few application challenges for preparers'* (paragraph 1.15(a))*, and;*

(ii) *'…any potential solution should limit unnecessary changes to classification outcomes that are already well understood'* (paragraph 1.17)*.*

These points are unconvincing.

2.5 The appropriate classification as debt or equity is straightforward for the great majority of financing instruments—they are either straight debt or ordinary shares. Difficulties arise only in a minority of cases. It is therefore unsurprising that existing requirements work for most financial instruments, as would any plausible alternative.

2.6 A fundamental review might, or might not, conclude that significant changes to existing requirements should be considered. In that consideration, it would be appropriate to address whether any changes were excessively disruptive or costly. However, that evaluation cannot be made until the fundamental review is concluded. But it might be that the improvement in the quality of financial reporting would outweigh the inconvenience or cost of changes. Alternatively, if it were judged that conceptual improvements should not be carried through to accounting standards on pragmatic grounds, the fundamental review would have served the useful purpose of identifying the conceptually correct solution.

2.7 Any fundamental review should address the fundamental problem that the antithesis between 'liabilities' and 'equity' is false. Intuitively most claims that are liabilities contain an obligation to transfer economic resources, and those which are equity do not, but instead receive a return that depends on the future performance of the entity. However, there are exceptions:

- claims that do not contain an obligation to transfer economic resources and whose return is specified in a way that does not depend on the future performance of the entity; and

- claims that contain an obligation to transfer economic resources, but the amount of that claim <u>does</u> depend on the future performance of the entity.

A solution that seeks to classify all claims as either liabilities or equity will therefore result in some claims being classified in an unintuitive way.

2.8 This cannot be solved simply by imposing on the users of financial statements the obligation to understand that terms such as 'liabilities' and 'equity' are used in financial reporting in an idiosyncratic sense defined by the standard-setter. The Conceptual Framework notes that *'Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently'* (paragraph 2.36). It rightly does not require the user to have a grasp of the detail of accounting standards and understand that in IFRS financial statements words may be used in a different (and not just a more specific) way from that of ordinary use. Appendix A to this response summarises an approach that would, at least, minimise this problem.

2.9 In our response to the IASB's 2015 Agenda Consultation we recommended that any research project to review IFRS 2 'Share-based Payment' should be deferred until both the FICE project, and any consequential amendments to the Conceptual Framework, were completed. A fundamental review might lead to insights that suggest possible improvements to IFRS 2.

2.10 More than half of the Discussion Paper is devoted to the classification of claims. This uses new, and in some instances perplexing, terminology but (as is its stated purpose) does not change reporting outcomes for the great majority of claims.

3 The 'amount test'

3.1 As noted above, we agree that whether a claim is for an amount that depends on the future performance of the entity is a significant factor and that such claims and their entitlement to performance-related returns should be clearly distinguished in financial statements from those of claims for an amount that does not. However, we disagree that a claim should be reported as a liability where the entity is under no present obligation to transfer economic resources in respect of the claim.

3.2 The Discussion Paper's approach creates the problems that were noted in the AAA Financial Accounting Standards Committee's response to an earlier FASB Exposure Draft, in that it:

> *classifies most complex financing instruments as liabilities, yielding a very heterogeneous set of liabilities and an artificially narrow set of equities. This*

decreases the usefulness of the balance sheet both for assessing a firm's solvency and for valuing its residual claims.[1]

3.3 A more understandable classification would result if only claims that met the Conceptual Framework's definition of liabilities were classed as liabilities—that is, claims that require a transfer of economic resources and would typically result in the entity's liquidation or bankruptcy if not fulfilled. Under the proposals in the Discussion Paper, some claims would be reported as liabilities although they do not require a transfer of economic resources and would in no circumstances lead to bankruptcy.

3.4 We appreciate that the IASB's Conceptual Framework was finalised without prejudging the outcome of the FICE project. It is therefore understandable if the FICE project provides proposals that are inconsistent with the Framework. But in our view the proposals made in the Discussion Paper do not provide an improvement on what could be achieved by adhering to the Framework's definition of a liability.

3.5 We are very concerned about the possibility of a revision to the Conceptual Framework if the proposals in the Discussion Paper are taken forward to an accounting standard, given that the Discussion Paper does not contemplate a deliberation of the principles but instead represents a narrow-scope review. This would be a rejection of a principle-based approach to accounting standard-setting, which both we and the IASB have long supported.

3.6 In support of its inclusion of the amount test to require a claim to be reported as a liability, the Discussion Paper argues that there is always a risk (albeit sometimes small) that the entity may not have sufficient available economic resources to meet the amount due to the holder of the claim. However, the consequences of this may be:

(a) the issuer is required to make a cash payment to the holder. If that is the case, the claim would be required to be reported as a liability under the 'timing' test, and the amount test is otiose. Alternatively:

[1] Evaluation of the FASB's Proposed Accounting for Financial instruments with Characteristics of Liabilities, Equity, or Both. Stephen G. Ryan, Chair; Robert H. Herz; Teresa E. Iannaconi; Laureen A Maines; Krishna Palepu; Catherine M. Schrand; Douglas J. Skinner; Linda Vincent. *Accounting Horizons* Vol. 15 No. 4 December 2001 pp.387-400.

(b) the holder may have no rights, or rights only to receive equity. If that is the case, classification as a liability is arguably inappropriate.

3.7 Our response to Question 2 in Appendix C notes that we have further qualms about the 'amount test' including the language used to describe it and its inclusion of amounts that would be required to be paid only on liquidation.

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I should be pleased to discuss the issues addressed in the Discussion Paper further, if that would be helpful. Please contact me or Anthony Appleton on a.appleton@frc.org.uk.

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Appendix A

Fundamental considerations and an alternative approach

A1 As stated in the body of this response, we agree with the Discussion Paper's proposal that there should be a clear distinction between liabilities and other claims.

A2 We also agree that the main principles the Discussion Paper has identified are highly significant, viz:

(i) whether a claim contains a present obligation to transfer an economic resource; and

(ii) whether the amount of any claim depends on the future performance of the entity.

A3 Intuitively (and in the ordinary meaning of words) it would be expected that:

(i) claims that contain a present obligation to transfer an economic resource would be reported as liabilities; and

(ii) claims that depend on the future performance of the entity would be reported as equity.

A4 A single financial instrument may contain more than one kind of claim. This challenge, however, may be overcome by separating the instrument into components and classifying each component separately. This is consistent with the proposals made in the Discussion Paper.

A5 A more significant challenge is presented by claims that neither contain a present obligation to transfer economic resources nor a claim that is dependent on the future performance of the entity. An example is a preference share which is only entitled to a dividend if dividends are paid on ordinary shares. Such a claim cannot be reported as a liability without contradicting the definition of a liability given in the Conceptual Framework. Nor can it be reported as 'equity': an investor would feel mislead if she invested in a fund that purported to invest in 'equities' but turned out to hold only such preference shares.

A6 This demonstrates the distinction between liabilities and equity is a false antithesis. It is simply not possible to maintain a binary distinction between liabilities and pretend that the resulting classification will correspond to the ordinary language meaning of words.

A7 One solution is to maintain the binary distinction between liabilities and other claims but refrain from calling the 'other claims' equity. This would enable a more representationally faithful label to be used for the 'other claims': in this response we use the term 'residual interest' but other labels might be considered.

A8 It would then be possible to require analysis of the residual interest between that which has an interest in the future performance of the entity and that which does not. An appropriate label for the former would, indeed, be equity, and the latter could appropriately be described as 'non-equity'.

A9 The advantages of this approach over the Discussion Paper's proposals are.

- All amounts reported as liabilities meet the definition of liabilities set out in the Conceptual Framework.
- Claims other than liabilities that do not participate in future performance are highlighted and reported at a meaningful amount.

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Appendix B

Summary of classification outcomes under the alternative approach summarised in Appendix A and the approach advocated in the Discussion Paper

This appendix is based on Appendix C to the Discussion Paper, with the addition of further examples.

Claim	**Alternative approach**	**Discussion Paper**
Simple bonds	Liability	Liability
Ordinary shares	**Equity** element of residual interest	Equity
Written call option to deliver a fixed number of ordinary shares for a fixed amount of cash	**Equity** element of residual interest	Equity (gross physically settled and net-share settled) Liability (net-cash settled)
Shares redeemable for their fair value (assuming puttable exception does not apply)	Liability	Liability
Irredeemable **non-cumulative** preference shares	**Non-equity** element of residual interest	Equity (except for fixed amount payable on liquidation which is stated at nil or an insignificant amount)
Irredeemable **cumulative** preference shares	**Non-equity** element of residual interest	Liability
Obligation to deliver a variable number of shares with a value equal to a fixed amount of cash	**Non-equity** element of residual interest	Liability

Appendix C

Responses to questions raised specifically in the Discussion Paper

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?

C1.1 We agree that financial statements should, as required by the Conceptual Framework, make a clear distinction between liabilities and other types of claim, and that this gives rise to conceptual and practical challenges. However, the Discussion Paper does not address the fundamental problem, which is that while <u>most</u> claims that are not liabilities (that is, do not contain a present obligation to transfer economic benefits) meet the intuitive concept of equity (in that any return to the holder reflects the future performance of the entity) there are some that do not. We discuss this more fully in Appendix A.

C1.2 We agree that the challenges in applying existing standards are sufficiently pervasive to justify standard-setting activity. However, the IASB should consider the priority of this project relative to that of its other existing and potential projects in taking this forward. It seems unlikely that converting the proposals in the Discussion Paper into a principle-based standard that can be readily understood and applied will be worth the considerable effort as it will merely result in minor changes to existing requirements. Any benefit to preparers from an improvement in the clarity of the principles will be outweighed by the cost of transitioning to the new requirements which will require a review of many instruments in issue and, until the new requirements are clearly and consistently understood, lack of certainty about the required reporting for new instruments.

C1.3 As noted in Section 2 of the body of this response, we consider that further work in this subject should take the form of a fundamental review, or alternatively should focus on improving disclosure requirements of current standards.

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?

C2.1 We disagree. In our view, the 'amount test' should not be elevated to a principle that drives the distinction between liabilities and other claims, but instead should be used as a key element in framing appropriate disclosure requirements.

C2.2 The approach advocated in the Discussion Paper would have the result that some claims would be reported as liabilities, even though the entity has no present obligation to transfer economic resources. As noted in the body of this response, this would result in a heterogenous set of claims being reported as liabilities.

C2.3 As is explained in the body of this response, we agree that financial statements should provide information about claims that (i) contain an unavoidable obligation to transfer economic resources and (ii) claims that give the holder a return that varies according to the future performance of an entity.

C2.4 Irrespective of how these criteria are used to determine the distinction between liabilities and other claims (and we agree that financial statements should make such a distinction), supplementary presentation and disclosure requirements are necessary to provide the information that users of financial statements legitimately require. A more understandable and coherent result would be obtained if liabilities were identified as only those claims that contain an obligation to transfer economic resources, and the second criterion—the so-called 'amount test'—were used to drive presentation and disclosure requirements.

C2.5 As noted in the body of this response, such an approach would maintain consistency between the principles that distinguish liabilities from other claims and those that are implicit in the definition of a liability given by the Conceptual Framework.

The relevance of claims payable only on liquidation

C2.6 In our view, a claim that would arise only on the liquidation of the entity is irrelevant in financial statements that are prepared on a going concern basis (except, perhaps, for supplementary disclosure[2]). We therefore believe that the reference to 'other than at liquidation' in the so-called timing test is incorrect. And, if it is to be retained, then its omission from the so-called amount test is difficult to understand. We appreciate that the Discussion Paper's proposed principles result in irredeemable cumulative preference shares being classed as liabilities and ordinary shares being classed as equity, and that probably many would feel comfortable with these outcomes. But financial reporting practices should follow from principles, rather than principles being devised to support comfortable outcomes.

The 'fixed for fixed' conundrum

C2.7 A pivotal issue arises where an entity has a claim that:

- it has the ability, or is required, to settle the claim by issuing its own equity;
- the amount of the claim does not reflect the performance of the entity, but is for a fixed amount, or an amount determined by an external factor (e.g. the gold price).

For convenience we refer to such claims as 'fixed amount' claims.

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[2] Our observations on disclosures that address amounts that are payable on liquidation are set out in paragraph C9.3 below.

C2.8 It is widely suggested that such claims should be classified as liabilities. If this were not the case, a contract with any supplier could contain a term that permitted the entity to settle in shares and no liability need be recognised. In principle (assuming liquid markets and ignoring transaction costs) a supplier would be indifferent between receiving cash and receiving shares to the same value. And if the entity purchases (rather than issues new) shares, the cash outflow would be the same as that of settling a cash liability.

C2.9 The 'amount test' has the advantage of preserving liability classification for claims of this kind. We acknowledge that it also is useful for holders or prospective holders of ordinary shares who would tend to view fixed amount claims as a reduction in the funds that are available to provide a return on ordinary shares. However, the Conceptual Framework identifies a wider class of users, including 'lenders and other creditors'. It is therefore questionable whether the principal information needs of ordinary shareholders should be the main consideration.

C2.10 The 'amount test' is not the only rationale that could be used, and others merit consideration. For example:

(a) the notion of 'an obligation to *transfer* an economic resource could be replaced by that of 'an obligation to *provide* economic resources'. Because equity claims are not economic resources of the entity, an obligation to issue shares in the future does not meet the current definition of a liability. It is, however, clear that the shares are, when issued or transferred, an economic resource of the recipient.

The drawbacks of this approach are, however, that:

– it would be a significant departure from the current Conceptual Framework and of the general understanding of similar Frameworks that has prevailed for some time;

– it would imply that 'conventional' options (that, is claims that require merely the exchange of a fixed number of shares for a fixed cash amount) are also liabilities, and therefore income and expenses would be reported when the value of such options changes. It is questionable whether such an outcome is representationally faithful.

(b) the focus on the distinction between liabilities and other claims should be on reporting faithfully the nature of the claims that exist at the reporting date, rather than the possible or probable settlement outcomes. (We question the focus on settlement outcomes in our response to Question 6 below (especially at paragraphs C6.6 and C6.7)). On this approach the mere obligation or right to settle an existing claim by the issue of equity is not determinative that the claim is not a liability at the reporting date. There are other instances that fit this model:

– the liability component of convertible debt is reported as a liability even when it is highly likely that it will be converted and thus its settlement will require an increase in equity, rather than an outflow of cash or other economic resources.; and

– under IFRS 15 'Revenue from contracts with customers' liabilities for performance obligations arise where the customer has paid in advance: these are measured at the amount that has been received, not at the amount of the outflow that is required to settle them, which will typically be significantly lower.

C2.11 We acknowledge that approach (b) outlined in the above paragraph would require further development. In particular, guidance would be necessary as to when a claim should be reported as a liability even where equity-settlement is probable or available to the entity. However, the Conceptual Framework notes (in paragraph 4.43) that where an entity has already obtained economic benefits it has a present obligation to pay for them[3]. It could therefore be stipulated that when a claim arises from the provision of cash, goods or services, that claim is a liability until such time as it is satisfied by the issue of equity.

C2.12 It remains conceivable that, under this approach, a claim that will be satisfied by the issue of equity would be reported as equity, although it would be reported as a liability under the 'fixed for fixed' test in IAS 32. It would seem to be rare for such a claim to arise where the entity has not obtained economic benefits in return for

[3] To accommodate this solution while preserving consistency with the Conceptual Framework a minor revision to paragraph 4.43(b) of the Framework would seem to be necessary.

granting the claim. In any event, as stated in the body of this response, it would seem inappropriate to report a claim as a liability if the only rights of the holder is to receive equity instruments (and therefore that the issuer has absolutely no obligation to transfer economic resources).

Clarity of terminology

C2.13 We are also concerned that the Discussion Paper arguably uses terms to mean what the authors want them to mean, which only becomes apparent after close study and reflection. The so-called 'timing' test is not really about timing, but whether there is a present obligation to transfer an economic resource: a more suitable label would be 'the obligation test'. Similarly, the so-called 'amount test' is not really about the amount of the claim but whether it is performance-related.

C2.14 Furthermore:

- the 'timing' test refers to *'at a specified time'.* This appears to mean 'at a specified time, or on the occurrence of a future event'.

- the 'amount test' refers to an *'an amount <u>independent</u> of the entity's available economic resources'*. What seems to be meant is an amount that <u>might exceed</u> the entity's available economic resources: paragraph 3.20 explains that a claim that is indexed to twice available economic resources is 'not independent' while ordinary language would imply that such a claim is <u>highly</u> dependent. If the 'amount test' were expressed in terms of 'might exceed' rather than 'independent of' the logic of the proposal would be clear.

- *'independent of the entity's available economic resources'* is vague and ambiguous, and hinges on fine distinctions. For example:

  — the Discussion Paper (in paragraph 4.52) invites consideration of "…*a derivative that requires a transfer of 1% of EBIT of an entity."* It goes on to argue that: *"The net amount of the derivative would increase as long as the entity's EBIT increases, even when the entity makes a net loss resulting in a decrease in the entity's available economic resources. Such a variable is an independent variable."* This leaves it unclear which, if any, measure of financial performance could provide the basis for the amount payable in respect of a claim without being an independent variable? Net profit, although plausible, would be open to the same objection that the Discussion Paper makes in respect of EBIT—there may be losses reported in other comprehensive income. Would a link to comprehensive income be independent?—perhaps not, as 'available economic resources' includes unrecognised assets.

— the Discussion Paper states that "…*if a financial instrument contains an obligation for an amount based on changes in the price of a particular asset of the entity (such as property or a brand value), the amount of the financial instrument is independent of the entity's available economic resources."* (paragraph 3.23(b)). It also states that "*an ordinary share in a subsidiary held by a non-controlling interest as the ordinary share would depend on the available economic resources of the subsidiary, which are a part of the available economic resources of the consolidated group."* (paragraph 3.24(c)). This suggests that there is a difference in the reporting of (i) a claim that is based on changes in the amount of an asset; and (ii) a share in a subsidiary held by a non-controlling interest that holds only that asset.

C2.15 The 'timing' and 'amount' tests are key principles of the Discussion Paper's proposals. If the IASB pursues them, they need to be redrafted to meet the above points.

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?

C3.1 We disagree. Please refer to 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?

C4.1 We agree that under the Board's preferred approach the puttable exception would be required if it is considered inappropriate for an entity that has no equity instruments in issue to report no equity. However, we would prefer the IASB to develop a presentation solution rather than continue with a narrow exception to its principles that allow some claims to be reported as equity although similar instruments issued by another entity would be reported as liabilities.

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?

C5.1 We agree that a derivative on own equity should be classified in its entirety as an equity instrument, a financial asset or a financial liability. This is consistent with the Conceptual Framework (paragraph 4.57), which concisely and convincingly explains that an executory contract establishes a combined right and obligation to exchange economic resources, which are interdependent and cannot be separated.

C5.2 However, we do not agree with the argument put forward in the Discussion Paper in support of this view that the classification of derivatives on own equity in their entirety has the disadvantage that it is inconsistent with how similar rights and obligations would be classified if they had existed independently, as there may be significant economic differences between the two cases. This cannot be assessed without an understanding of how the independent rights and obligations might come about, and therefore what financial reporting would be appropriate in these cases.

C5.3 The same principles should be applied to classifying derivative instruments and non-derivative instruments. Therefore, if the Discussion Paper's approach is to be pursued, the criteria in part (b) of the question should be retained. However, as stated in our answers to Questions 2 and 3, it is our view that the amount test should not be used to determine the classification of instruments as liabilities. The lengthy discussion of *'Further guidance on variables that affect the net amount of derivatives on own equity'* (paragraphs 4.45–4.66) attest to the complexity caused by using the amount test to drive the binary distinction between liabilities and other claims. It is likely that complexity would be significantly reduced if the amount test were used solely to identify claims and changes in claims for which separate disclosure is required but are not liabilities.

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?

C6.1 We have several reservations with the proposals in paragraphs 5.48(a)–(b) of the Discussion Paper.

C6.2 These proposals are driven by the view that the same accounting should be accorded to (i) the issue of convertible debt; and (ii) the issue of shares and the simultaneous issue of a put option to repurchase the shares. This is the result of an analysis of the similarities and differences between the two cases, which seems to be based on a focus on settlement outcomes. However, we note that a different view of the substance might result from a focus on the position at the reporting date.

C6.3 The Conceptual Framework states that 'a liability is a present obligation of the entity to transfer an economic resource as a result of past events'. An entity has a present obligation to transfer economic resources if it has issued debt, including where that debt is convertible (and even where conversion is probable). In contrast, the entity does not have such a present obligation where it has written a put option: rather its obligation is (if required) to issue its own equity instruments in exchange for cash.

C6.4 One of the achievements of the new Conceptual Framework is to make a clear distinction between the existence of a liability (or an asset) from the future transfer (or receipt) of economic benefits. While predictive value enhances the relevance of information presented in financial statements, the amounts reported in financial statements do not represent predictions of future cash flows: they 'provide information about the … entity's economic resources and the claims against the reporting entity' (Conceptual Framework, paragraph 1.12). An exclusive focus on settlement outcomes rather than the position at the reporting date is therefore not obviously correct.

C6.5 The Conceptual Framework also notes (in paragraphs 4.40–4.41) that an obligation may be settled in various ways, but that an entity has a liability until that obligation is settled. That is why the liability element of convertible debt is reported as a liability until it is converted, irrespective of the probability of conversion—that is, the settlement outcome.

C6.6 If, despite the considerations set out above, it were to be accepted that written put options on own equity give rise to a similar economic position to that of convertible debt, it would necessary to decide whether the accounting for put options should, as proposed in the Discussion Paper, be aligned with that for convertible debt or *vice versa*? A possible defence of what is proposed is that it is more prudent to overstate liabilities, but this is not supported by the Conceptual Framework's discussion of prudence.

C6.7 Objections to the accounting proposed in the Discussion Paper for written put options include:

- The reported liability is not a liability and it is not representationally faithful to report it as such.
- Equity is derecognised, although it remains in issue.

Financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer)

C6.8 We do not agree that a reverse convertible bond should be classified as equity, for the same reasons that the liability component of a conventional convertible bond is not classified as equity, irrespective of the probability of conversion. Like a conventional convertible bond, a reverse convertible bond is a liability until it is converted.

C6.9 Equity classification of a reverse convertible bond can be seen as plausible because the entity can avoid any transfer of cash or other economic benefits by converting at any time. But it is less plausible if the option to elect for equity settlement is only exercisable at certain times. If the option can only be exercised at maturity—which might be many years after the reporting date—it would appear that under the Discussion Paper's proposals it would be reported as equity for the whole period for which the bond is outstanding, which seems much less plausible.

C6.10 The amount received on issue of a reverse convertible bond will be lower than the amount that would be received for a straight bond that is otherwise similar. In essence the difference represents what the entity has 'paid' in order to obtain the put option. It would be logical for this to be treated as a reduction of equity, as it is an amount incurred in anticipation of a possible repurchase of equity. This would be symmetrical with increasing equity by the equity component of a conventional convertible. This contrasts with the proposal in the Discussion Paper that the option to elect for cash settlement would be reported as an asset.

C6.11 The Discussion Paper seems to suggest that separating the liability and equity components of a reverse convertible bond gives rise to more significant difficulties than those that arise in the case of a conventional convertible bond. It is difficult to see why this would be the case.[4]

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?

C7.1 As stated in paragraph 1.6 of this response, we agree that a binary distinction between liabilities and other claims will not, in itself, meet the reasonable information needs of users and that it is important that presentation and disclosure requirements are enhanced. However, the Discussion Paper has failed to develop disclosure requirements that seem capable of implementation in a practical and understandable manner: it is difficult to imagine, for example, how a preparer can respond to a requirement to disclose separately in the statement of financial position the carrying amount of *"partly independent derivatives that meet the criteria in paragraph 6.34"*

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[4] We particularly struggle to understand the example discussed in footnote 72, where the issuer has the option to issue of shares or pay cash, and share settlement appears, at issuance, to be much more expensive than the cash alternative. Footnote 72 analyses this as an obligation to issue shares and an option to pay cash, and notes that this would give rise to the result that the entity would report a significant credit to equity and a large asset in respect of the option to pay cash. We agree that this does not seem to be a defensible outcome.

But if, as we would suggest, the liability component is isolated first (which is consistent with the approach to conventional convertibles) the option to settle in equity would have only a small value and most of the value of the instrument would be reported as a liability.

(paragraph 6.4(a)(iii)) or how this might be interpreted by a reader of the financial statements.

C7.2 The IASB has in progress work on (i) principles of disclosure and (ii) primary financial statements. It is important that any disclosures relating to capital instruments build on the principles developed in these projects. This should ensure that financial statements continue to provide the information that can reasonably be expected of general purpose financial statements but should not be cluttered with information that is publicly available from a more appropriate source elsewhere.

The disaggregation approach vs the criteria-based approach

C7.3 The Discussion Paper contrasts a 'disaggregation approach' with a 'criteria-based approach'. The discussion of this issue starts at paragraph 6.21, which helpfully refers back to paragraph 6.20 (which has four sub-paragraphs, and eight sub-sub-paragraphs). In turn, paragraph 6.20 refers back to paragraph 6.11, which has three sub-paragraphs. It is possible that we have failed to grasp the exact scope of the Discussion Paper's proposals.

C7.4 The difference between the disaggregation approach and the criteria-based approach seems to be that:

- under the disaggregation approach income and expenses would be separated into those that 'result from the effect of dependent variables' and those that do not; while
- under the criteria-based approach there would be no requirement to disaggregate income and expenses and the entire change would be reported as a single amount.

C7.5 Conceptually it would appear that the disaggregation approach would provide superior information, because the effect of independent variables would be isolated from the effect of other variables. But we do not suggest that this point should be determinative; rather the choice between the disaggregation and the criteria-based approaches should be informed by research that establishes:

(i) the costs that would be incurred by preparers of financial statements; and

(ii) the relevance and understandability of the information that results from each approach.

C7.6 One objection to the disaggregation approach, as noted in the Discussion Paper is that of interdependencies between different variables. Hence the effect of any one variable can only be identified by an arbitrary allocation. We would not agree, however, that this is a fatal objection to such an approach. Accounting frequently uses arbitrary allocations and this does not necessarily result in information that is meaningless. Consistent application of an arbitrary allocation can facilitate insightful comparison between entities and of the financial performance and position of the same entity at different times.

What should be reported separately?

C7.7 The Discussion Paper (paragraph 6.53) proposes that the carrying amount and income/expenses relating to the following should be presented separately:

(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

C7.8 One underlying problem seems to be that identified in paragraph 6.11 of the Discussion Paper: that some *'…instruments are classified as financial liabilities even though they do not contain an obligation for an amount independent of the entity's available economic resources.'*

C7.9 As noted elsewhere in this response, we do not agree that such claims should be reported as liabilities. However, if the proposals in the Discussion Paper are to be taken forward, we agree that their carrying amounts should be reported separately in the statement of financial position (or in the notes thereto) and changes in their carrying amounts in the statement(s) of financial performance. We therefore agree with the proposal that claims (and changes in them) in item (i) in paragraph C7.7 above should be presented separately.

C7.10 We also agree that claims (and changes in them) in item (ii) in paragraph C7.7 above should be presented separately, although it is not clear why this is restricted to derivative instruments rather than applied more generally.

C7.11 We are not convinced that separate presentation should also apply to the claims identified in item (iii) in paragraph C7.7 above. This seems to create a different presentation for claims that meet a very restrictively drafted set of conditions (set out in paragraph 6.34 of the Discussion Paper). This is more appropriate to a rules-based than a principles-based accounting standard.

Reporting in other comprehensive income, without reclassification ('recycling')

C7.12 We agree with the Discussion Paper's proposals for separate presentation in other comprehensive income without reclassification for claims (and changes in those claims) for which separate presentation is appropriately required.

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?

Attribution of income and expenses to some equity instruments other than ordinary shares

C8.1 Although it is superficially attractive to suggest that the usefulness of financial statements would be enhanced by distinguishing the returns to ordinary shares and other equity instruments, we do not consider that the proposals set out in the Discussion Paper provide a practical means of achieving this which provides useful information.

The attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33

C8.2 As stated elsewhere in this response, we regret that the IASB has not undertaken a more fundamental review of the issues. We note that IAS 33 has not been the subject of a fundamental review since it was issued in February 1997(although some improvements were made in 2003) and it would be unwise to build on such an old standard without thorough reconsideration.

C8.3 That said, we have not identified any fundamental issues with IAS 33 for this purpose.[5] However, we have not undertaken an in-depth analysis of the requirements of IAS 33 for the purpose of preparing this response.

Attribution approach for derivative equity instruments

C8.4 We do not support any of the approaches for attribution for derivative financial instruments that are classed as equity. The objectives for such attribution and the significance of the information provided by attribution is unclear. This is, perhaps, demonstrated by the Discussion Paper setting out three approaches one of which would attribute to a class of warrants, income of +CU4,120 while another would attribute –CU5,558 (albeit that we understand that the latter includes a 'catch-up' adjustment from fair value on issue to *relative* fair value) (illustrative example after paragraph 6.91).

C8.5 All three approaches rely on introducing into financial statements amounts derived from the fair value of equity instruments. But financial statements do not purport to reflect the fair value of equity or the market's perspective of the return earned by an ordinary shareholder or holder of warrants. None of the three approaches provide a meaningful measure of the claims in respect of warrants and ordinary shares.

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[5] We note, however, that some of the language in IAS 33 reads oddly in today's context. For example, paragraphs 15 and 16 refer to charging amortisation and other charges 'to retained earnings'.

- The fair value approach invites a comparison of the fair value of warrants with the residual allocation of reported net assets to ordinary shares.

- As noted in the illustrative example presented after paragraph 6.91 in the Discussion Paper, the average-of-period approach results in an updated carrying amount for the warrants that has 'no meaning on its own, or in relation to the carrying amount of ordinary shares'.

- The end-of-period approach results in the reported amount attributed to warrants and ordinary shares based on their relative fair values: as noted above, financial statements do not purport to reflect the fair value of equity or the market's perspective of the return earned by an ordinary shareholder or holder of warrants.

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?

C9.1 Developing appropriate disclosure requirements is a significant challenge. As noted in paragraphs C7.1 and C7.2 above, we regret that, despite the attention that the Discussion Paper devotes to this issue, it has failed to develop disclosure requirements that seem capable of implementation in a practical and understandable manner. We hope that the IASB's work on principles of disclosure and primary financial statements will provide the basis for doing so.

C9.2 One of the primary considerations is establishing boundaries between the information that can reasonably be required to be provided in general purpose financial statements and that which is more appropriately provided elsewhere.

Priority on liquidation

C9.3 It is important that financial statements provide information about claims that could cause liquidation if not met. But we question whether it is reasonable to expect general purpose financial statements prepared on a going concern basis to provide information on how the available assets would be divided between holders of different claims in the event of liquidation. In some jurisdictions, for example, obligations to employees or tax authorities have a preferential status over other creditors. Where liquidation is only a remote possibility, we would not expect most entities to track or quantify such liabilities, and nor would we expect such information to be relevant to most users of the financial statements. However, unless these were included in the table suggested in paragraph 7.9 of the Discussion Paper, it would be misleading and of limited usefulness. There are also the difficulties set out in paragraph 7.10 of the Discussion Paper.

Potential dilution

C9.4 It is relevant for general purpose financial statements to provide information about potential dilution, and it seems doubtful that this can be achieved using the existing requirements of IAS 33. However, the requirements to secure such disclosure must be cast in general rather than prescriptive terms so that they would capture, for example, an instrument that might give the holder the right to receive a new class of share that is entitled to a dividend of a multiple of that paid on ordinary shares.

Terms and conditions

C9.5 We agree that general purpose financial statements should contain high-level information about the terms and conditions of instruments that are in issue. For example, it might be concluded that general purpose financial statements should contain information about the circumstances in which failure to meet the terms of a subordinated bond could result in liquidation; but that they should not contain all the information that an investor in such a bond would need to know and understand.

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?

C10.1 All claims should be classified in accordance with the substance of their contractual rights and obligations. Requirements to achieve this should build on the discussion of the topic in the Conceptual Framework (at paragraphs 4.59ff).

C10.2 This section of the Discussion Paper reverts to a discussion of reverse convertible bonds. We disagree with the Discussion Paper's analysis. Our views on reverse convertible bonds are set out above in paragraphs C6.10ff.

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?

C11.1 Challenging issues arise in distinguishing the boundary between the terms of a contract and that of legislation, but it is difficult to see how general guidance on this could be developed. It does, however, seem incorrect to ignore legislative requirements that, although not directly referred to in the contract, will have a significant effect on the rights and obligations of the issuer.

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