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Mr Hans Hoogervorst
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Our ref

RD/288

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Dear Mr Hoogervorst

Comment letter on Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity*

We appreciate the opportunity to comment on the above Discussion Paper (“the DP”). We have consulted with, and this letter represents the views of, the KPMG network.

We support the International Accounting Standards Board’s (IASB or the Board) efforts to respond to challenges in distinguishing financial liabilities from equity instruments and to improve the quality of disclosures about an entity’s capital instruments.

We agree with the Board’s assessment that IAS 32 *Financial Instruments: Presentation* currently works well when it comes to classifying the vast majority of financial instruments but there are cases where it is unclear how IAS 32 should be applied in practice.

We therefore believe that the Board’s focus with respect to classification and related measurement issues should be to clarify the existing requirements of IAS 32 without fundamentally changing the current classification outcomes. We fear that instead the DP’s approach would introduce new abstract concepts that would lead to new judgements and challenges and that its application would be unnecessarily costly and may have unintended consequences or be disruptive. In particular, we are concerned that the amount feature uses novel and potentially misleading language and seeks to change the classification of many preference shares that we believe are more appropriately classified as equity to liabilities.

We agree with the Board’s thesis that a binary equity/liability classification model cannot alone provide users with adequate information about an entity’s capital structure. However, we again fear that complex and costly new requirements for presenting some gains and losses in OCI or attributing comprehensive income to different classes of equity would not be an effective - let alone efficient – route to

improving transparency. We believe the focus should be on providing better disclosure about relevant risks and the key terms of equity instruments.

Below is a summary of our responses to the individual questions in the DP. Our detailed views and other observations are contained in *Appendix A - KPMG's responses to specific questions posed by the Board*.

We agree with certain of the Board's specific proposals, including:

- The timing of required payments and the amount of those payments should be the most relevant factors in distinguishing financial liabilities from equity.
- The classification of an instrument should generally be based solely on the instrument's contractual terms.
- The puttables exception in IAS 32 should be retained.
- A derivative on own equity should generally be classified in its entirety as an equity instrument, financial asset or financial liability (as opposed to being separated into multiple units of account).
- However, when a derivative on own equity requires an entity to extinguish its own equity, a gross liability should be recognised and the related equity instruments should be derecognised.
- Required disclosures should be expanded to provide more information on capital instruments regardless of whether they are classified as a liability or equity, including information about key contractual terms and conditions, priority on liquidation and potential dilution of ordinary shareholders.

However, we recommend the following changes to the Board's proposals in the DP.

- As stated above, we recommend that the amount feature be more closely aligned with the existing requirements in IAS 32, including retaining existing guidance on 1) non-derivative instruments that include an obligation to deliver a variable number of own equity shares and 2) the fixed-for-fixed criterion for derivatives on own equity.
- We recommend that the amount feature should not be applied to amounts payable only at liquidation if liquidation is neither predetermined nor within the holder's control. Applying the amount feature in these instances would fundamentally change existing classification outcomes under IAS 32. We believe that information about the amount of these potential claims (e.g. cumulative dividends) should instead be provided through enhanced disclosures.
- We do not agree with eliminating the foreign currency rights issue exception. We understand that the foreign currency rights issue exception is applicable only in limited circumstances and the Board has not fully explained why this exception should be eliminated.

- We recommend that the Board not create new classes of financial instruments that are remeasured through OCI. We agree that for some (but not all) of such instruments including the related income or expense in profit or loss (P&L) may have a counter-intuitive effect; however, we recommend that this issue is best addressed by clear presentation in the statement of profit or loss, which shows how much profit or loss is dependent on the fair value of an entity's own equity or an entity's earnings, and enhanced disclosures about key contractual terms and conditions of those financial instruments together with sensitivity analysis on the P&L impact. This approach would be preferable to expanding the use of OCI and adding significant additional complexity to the classification framework.
- We do not agree with the proposal to attribute total comprehensive income within equity and update the carrying amount of each instrument classified as equity. We do not believe that attributing total comprehensive income to equity derivatives based on changes in fair values provides useful information because of the imperfect relationship with the instruments' potential dilutive effect. Instead, we believe that sufficient additional information about the terms of an entity's outstanding derivatives on own equity and the potential dilutive effect of these instruments should be provided through the Board's proposed disclosures.

Please contact Reinhard Dotzlaw or Chris Spall at +44 (0)20 7694 8871 or Mark Northan at +1 (0)212 954 6927 if you wish to discuss any of the issues raised in this letter.

Yours sincerely



KPMG IFRG Limited

Appendix A

KPMG's responses to specific questions posed by the Board

| Question 1 |
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| <p>Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.</p> <p>(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?</p> <p>(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?</p> |

We agree with the conceptual challenges identified by the Board, where a binary classification approach provides only some of the relevant information about the features of an instrument. This means that for financial instruments with characteristics of equity, which share characteristics of both financial liabilities and equity instruments, sufficient information would not be provided to users of financial statements solely by their classification. We also agree that the challenges are pervasive enough to warrant standard-setting activity.

In addition to the challenges identified by the Board, we believe that there are other practical challenges that the Board should address:

Whether a shareholder is considered to be acting as an individual investor or as a part of an entity:

The IFRS Interpretations Committee (“IFRIC”) discussed this issue in March 2010, noting that diversity may exist in practice in assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer’s shareholders, and consequently whether a financial instrument should be classified as a financial liability or equity. When this issue was discussed by the IFRIC, it recommended that the Board should address this issue as part of FICE project.

Classification of contingent consideration that is provided in a business combination:

IFRS 3.40 requires an obligation to pay contingent consideration to be classified as a liability or equity on the basis of the definitions of a financial liability and an equity instrument under IAS 32. It is often not clear how to apply the IAS 32 requirement to

these arrangements. There are cases where the number of shares to be delivered depends on an acquiree's performance after the acquisition. For example, the agreement might include a series of obligations to deliver different numbers of shares based on different profit targets for different years. There are differing perspectives in practice regarding whether these obligations meet the requirements for equity classification in IAS 32.

Unit of account and disconnect between classification and measurement of a financial liability when an obligation arises under a contingent settlement provision:

IAS 32.BC 12 indicates that a financial liability is measured at the full amount of a conditional settlement or redemption obligation. IAS 32.23 states that an obligation to purchase an equity instrument for cash or other financial assets gives rise to a financial liability for the present value of the redemption amount. However, there is no implementation guidance that clarifies how the guidance is consistent or interacts with the general requirements on initial and subsequent measurement of financial liabilities in IFRS 9. In particular, IFRS 9's general requirements in relation to measurement at fair value or amortised cost may look to probabilistic expectations as to the timing and amount of different possible settlement outcomes rather than just the "full amount." Also, there is no discussion of cases in which measuring the obligation at the full amount would appear to be counterintuitive – e.g. the contingent redemption amount is greater than the issuance proceeds of the instrument and the occurrence of the contingency is unlikely to occur in the foreseeable future (e.g. a non-derivative instrument is issued for its initial fair value of 100 but is redeemable at 120 in the event of an improbable contingency, or a debt instrument that is repayable at a premium in an event of default).

Although IAS 32.BC12 and 23 focus on recognition of a liability for a particular settlement obligation and IAS 32 defines a financial liability as an obligation, some stakeholders interpret the wording of IAS 32.25 to mean that a financial instrument or contract that contains a contingent settlement provision is a financial liability in its entirety and this ambiguity may lead to diversity in practice.

IFRIC was required to consider these issues in January 2014 in the context of classification and measurement of a financial instrument that is mandatorily convertible into a variable number of own shares upon a contingent 'non-viability' event. However, the IFRIC concluded that the scope of the issues raised was too broad for it to address in an efficient manner.

Presentation of discretionary payments when no amount is recognised for the equity component:

When all of the fair value of the consideration received for issuing an instrument with a discretionary dividend or coupon feature is allocated to and recognised as a financial liability, IAS 32 is not clear about whether those discretionary payments are presented

in equity or as expense in profit or loss. This issue was discussed by the IFRIC in January 2014 and IFRIC noted that the scope of the issues raised was too broad for it to address in an efficient manner. We believe that there is diversity in practice on this issue.

| Question 2 |
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| <p>The Board's preferred approach to classification would classify a claim as a liability if it contains:</p> <ul style="list-style-type: none">(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. <p>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.</p> <p>The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.</p> <p>Do you agree? Why, or why not?</p> |

We agree with the view that the timing and amount of required transfers are the most relevant factors to distinguish a liability from equity. We also generally agree that information about other features would best be provided through presentation and disclosure.

However, we believe that the amount feature proposed (i.e. whether an amount is independent of an entity's available economic resources) is very theoretical, academic and difficult to understand. Although the DP says that whether an amount is independent of an entity's available economic resources should be clear from the contractual terms, contractual terms of financial instruments do not use that terminology. As a result, we have a concern that introducing such a theoretical concept/terminology would require new judgments or interpretations and pose conceptual or practical challenges that we currently do not have under IAS 32 and which could lead to unintended consequences and disruption in practice. Even though the Board's expectation is that classification outcomes would be largely consistent with IAS 32, this new classification principle is untested in practice. In addition, this approach would not be cost-effective to deal with challenges identified by the Board because it would require preparers to make (and document) a new assessment of all of their financial instruments based on this new framework.

We recommend that the amount feature be more closely aligned with the existing requirements in IAS 32, including retaining existing guidance on 1) non-derivative instruments that include an obligation to deliver a variable number of own equity instruments and 2) the fixed-for-fixed criterion for derivatives on own equity.

We also disagree with the amount feature applying to amounts which are payable only at the liquidation of an entity (unless liquidation is predetermined or within the holder's control). Requiring an instrument to be classified as a liability based solely on its rights at liquidation dates that are neither predetermined nor within the holder's control would fundamentally change existing classification outcomes under IAS 32, which is inconsistent with the Board's stated objectives. IAS 32.BC 18 states that if classification were made based solely on rights at liquidation of the issuer, this would be inconsistent with the going concern assumption. When an entity is a going concern, we believe that better information is provided to users of the financial statements when the entity's liabilities are limited to claims arising prior to liquidation.

We acknowledge that the Board's approach of applying the amount feature to amounts payable only at the liquidation of an entity might address concerns about certain arrangements that economically incentivise redemption (such as callable preference shares with an increasing cumulative dividend). However we do not believe that these instruments are pervasive enough to necessitate a significant change in classification for a much broader population of instruments (especially preference shares that do not similarly incentivise redemption). We also observe that, under the Board's preferred approach, information about features such as redemption options and cumulative dividends would be provided through disclosures.

We believe that the Board should separately address how the timing feature is applied when an instrument is redeemable only at liquidation but liquidation is at the option of holder(s) or the liquidation date is predetermined. IAS 32.16C currently merely acknowledges that an obligation exists in such circumstances and only in the context of describing how an exemption from liability classification might apply.

Also, if the Board retains the proposed approach for the amount feature, we believe that the Board should further emphasise its intent that the amount feature would only be met if the claim was *fully* dependent on an entity's available economic resources. Additional emphasis on this point will help avoid confusion about the assessment of instruments with claims that are partly independent of (or partly dependent on) an entity's available economic resources (such as a preference share that is redeemable at the lower of a stated amount or a specified portion of the entity's available economic resources).

We also believe that the term "unavoidable obligation" is potentially misleading for a similar reason. Under IAS 32 an obligation leading to financial liability classification exists unless the issuer has the discretion to avoid the transfer of resources – eg. it is not conditional on something that is outside its control. The notion of an "unavoidable

obligation” suggests a much narrower and inappropriately small population of liabilities, e.g. an obligation might arguably be avoidable if the issuer can persuade the holder not to exercise a redemption right or the issuer has inadequate resources to satisfy the obligation.

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?

As indicated in our responses to Question 2 (above), we recommend that the amount feature not be re-articulated in such a different manner from IAS 32 and that the amount feature should generally not be applied when amounts are payable only at the liquidation of an entity.

However, if the Board retains the proposed approach, we believe that further clarification should be made for the following:

- DP 3.17 says that “an entity’s available economic resources are the total recognised and unrecognised assets of the entity that remain after deducting all other recognised and unrecognised claims against the entity (except for the financial instrument in question)”. The Board should clarify how the fair value of an entity’s equity instrument passes the amount feature, especially whether “unrecognised assets” and “unrecognised claims” reflect market-based factors so that an entity’s available economic resources as defined are approximately equal to the fair values of its equity instruments. Also, the Board should clarify whether amounts based solely on an entity’s recognised net assets, and excluding its unrecognised net assets, would pass the amount feature.
- DP 3.23 (b) suggests that if an amount is specified by reference to specific recognised or unrecognised assets the entity controls, then it would fail the amount feature. However, DP 3.24 (c) suggests that if an amount is specified by reference to the shares of a subsidiary within a consolidated group, then it would pass the

amount feature. However, a subsidiary is effectively a group of specific recognised (or unrecognised) net assets that the entity controls. Therefore, it is not clear how the Board reached these differing conclusions and how a distinction would be made in practice. For example, if the subsidiary that issued the equity shares was an SPE that held only a limited number of assets, there could be conflicting guidance on whether the equity shares issued by the SPE would meet the amount feature criterion. On one hand, the guidance on DP 3.23(b) would appear to support liability classification because the SPE's equity shares are effectively linked to specified assets that the entity controls. On the other hand, 3.24(c) would appear to support equity classification because the instruments are shares of a subsidiary within a consolidated group.

- In this regard, the Board should clarify from which perspective the amount feature should be assessed – i.e. whether it is from an individual entity's (e.g. subsidiary's) perspective or the consolidated entity's perspective. There could be circumstances in which the available economic resources of a subsidiary could exceed the available economic resources of the consolidated group (such as when the other parent and/or other subsidiaries have negative equity).
- The Board should clarify the subsequent accounting treatment of a liability component whose obligation arises only at liquidation. The analysis presented in DP 3.24(b) appears to require more detailed consideration. Firstly, stated coupons or dividends that are specified as a rate or return or amount of cash but which are non-cumulative and discretionary appear *prima facie* to be independent of the entity's economic resources – rather, they would not give rise to a liability because they are avoidable. Secondly, it is stated that a fixed amount payable on liquidation “would be discounted back to nil or an insignificant amount if measured on a going concern basis.” As we argue under Question 2, a going concern basis would suggest that there is no liability – not that there is a liability measured at close to zero. If the Board believes that a liability should be recognised for this obligation, then it is unclear why it believes the “full amount” approach to measurement described in IAS 32.BC12 should not apply.
- We note that the Board states that it plans to carry forward the conclusions of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. IFRIC 2 requires an entity to present an instrument as equity if there is a statutory prohibition on redemption. This applies without reference to the amount that would be paid on redemption or liquidation. It is therefore unclear how the Board's proposals with respect to the amount feature would interact with this.

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| Question 4 |
| <p>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?</p> |

We agree with the proposal to retain these exceptions because we agree with the concerns (as articulated by the Board in the DP) that would arise if no equity is recognised. We agree that this concern is not otherwise resolved under the Board's preferred approach.

| Question 5 | |
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| <p>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:</p> | |
| (a) | <p>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</p> |
| (b) | <p>a derivative on own equity is classified as a financial asset or a financial liability if:</p> |
| (i) | <p>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</p> |
| (ii) | <p>the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.</p> |
| <p>Do you agree? Why, or why not?</p> | |

We agree with the Board's preliminary view that a derivative on own equity should generally be classified in its entirety as an equity instrument, financial asset or financial liability (as opposed to being separated into multiple units of account).

However, consistent with our response to Question 2 (above), we believe that the amount feature should be more closely aligned with the guidance in IAS 32, including retaining the existing fixed-for-fixed criterion. We understand that there are application challenges in applying the fixed-for-fixed criterion because IAS 32 provides little guidance on how to interpret the fixed-for-fixed criterion. Therefore, we recommend that the Board should consider whether the unresolved challenges in Section 1 of the DP could be addressed by providing additional application guidance related to the fixed-for-fixed criterion.

We do not agree with the proposal of removing the foreign currency rights issue exception under IAS 32 as this exception is only applied to the limited circumstances where the rights issue partially resembles dividends paid in shares (IAS 32.BC4F). The DP explains that this exception should be eliminated in order to provide consistency with the accounting for the embedded conversion option in a foreign currency

convertible bond. However, considering that the foreign currency rights issue exception is only applicable in very limited circumstances, and the resemblance of that circumstance to dividends paid, we think that the Board should retain the exception.

If the Board retains the proposed approach for the amount feature, we believe that further clarifications should be provided about the following:

- IAS 32.26-27 indicate that a cash settlement option exercisable only by the issuer fails the fixed-for-fixed criterion. Although the DP implies that a cash settlement option exercisable only by the issuer would not preclude equity classification (see DP 5.44), this point is not explicitly discussed in the DP and it is also not mentioned in the Board's discussion of the differences between the proposed approach and IAS 32 (see DP 4.42). Therefore, the Board should clarify more explicitly whether an issuer's cash settlement option in an asset/equity exchange derivative affects its classification under the Board's preferred approach.
- DP 4.53 states that a variable that reflects compensation for the time value of money that is relevant to a derivative, such as an interest rate, could be a dependent variable. The logic behind this is that time value of money is considered to be an inherent component in both derivatives and an entity's available economic resources. The DP seems to say that any interest rate would be considered to be a dependent variable as long as it is not leveraged or unrelated to the derivative (e.g. the benchmark interest rate of an unrelated currency), meaning that the DP seems to give time value of money exceptional treatment. It is not clear why only time value of money is treated exceptionally, how far this concept extends and whether an entity could analogise to this guidance for other types of variables or indexes. For example, whether the same logic would apply if principal and interest payments on a convertible bond are indexed to inflation in the economic environment of the entity.
- DP 4.54 discusses the case when a written call option on own equity has multiple exercise dates and a strike price that increases based solely on a relevant interest rate at each exercise date. This paragraph could be read to imply that these predetermined changes would all need to be dependent on (or be explained by) an entity's available economic resources (or time value of money). We believe that the Board should consider clarifying whether, when an instrument has predetermined changes over time in either the strike price and/or number of shares, the amounts of those changes are variables that need to meet the amount feature criterion. When viewed as a single contract, it would appear that the changes in settlement amounts would not meet the amount feature criterion. Alternatively, the contract could be viewed as a series of European-style option contracts that would each be separately evaluated to determine if the amount feature was met (each individual option would be settled by delivering a fixed number of its own shares for a fixed amount of cash).

Question 6

Do you agree with the Board’s preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity’s own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

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

- (a) Do you think the Board should seek to address the issue? Why, or why not?
- (b) If so what approach do you think would be most effective in providing the information, and why?

We agree with the Board’s proposal to recognise a gross liability when a derivative on own equity requires an entity to extinguish its own equity, consistent with IAS 32. From an issuer’s perspective, we believe that the accounting for these instruments should be the same regardless of whether they are issued as a compound instrument or separately as shares and standalone derivatives. For example, the combination of ordinary shares and a standalone written put option on the ordinary shares should be reflected in the financial statements in a similar manner to redeemable shares. In both instances the issuer is contractually required to deliver cash or another financial asset in exchange for its own equity. Providing different models for these arrangements would result in different accounting for similar economic arrangements and potentially lead to structuring opportunities. Also, the proposal to recognise a gross liability is consistent with the current requirement of IAS 32.23 and changing this requirement would have a significant impact on practice, which is contrary to the stated objective of the project.

DP 5.28 states that when an entity recognises a gross liability, the underlying equity would be derecognised. We agree with this approach on the basis that it 1) avoids the creation of a separate amount within equity that is not directly associated with an equity instrument or transaction, 2) avoids the complexity of separate accounting for the outstanding equity instruments and related gross redemption liability and 3) aligns the accounting for redemption obligation arrangements with the accounting for a compound instruments.

We also agree with the proposal to look at the combined rights and obligations as a package (combining the derivative and the underlying equity shares) and classify the remaining rights and obligations as either an equity instrument, financial asset or financial liability by applying the classification requirements applicable to other derivative instruments, consistent with the requirements of a compound instrument.

We agree that the Board should address the need for information about instruments with alternative settlement outcomes controlled by the issuer that are classified as equity. We support an approach of providing additional information through disclosure rather than requiring the separation of an embedded derivative. Recognising an embedded derivative asset in this case would not be optimal financial reporting because it would result in the recognition of an asset related to a future equity transaction (specifically, the purchase of an entity's own shares).

In addition, we believe that the following should be clarified.

Measurement of a liability component

It is not clear whether the DP would change existing guidance for measuring the liability component of a compound instrument. Currently, IAS 32.32 states that a liability component of a convertible bond is measured at the fair value of a similar liability that does not have an associated equity component. This means that the discount rate used in measuring such a financial liability would be the market interest rate for a similar liability without a conversion option. However, the DP implies that a convertible bond and a written put option on own equity should be measured in a similar manner. The measurement basis at initial recognition for an obligation to purchase own equity instruments under IAS 32.23 is the present value of the redemption amount. Thus, the requirements for measurement under IAS 32.23 and .32 are not identical.

The Board should consider clarifying the discount rate that should be applied when measuring the present value of the liability associated with redemption obligation arrangements. We understand that there is diversity in practice on this issue. Some may interpret that the discount rate should be a risk-free rate, while others might believe that the rate should reflect an issuer's credit risk or a rate that reflects the uncertainty inherent in the variability of cash flows.

Subsequent accounting treatment arising from derecognised equity

Under the Board's preferred approach, underlying equity would be derecognised and a gross liability would be recognised when a liability/equity derivative is issued. If an issuer pays discretionary dividends to holders of equity shares which have been derecognised under this approach, it is not clear whether these discretionary dividends paid should be recognised in profit or loss or equity. We recommend that the Board consider this matter and provide clarificatory guidance.

The impact the Board's preferred approach would have on the accounting treatment of non-controlling interests (NCI) under IFRS 10 Consolidated Financial Statements

Under the Board's preferred approach, gains or losses arising from the subsequent measurement of NCI put liabilities are recognised in profit or loss. We agree with this approach (see also our response to Question 7). However, IFRIC has acknowledged diversity in practice regarding whether changes in the subsequent measurement of an NCI put liability are recognised in profit or loss or equity, citing a perceived conflict between IAS 27 (IFRS 10) and IAS 39 (IFRS 9 *Financial Instruments*). We understand that the rationale for recognising these changes in equity is that the put option relates to a transaction with equity owners in their capacity as owners. The Board should resolve this conflict.

Based on the logic put forward in the DP, if a non-controlling interest is derecognised when a NCI put liability is recognised, the Board should clarify that a portion of the subsidiary's profit or loss and OCI would not be attributed to the NCI. In resolving this matter, we recommend that the Board at the same time consider any other potential consequences arising from derecognising the underlying equity instruments and ensure that users are provided with a full and fair package of information regarding the impact of such arrangements, such as implications for EPS calculations or a need for additional disclosures. In particular, if a share of a subsidiary's earnings are not attributed to NCI that is subject to a written put option, earnings attributable to shareholders of the parent will effectively be subject to dilution in the event that the put option is not exercised and this might not be portrayed when applying the current requirements of IAS 33 *Earnings per Share*.

Issuer's cash settlement option in a liability/equity exchange derivative

We understand that the redemption obligation arrangement requirements would apply to a derivative that includes an obligation to extinguish an entity's own equity instruments. However, it is not clear whether the issuer of a contract to purchase its own equity instruments with an issuer option to settle the contract on either a gross or a net basis should recognise a gross liability based on the full redemption price or measure the instrument at fair value through profit or loss.

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?

We do not agree with the Board’s preliminary views.

The Board’s proposal would effectively create new classes of financial instruments that are measured in OCI. We recommend that the Board take a different approach for the following reasons:

- The default requirement in the Conceptual Framework for presenting income and expenses is to present them in profit or loss. In our comment letter on the exposure draft of the *Conceptual Framework for Financial Reporting*, we recommended that the Board provide a conceptual basis for the use of OCI, noting that the first step to develop founding principles for the dividing line between profit or loss and OCI, as well as principles for recycling (or not), should be a proper debate around the notion of performance (e.g. whether profit or loss is performance and OCI is not performance, or they are both performance and the split is presentational disaggregation). Accordingly, we would not support expanding the use of OCI in the absence of such a clear conceptual basis.
- The gains or losses on these financial instruments represent true economic gains or losses related to valid claims against the entity and therefore would be more appropriately presented in profit or loss.
- A new category of financial instruments remeasured through OCI would introduce additional complexity to financial reporting that we do not believe would be beneficial or cost effective.
- We are concerned that the proposal might provide structuring opportunities (eg. an entity may try to avoid presenting funding costs in profit or loss by structuring transactions such that the amount of the obligation meets the amount feature).

We agree that including the income or expense related to some instruments in profit or loss may have a counter-intuitive effect. However, we recommend that this issue is best addressed by clear presentation in the statement of profit or loss, which shows how much profit or loss is dependent on changes in the fair value of an entity’s own equity or an entity’s earnings, and enhanced disclosures about key contractual terms and conditions of those financial instruments together with specific sensitivity analysis on

the P&L impact (perhaps building on the existing requirements in IFRS 7.40-42). We recommend that the Board consider requiring such additional disclosures to help users of financial statements to understand the impact of those financial instruments on an entity's profit or loss.

This approach would be preferable to expanding the use of OCI and adding significant additional complexity to the classification and presentation frameworks.

Question 8

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

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

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

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

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

We do not support the proposal to attribute total comprehensive income within equity and updating the carrying amount of each item classified as equity because we believe that attribution within equity does not provide the most meaningful information and would be costly to prepare and present.

We believe that the best approach is to provide information about the effect of derivative equity instruments through diluted earnings per share and improved disclosures such as those proposed in DP 7.13-7.25. With respect to derivative equity instruments, we believe that the best information that can be provided to users of the

financial statements relates to the potential dilutive effect of those instruments, as opposed to the change in fair value of those instruments. While the change in fair value of those instruments would be impacted by some inputs that relate to the potential dilutive effect (e.g. changes in the likelihood of exercise), the change in fair value can also be significantly affected by unrelated factors (e.g. share price volatility, changes in interest rates or movement towards the option's expiration date). Those aspects of fair value that are unrelated to the potential dilutive effect of these instruments would diminish the usefulness of the attributions of income and expense under the Board's proposed approaches.

Instead, we would recommend that the Board focus on enhancing disclosures that would provide users of financial statements with more information about the potential dilutive effect of equity-classified derivatives as stated in the DP (see DP 7.22). These disclosures would provide more information about the shares that might be issued upon exercise, the exercise prices and dates and any conditionality to be met for the instrument to be exercised.

| Question 9 |
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| <p>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:</p> <ul style="list-style-type: none"> (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). <p>Do you agree with the Board's preliminary view? Why, or why not?</p> <p>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?</p> <p>Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?</p> |

We agree with the proposal to expand the disclosure requirements, as we believe that current disclosure requirements do not require all useful information to be disclosed about instruments within the scope of the DP.

Priority on liquidation

We agree that it would be useful to provide such information, especially for entities that have a complex capital structure (such as some financial institutions).

However, the DP proposes that this information be presented in the statement of financial position and it is not clear how this would be consistent or interact with balance sheet classification or ordering of items by liquidity in accordance with IAS 1 *Presentation of Financial Statements*.

We also note that in DP 7.11 the Board explores possibilities that would permit information about the priority of financial liabilities and equity instruments to be prepared with limitations that would be designed to address the challenges articulated in DP 7.10. We believe that the Board should seek to avoid such limitations in an effort to maximise the usefulness of these disclosures.

Potential dilution of ordinary shares

The DP proposes disclosing additional information about the potential dilutive effect of outstanding instruments. We agree with this proposal and believe that it would be preferable to the suggested attribution approach (see our response to Question 8) but it would be necessary to address the relationship with IAS 33 calculations and IAS 1 disclosures about share capital because of the potential for overlapping, inconsistent or redundant information.

Contractual terms and conditions

We agree that it would be useful to users of financial statements to expand the disclosures to include additional information about the terms and conditions of financial instruments, and specifically information about terms and conditions that will, or could, affect the amount and timing of cash flows. This information can be used to better assess the potential for distributions to equity holders in different future scenarios.

Question 10

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

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

Why, or why not?

We agree with the proposal not to change the current principles in IAS 32 in regard to economic incentives and indirect obligations.

DP 8.22 indicates that a cash settlement (or variable share settlement) option that is exercisable by the issuer would give rise to an indirect obligation when the cash settlement option is always favorable to an option to settle in a fixed number of shares. However, the DP does not discuss whether the fixed share settlement alternative should only be considered to allow equity classification when it is substantive. We recommend that the Board consider clarifying that an issuer's settlement option should only impact classification when it has been determined to be substantive, and develop additional guidance to assist entities in determining whether an issuer's settlement option is substantive. We believe that guidance on substantive settlement options consistent with IFRIC's January 2014 agenda decision would be helpful. That decision related to an instrument that was mandatorily convertible into a variable number of shares with an option exercisable by the issuer to settle in a fixed number of shares. The IFRIC noted that judgement would be required to determine whether the issuer's fixed share settlement option was substantive, including understanding whether there are actual economic or other business reasons for the issuer to exercise the option. The IFRIC also noted that in making that assessment, the issuer could consider, along with other factors, whether the instrument would have been priced differently if the issuer's fixed share settlement option had not been included in the contractual terms.

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?

We agree with the Board's preliminary view that the Board's preferred approach should be applied to the contractual terms of a financial instrument consistent with the existing scope of IAS 32.

As outlined in the DP, the issues of whether and how to recognise rights and obligations arising from laws and regulations should be outside the scope of this project. If the Board wishes to further explore these issues we would encourage it to address them comprehensively in the IFRS standards, as opposed to focusing solely on the impact on financial instruments with characteristics of equity.

However, we suggest that the Board consider providing additional guidance on distinguishing laws and regulations from contractual terms. Specifically, there are cases where applicable laws may require that certain features (such as contingent redemption or conversion features) be included in an instrument's contractual terms. In other cases, an entity may voluntarily incorporate terms into the contract solely to reflect applicable laws and regulations (for example, there are cases where a contract explicitly incorporates laws and regulations into the contractual terms and other cases where the contract does not explicitly incorporate laws and regulations into the contractual terms but simply has a cross-reference to them or requires the holder to acknowledge the existence of them). In these circumstances, it may not be clear whether features derived from laws and regulations should be included in the classification assessment. These issues are not discussed in the DP. We believe that the Board should consider providing additional guidance to assist entities in determining whether (or when) contractual terms that are either consistent with, or refer to, existing laws or regulations would impact classification.

Furthermore, if the Board does not believe that the principle in IFRIC 2 that an unconditional prohibition on redemption derived from local law or regulation negates the existence of a financial liability (see IFRIC 2.6-8) applies "more broadly", then it should make this clear in any amendments to IAS 32, including what "more broadly" means. We note that, despite the title of IFRIC 2, its scope paragraph states that: "This Interpretation applies to financial instruments within the scope of IAS 32, including financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity" and its Basis for Conclusions suggests that the Interpretation is not a modification of the general principles in IAS 32.