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International Organization of Securities Commissions
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المنظمة الدولية لهيئات الأوراق المالية

7 January 2019

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Discussion Paper- *Financial Instruments with Characteristics of Equity*

Our ref: 2019/MS/C1/IASB/1

Dear International Accounting Standards Board Members:

The International Organization of Securities Commissions (IOSCO) Committee on Issuer Accounting, Auditing and Disclosure (Committee 1) thanks you for the opportunity to provide our comments regarding the International Accounting Standards Board (IASB or the Board) Discussion Paper: *Financial Instruments with Characteristics of Equity* (the Discussion Paper).

IOSCO is committed to promoting the integrity of the international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Committee 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect the general consensus among the members of Committee 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

General Observations

We support the IASB's efforts to improve the accounting for instruments with characteristics of equity. This is a complex area, and existing standards lack a clear or consistent principle, which contributes to it being a more common source of errors in our various jurisdictions. We believe the quality of financial reporting can be improved by making changes to the existing models at the standard level. We are also very supportive of the effort to improve disclosure associated with instruments with characteristics of equity, which will help financial statement users better understand the terms and characteristics of complex instruments. We also support the Board using presentation as a way to deal with concerns that fair value through profit and loss on certain liability-classified instruments may not provide the most relevant information to users of the financial statements. We also believe that much of the Board's proposal to expand disclosure requirements would also contribute to improved financial reporting. While we applaud the Board's efforts in attempting to address current challenges in this area, we also have some concerns in the operability and clarity of the Board's preferred approach.

We believe there is lack of clarity in the concept of amounts "independent of the entity's available economic resources," including the lack of consistency in the meaning of "economic resources" within the Discussion Paper and as compared to the International Financial Reporting Standard ("IFRS") *Conceptual Framework.* We are concerned that the Board's preferred approach may simply shift the existing application challenges to confusion over what qualifies as an amount "independent of the entity's available economic resources." Similarly, there are a number of current practice issues with some types of financial instruments that have been identified in various jurisdictions, and it is not apparent that the Board's preferred approach sufficiently resolves those challenges pertaining to the appropriate classification and measurement of those instruments. (See more detailed discussion in responses below.)

Given the complexity of instruments issued in many jurisdictions, we acknowledge that it may not be possible to develop a model that fully addresses all potential stakeholder concerns for all instruments that exist today and may be created in the future. For this reason, we believe better financial reporting can be achieved through a) creating a model with underlying principles that are clearly understood and simple to apply and b) requiring enhanced disclosure to provide financial statement users with additional information regarding the nature and terms of the instrument. We believe the Board's preferred approach, as currently described, may not be sufficiently clear to overcome the challenges users may encounter, as noted in paragraph 1.39 of the Discussion Paper, because certain aspects of the preferred approach may not be sufficiently understandable to result in consistent application by simplifying or clarifying how to determine classification.

Most members are also concerned about the lack of reconciliation between the definition of a liability in the Board's preferred approach and the *Conceptual Framework.* The Discussion Paper appropriately identifies this as a challenge in applying the existing guidance, but the Board's preferred framework does not solve this problem, nor is it clear that the Board intends to attempt to solve this problem. Most members believe it is critical that one of the results of this project is that the *Conceptual Framework* definitions and the concepts for classifying financial instruments be aligned as closely as possible; however, some prioritize the intended objectives of the Board's proposed framework over consistency with the *Conceptual Framework.*

Our detailed feedback on each section of the Discussion Paper is provided below.

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Responses to the Board's Questions

Question 1
Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.

(a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

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

Response:

Committee members generally agree with the identified challenges and their causes, and Committee members similarly agree that the challenges identified are important enough to require standard setting activities.

In addition to the challenges identified in the Discussion Paper, Committee members also raised other existing challenges as follows:

- International Accounting Standard ("IAS") 32 *Financial Instruments: Presentation* requires an issuer to classify and measure compound financial instruments separately as financial liabilities, financial assets, or equity instruments.[1] It is not always clear whether and when an instrument should be considered a compound instrument, which has led to inconsistent interpretations and applications in practice. Further, when practitioners conclude an instrument should be considered a compound instrument, IAS 32 does not provide clear guidance on how to measure the liability component. More specifically, it is unclear whether the liability component is measured based on the amount due on-demand (or a discounted amount based on the potential put date), or measured based on fair value as defined by IFRS 9 *Financial Instrument* (which would consider the probability of exercise of the underlying put option). Since the concepts of compound instruments appear to largely be retained in the Board's preferred approach, it is not immediately clear whether the new framework would address existing confusion in this area.
    - For example, consider a convertible instrument that may be converted into either a fixed or variable number of shares, depending on the issuer's share price. We have observed issues in practice that it is not well understood whether the fixed leg can or should be separated from the variable leg.

[1] Paragraphs 28-32 address the accounting for compound financial instruments.

- In order for a derivative contract that will, or may, be settled in an issuer's own equity instruments to qualify for equity presentation under IAS 32, the derivative must be settled by the exchange of a fixed amount of cash (or another financial asset) for a fixed number of the entity's own equity instruments.[2] It is not always clear how to apply this so-called "fixed-for-fixed" condition, which leads to diversity in practice. The fixed-for-fixed concept is eliminated in the Board's preferred approach, but the new concept of "amounts independent of the entity's available economic resources" may result in similar lack of clarity.
    - For example, consider a variable net share settled warrant, which may be settled at the option of the holder. The settlement of this instrument may not be economically different from an instrument that requires the holder to exchange cash equal to a fixed strike price for a fixed number of shares. Under the current guidance, however, it may not be clear whether the variable share settled feature would require liability classification.
- IAS 32 does not provide specific guidance on classification of a financial instrument when the contractual obligation to deliver cash is at the discretion of the issuer's shareholders. If a financial instrument includes a contractual obligation to deliver cash, subject to a shareholder vote, it is unclear whether such a provision requires financial liability presentation. Questions around such arrangements have been raised to the IFRS IC historically, and we understand that the Board's current project on Financial Instruments with Characteristics of Equity was expected to respond to these issues, amongst others. It is not immediately clear how the Board's preferred approach would consider such arrangements.

In addition to these more specifically identified practice issues, most Committee members agreed with the conceptual challenges discussed in paragraphs 1.28 through 1.34. Paragraph 1.28 appropriately notes that IAS 32, other IFRS Standards, and the *Conceptual Framework* use various features to distinguish liabilities, and most Committee members are supportive of attempting to resolve these inconsistencies and lack of a consistent conceptual basis as part of this project. Some Committee members feel strongly that failing to resolve these inconsistencies as part of this project could cause confusion with respect to the new framework. Committee members with this view note that consistency could be achieved either by amending the *Conceptual Framework* to align with the final standard or by aligning the final standard with the *Conceptual Framework*. Alternatively, the Board could address how it evaluated the inconsistencies between the *Conceptual Framework* and the Board's preferred approach to conclude such inconsistencies are appropriate.

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[2] Paragraph 11 of IAS 32 contains the definition of a *financial asset* and *financial liability*.

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?

Response:

When considering the alternative approaches described in paragraphs 2.43-2.47, Committee members agreed that the Board's preferred approach is more favorable. Committee members agreed that information about the (a) timing, and (b) amount of transfer, are more relevant to financial statement users than other factors and found the discussion of those features to be meaningful.

Committee members understood and agreed with criterion (a) as a driver of classification as a financial liability. The concept is well-articulated, and it is generally clear from the Discussion Paper how one might apply the concept in practice. It is also relatively consistent with the *Conceptual Framework* definition of a liability.[3] As discussed further in our response to Question 10, we believe the Board should further clarify the distinction between an "***unavoidable***" obligation (used in the Board's preferred approach) from the "***practical ability to avoid***" a transfer (used in the existing *Conceptual Framework*), including how the existence of non-substantive or uneconomic terms in an instrument impact this analysis.[4]

[3] Paragraphs 4.26 and 4.27 of the *Conceptual Framework* describe the definition of a liability as follows, in part, "A liability is a present obligation of the entity to transfer an economic resource as a result of past events."
[4] Paragraph 4.29 of the *Conceptual Framework* describes an obligation as "a duty or responsibility that an entity has no practical ability to avoid."

With respect to the application of criterion (b), as currently drafted, Committee members believe that the concept of "an amount independent of the entity's available economic resources" requires further clarification.

Table 4.1 within the existing *Conceptual Framework* indicates that "economic resources" are ***assets*** that represent "a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits." The *Conceptual Framework* definition appears to indicate that economic resources are only ***assets*** of the entity. Paragraphs 3.17 and 3.18 of the Discussion Paper appear to alter the concept of "economic resources" quite significantly by comparison when referencing an entity's "available economic resources," seeming to indicate that economic resources are more akin to the ***net assets*** or ***net performance*** of an entity.[5]

Further, it is not clear whether the concept of economic resources is consistent between criterion (a) and (b). Criterion (a) refers to "an unavoidable obligation to transfer economic resources at a specified time other than at liquidation." This implies that "economic resources" in this context means cash or other assets (which is more aligned with the *Conceptual Framework* definition referenced above); however, criterion (b)'s reference to amounts "independent of the entity's available economic resources" appears to imply a different definition of economic resources.

The Committee members' respective interpretations of the intended meaning of economic resources in the context of criterion (b) were broad; therefore, we believe it is critical that the Board provide further clarification.

[5] Paragraph 3.17 states, in part, "An entity's available economic resources are the total recognised and unrecognised assets of the entity that remain after deducting all other recognized and unrecognized claims against the entity (except for the financial instrument in question)."

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?

Response:

As stated earlier, Committee members in response to Question 2 raised concerns regarding the lack of clarity of criterion (b) that carry into the discussion of the application of the Board's preferred approach to non-derivative instruments. For example, if it is unclear how to determine whether a settlement amount is for an amount independent of the entity's available economic resources more broadly, it is similarly difficult to interpret and apply that concept when evaluating individual non-derivative financial instruments. Further, we acknowledge that the application of the proposed approach would generally result in more instruments being classified as liabilities, either in whole or in part, which requires enhanced clarification in presentation and disclosure. Committee members believe the Board's preferred framework, as written, does not fully satisfy the objective of improving clarity of the model.

The Board's preferred approach also does not change the way in which contingencies are analyzed. In other words, the probability of whether or not a contingent event may occur that could lead to the redemption of an instrument is not relevant to the classification of such instrument. (For example, consider a preferred share that becomes puttable if the issuer experiences a change in control. This instrument would require liability presentation since it is redeemable for cash outside of liquidation, even though a change in control may be very unlikely to occur.) We encourage the Board to explore whether introducing a probability assessment into the classification model would lead to better financial reporting, including consideration of the enforceability and auditability of such analysis. More specifically, some Committee members believe that remote contingencies should not drive classification of a financial instrument and that allowing remote contingencies to determine classification may actually result in inconsistent accounting outcomes compared with the principle of accounting for the substance of the transaction under paragraph 15 of IAS 32.[6] If instruments are required to be classified as a liability due to the existence of a contingency that is remote of occurring, for example, issuers may provide information in its disclosures to clarify why the instrument is classified as a liability even though the issuer does not ever expect to settle it in cash or other assets.

Finally, some Committee members do not believe that the Board's intent with respect to componentization is clear. Paragraph 3.15 appears to indicate that an instrument with any settlement outcome that meets either criterion (a) or (b) is classified as a financial liability ***in its entirety***; however, paragraph 3.24(b) and the discussion in paragraphs 3.25-3.28 appear to indicate that it might be appropriate to componentize an instrument with multiple settlement outcomes. Question 3 notes, "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," indicating that any settlement outcome that meets either criterion (a) or (b) taints the entire instrument as a financial liability (rather than evaluating to determine if the settlement feature should be separated into equity and liability components).

If this is the Board's intent, it is not clear, for example, why it would be better financial reporting for a perpetual preferred stock instrument with cumulative stated dividends to be classified as a liability in its entirety (as is suggested by paragraph 3.15 and indicated by the "Irredeemable cumulative preference shares" example in Appendix D) when only the dividend component of the instrument meets the Board's proposed liability definition. Alternatively, some Committee members may support a view that the cumulative stated dividends meet the proposed liability definition and should be classified as such, but the perpetual preferred component would qualify for equity presentation. This componentization would appear to be consistent with the concepts of separation described in Section 5, and it is unclear why they would not apply to this type of instrument.

[6] The concept of "remote" is already understood by stakeholders based on guidance in IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*. For example, IAS 37.28 states, "A contingent liability is disclosed…unless the possibility of an outflow of resources embodying economic benefits is remote."

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?

Response:

The concerns that led to the creation of the exception described in paragraphs 16A and 16B of IAS 32 would still exist in the proposed model. Therefore, Committee members generally agreed that the puttable exception would still be required under the Board's preferred approach.

Some Committee members expressed concerns that an exception would still be necessary after applying the new proposed framework. One of the key goals of this project is to develop a consistent framework for concluding whether instruments should be classified as financial assets, financial liabilities, or equity. It would be preferable to craft a model that does not require an exception for certain types of instruments (as exceptions call into question the conceptual basis of the model).

However, the concerns that led to the creation of the exception described in paragraphs 16A and 16B of IAS 32 would still exist in the proposed model. Therefore, Committee members generally agreed that the puttable exception would still be required under the Board's preferred approach.

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?

Response:

Committee members agree with retaining the concept of classifying derivative instruments in their entirety as a financial asset, financial liability, or equity (as opposed to classifying individual legs separately). This concept is well understood by stakeholders, and we do not believe that separating the legs of derivatives would lead to more useful or well-understood financial reporting.

Committee members are supportive of the Board's attempt to classify both derivative and non-derivative instruments as financial assets, financial liabilities, or equity using a consistent framework, and we generally agree that the proposed framework achieves that objective. We continue to share concerns on the clarity of when amounts or variables would be considered independent of the entity's available economic resources, however.

The Discussion Paper provides some explanation of how to evaluate whether a variable is "independent of the entity's available economic resources" for common types of terms; however, it is not always apparent how the Board applies this concept. For example, the discussion in paragraph 4.55-4.58 of the Discussion Paper discusses dilution, indicating that anti-dilution provisions would need to be analyzed to determine whether they introduce a variable that is independent of the entity's available economic resources, but it is not clear how a practitioner would perform that analysis. The Discussion Paper comments that ***asymmetric*** anti-dilution provisions (e.g., down-round protection) would not, on their own, be considered independent of the entity's available economic resources, and that an entity would instead need to perform an analysis to determine whether such an anti-dilution provision would preclude equity classification. Based on the Discussion Paper, it is not clear how one should go about performing such an analysis. Since a down-round protection adjustment seems to impact the settlement value by an amount that would not always be dependent on the entity's available economic resources, it appears that such a provision might preclude equity classification under the Board's preferred approach. It is not clear whether the Board would agree.

This leads to the underlying concern by the Committee that, although perhaps more conceptually consistent between derivative and non-derivative instruments, the Board's preferred approach may simply shift existing confusion and lack of clarity to a newly introduced concept.

Finally, as noted above in our response to Question 3, we do not believe the concept of componentization is clear. We further note that the terms "hybrid instrument" and "compound instrument" may be used interchangeably in the Discussion Paper, which could lead to inconsistencies in the application of the requirements under the Board's preferred approach. We observe that it is sometimes unclear under IAS 32 when an instrument is a hybrid instrument versus a compound instrument, and it is not clear that the Board's preferred approach would clarify the model.

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?

Response:

Some Committee members would like to further understand the Board's intent with respect to the concept in 5.48(a). Does the Board intend for this requirement to prevent structuring abuses, or does the Board intend for this requirement to apply more broadly? For example, would the requirement to effectively combine instruments apply regardless of the time elapsed between the issuance of the stand-alone equity instrument and the issuance of the stand-alone derivative to extinguish the equity instrument? If the instruments are issued at or near the same time, in contemplation of each other, and with the same counterparty, we understand the Board's approach; however, if the time elapsed between the two instruments' issuance is significant, then it is more likely they are two separate economic events and effectively combining the transactions could be inappropriate. Some Committee members are also troubled by the inconsistency in presenting legally outstanding shares as effectively extinguished for accounting purposes when applying this model.

With respect to 5.48(b), some Committee members continue to question whether it would be appropriate to allow remote scenarios to drive liability classification (as discussed in our response to Question 3). The Discussion Paper briefly discusses the fact that the existence of a remote outcome would likely result in the measurement of some instruments to be nearly nil (though the Discussion Pape also acknowledges that this would not be the case for all such instruments); however, the analysis seems incomplete since it does not consider whether remote scenarios should or could also drive classification.

With respect to 5.48(c), although the Board's preferred approach not to separate the potential cash obligation from the obligation to issue equity is not conceptually pure, we question whether financial statement users would find such a separation useful. Therefore, we do not object to the Board's preferred approach.

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?

Response:

Committee members generally understand the Board's proposal to distinguish between types of liability-classified instruments where volatility through the income statement would be meaningful to investors from those where such volatility would not be meaningful (and thus reflected through other comprehensive income (OCI)). If our concerns regarding the clarity of the application of the Board's preferred approach are resolved, we are supportive of the concept of providing this distinction with respect to presenting changes in the liability-classified instruments. We further emphasize that if the conclusion regarding whether amounts are "independent of the entity's available economic resources" drives not only balance sheet classification but also income statement recognition, it is critical that this concept is well-understood and easily applied.

Committee members generally do not believe that the revised model should create a requirement to separately measure and present changes in financial liabilities that are due to amounts that are ***not*** independent of the entity's available economic resources from ***other*** changes in the financial asset or liability (i.e., the "disaggregation approach" discussed in Section 6). This may be unnecessarily complex and difficult to apply in practice. This also seems inconsistent with the view that derivatives should be classified and measured in their entirety.

With respect to the alternatives described in Paragraph 6.38, we are supportive of Alternative A and believe it strikes the right balance between the benefits of providing useful information and the cost of application. We have observed in practice that due to the difficulty and complexity in determining the value of a bifurcated embedded derivative, entities may elect the fair value option to measure the hybrid instrument in its entirety at fair value.[7] If Alternative B were required, entities would no longer be able to avoid determining the value of embedded derivatives on a stand-alone basis.

If an entity issued a hybrid instrument with an embedded derivative whose settlement value was not independent of the entity's available economic resources, the entity could elect to bifurcate the embedded derivative and apply the separate presentation requirements (i.e., present the change in fair value from the bifurcated derivative within OCI rather than through profit or loss). However, we believe that it would also be appropriate for that entity to elect the fair value option for the hybrid instrument and therefore report the entire change in fair value through profit or loss. We believe this is consistent with the concepts of the model, since the Board's preferred approach appears to dismiss the "disaggregation approach" due to its complexity. As a result, the model acknowledges that there will be some changes in fair value that relate to amounts that are not independent of the entity's available economic resources reported through profit or loss. We also believe that the proposed enhanced disclosure requirements would sufficiently enable financial statement users to understand these types of instruments.

[7] Paragraph 4.3.6 of IFRS 9 *Financial Instruments* states, "If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivatives separately either as acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit and loss."

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?

Response:

Committee members acknowledge that existing earnings per share (EPS) guidance is already complex. The objectives of IAS 33 *Earnings per Share* ("IAS 33"), are to enable financial statement users to 1) compare performance between different entities, and 2) compare performance for the same entity between different periods.[8] The standard also acknowledges the limitations of the metric as one that may not necessarily be reflective of the true economics that would occur if the issuer liquidated and made distributions to equity holders, or if a financial statement user wanted to understand period on period changes in specific equity instruments. It is unclear how the Board's preferred approach reconciles to the existing performance objective of IAS 33. Accordingly, absent additional investor outreach to understand the demand and perceived usefulness of these expanded disclosures, we would not support requiring the additional attribution models.

[8] Based on paragraph 1 of IAS 33 *Earnings Per Share*.

Committee members are, however, broadly very supportive of expanding disclosure to provide investors with more information about the outstanding equity instruments (thereby reducing differences between the disclosures required for equity-classified instruments vs. liability-classified instruments).

Accordingly, we are most supportive of approach (d) described in Question 8. If the Board proceeded with one of the attribution approaches, we generally believe approach (a) a full fair value approach, is most reflective of the economics of potential attribution of total comprehensive income; however, we question whether the cost of determining the fair value of all outstanding and potentially outstanding equity instruments (including ordinary shares) is justifiable, since many of the objectives might be more efficiently accomplished through disclosures.

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:ç

(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?

Response:

Committee members are broadly supportive of the suggested disclosure items and agree that they would (a) provide useful information to investors and (b) would represent an improvement as compared to the existing requirements. We also expect that preparers likely already gather such information as part of their analysis of the instruments in question and preparation of EPS calculations.

Some Committee members noted that it would be beneficial for the Board to provide additional guidance on how to distinguish between different instruments that seem to have similar priority of claims to the entity. This might be accomplished by enhanced guidance or detailed examples.

Some Committee members also recommend considering whether contracts with potential share ***redemptions*** or ***repurchases*** should also be considered in the reconciliation of changes in the number of ordinary shares outstanding and the maximum number of additional potential ordinary shares that could be issued during the period.[9] We believe it might also be useful to financial statement users to understand the maximum potential ordinary share ***reductions*** as they analyze the performance of an issuer. For example, we would suggest including information about hedges or other derivative contracts that would limit potential dilution (e.g. convertible bond hedges).

Finally, we note that preparers will likely need to exercise professional judgment when evaluating which of the required disclosures is material to their financial instruments. We would encourage the Board to provide robust implementation examples to demonstrate how preparers may apply such judgments in common 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?

Response:

Committee members believe the Board should provide further clarity on how it is distinguishing the concepts of ***economic compulsion***, which is not included in the Board's preferred approach, ***and non-substantive terms***, which appears to be included in paragraph 20 of IAS 32 and retained in the Board's preferred approach. We believe the clarity of these concepts is further complicated by the competing concept of an obligation being one that the entity "has no ***practical ability*** to avoid," which is included in the *Conceptual Framework* definition of a liability.

For example, IAS 32 Paragraph 20(b) references an instrument which can be settled in (i) cash or (ii) its own shares at an amount that "exceed[s] substantially the value of the cash." The example provided in Paragraph 8.25 of the Discussion Paper references an instrument that could be settled in either cash equal to X or in its own shares at an amount "that is greater than X." It is not clear whether the difference in settlement amount between the cash option and share option must be "substantial" or that the share amount must simply exceed the cash amount by any amount. We question, for example, whether an entity would *always* choose to

[9] An illustrative example of this dilution disclosure is included within Paragraph 7.23 of the Discussion Paper.

settle an instrument in cash if there is only a slight disincentive when considering the settlement amount compared to settling in its own shares, especially if the entity had limited available cash but sufficient authorized and unissued shares.

We believe to the extent paragraph 20 is intended to be consistent with paragraph 15 of IAS 32 to account for the "substance of the contractual arrangement," it should be retained and that should be explained as the basis for retaining it. If the intent of paragraph 20 is based on ***economic compulsion*** and the Board rejects economic compulsion as a conceptual basis to conclude a company has an ***unavoidable obligation***, then we believe the exception should not be retained in order achieve consistency.

For example, we have observed instruments in various jurisdictions that involve the issuance of a perpetual bond, where the issuer can defer interest payments indefinitely; however, if the issuer elects to defer interest payments, the interest rate increases substantially. The penalty resulting from deferring the interest payment could be viewed to economically incent the issuer to make the interest payments. In this case, one may conclude that since economic incentives should be disregarded for purposes of classification, the instrument would not meet criterion (a) in the Board's preferred approach. Alternatively, the right to defer the interest payment could be viewed as a non-substantive term since it would not be logical for the issuer to elect to defer interest payments and incur the associated penalty.

Consider another instrument where the contractual terms do not obligate the issuer to make a cash payment; however, the issuer has publicly announced its intent to settle the instrument in cash. (Assume for the purposes of this example that the settlement amount is not independent of the entity's available economic resources.) One could assert that a public statement of intent could or should qualify as removing the issuer's "practical ability to avoid" payment. We believe the application of the existing guidance and the Board's preferred framework would likely preclude liability classification for such an instrument given the contractual terms do not require cash settlement. We believe further clarity with respect to the Board's intent for the application of these concepts would provide clarity.

It is also not clear whether this assessment should be made only upon the original issuance of the instrument or if it should be a continuous assessment each reporting period. Finally, we also do not believe it is clear whether non-substantive terms should be evaluated for each instrument on its own, or in consideration of other instruments that may be outstanding. For example, the terms of preferred shares may require quarterly cash dividend payments. An issuer may be permitted to defer interest payments on its outstanding bond, so long as the issuer does not make any dividend payments. When considering the bond on its own, the issuer might assert that it has the ability to avoid interest payments; however, when considering the terms of the preferred shares in combination with the bond, the issuer might not be able to assert that it has the ability to avoid paying interest to the bondholder(s).

We do believe that non-substantive terms should be disregarded and are therefore supportive of the concept of paragraph 20 of IAS 32; however, Committee members agree that further clarity on the distinction between non-substantive terms and economic compulsion would be meaningful. We also noted in our discussions of these concepts that paragraph 20 of IAS 32 may be interpreted differently when applying existing guidance, which further emphasizes the need to clarify the Board's intent.

Some Committee members feel strongly that the revised model should include consideration of economic compulsion in order to avoid structuring to obtain a desired accounting outcome that does not reflect the economics of the instrument. Others acknowledge that while it may be more conceptually pure to include a concept of economic compulsion in the revised model, it may expand the current project in such a manner that would substantially delay standard-setting. Regardless of the Board's direction on whether to include or exclude the concept of economic compulsion, we agree it is imperative that the Board clarify its intent with respect to the distinction between non-substantive terms, economic compulsion, and the "practical ability to avoid." It may be acceptable that the concepts are not aligned between the Board's preferred approach and the *Conceptual Framework*, but the Board should address how it evaluated these differences. The Board may consider a longer-term project to address economic compulsion more broadly, outside the scope of the Discussion Paper.

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?

Response:

Committee members generally agree that when evaluating the classification and measurement of financial instruments within the scope of IAS 32, one should generally only consider the contractual terms. However, if laws or statutes could require cash payments that could impact liquidity, then such terms should be treated similarly to contractual terms since they may also be ***unavoidable obligations*** of the Issuer. For example, jurisdictional laws might require redemption of the outstanding shares based on contingent events (e.g., redemption of employee options upon employee retirement).

When considering instruments commonly observed in relevant jurisdictions, Committee members were not aware of situations that would give rise to significant concerns if the existing scope of IAS 32 was retained.

Other feedback:

Although not specifically posed as a question for feedback on this Discussion Paper, we observed the Board's analysis of the *Conceptual Framework* included in Appendix B. More specifically, paragraph B5 notes, in part, "[i]f the Board ultimately decides to implement the preliminary views in this Discussion Paper, the Board might consider possible implications for the *Conceptual Framework*." As indicated at the beginning of this letter, we believe that for this project to achieve the desired objectives, the existing inconsistencies between IAS 32 and the *Conceptual Framework* must be resolved. If they are not, we believe that the confusion and lack of a conceptual basis for conclusions that exists today will persist with the Board's preferred approach.

Paragraph B6 also specifically notes that none of the changes in the Board's preferred approach would require changes to paragraphs 4.28-4.35 of the *Conceptual Framework*. We note that the liability section of the *Conceptual Framework* includes two subsections- "Obligation" in paragraphs 4.28-4.35 and "Transfer of an economic resource" in paragraphs 4.36-4.41.

We disagree that it would not be necessary to amend the Obligation section if the Board's preferred approach is implemented. This section discusses an obligation as one that the entity "has no practical ability to avoid," whereas the Board's preferred approach considers a liability to be when an entity has an "unavoidable" transfer of economic resources (without regard to likelihood), which we do not believe would always lead to the same conclusion.

Further, the Discussion Paper does not address whether revisions to the *Conceptual Framework* discussion of "transfer of an economic resource" would be needed if the Board decides to implement the Board's preferred approach. We believe that changes to such section would be required to achieve consistency between the *Conceptual Framework* and the Board's preferred approach described in the Discussion Paper; however, it is not clear from the discussion in Appendix B whether the Board has contemplated these differences.

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We appreciate your thoughtful consideration of the responses provided in this letter. If you have any questions or need additional information, please do not hesitate to contact Nigel James, Vice Chair of Committee 1 at +1 202-551-5300. In case of any written communication, please mark a copy to me.

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Sincerely,

Makoto Sonoda
Chair
Committee on Issuer Accounting, Audit and Disclosure
International Organization of Securities Commissions