THE 100 GROUP

Financial Reporting Committee

IFRS Foundation
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Canary Wharf
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Dear Sir/Madam

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

We welcome the opportunity to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* (FICE).

We support the IASB's efforts to address the challenges that arise when applying IAS 32 *Financial Instruments: Presentation* in practice and to improve the information that entities provide in their financial statements about financial instruments that they have issued.

We agree with the approach of trying to articulate the principles of classification of financial instruments as either financial liabilities or equity instruments with a clear rationale, but without fundamentally changing the existing classification outcomes of IAS 32.

However, we have a number of concerns about some areas of the proposals:

- The 'amount feature' of the proposed classification approach takes into account cash flows which only arise on liquidation of the entity which appears to contradict the underlying assumption that IFRS financial statements are prepared on a going concern basis;
- The introduction of new terminology, such as 'independent of an entity's available economic resources' is potentially confusing, particularly as it is not clearly defined;
- The proposed additional disclosures are potentially onerous, and may not be meaningful in large groups with multiple entities in different legal jurisdictions; and
- The proposed treatment of puts over equity produces a potentially misleading balance sheet during their life by including a notional liability for the strike price and extinguishing equity before their exercise.

Our detailed responses to the questions outlined in the Discussion Paper are included as an appendix to this letter.

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the UK FTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers

Please feel free to contact us through the 100 Group's website, www.the100group.co.uk, should you wish to discuss our comments.

Yours sincerely,

Russ Houlden
Chairman
Financial Reporting Committee

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?**

We agree with the description of the challenges and their causes. The definition of equity in IAS 32 is straightforward: 'a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'. In theory, equity is everything in the statement of financial position that is not an asset or a liability. However, the classification guidance for equity in IAS 32.16 is significantly more complex than the definition and opens potential gaps with the liability definition. This has led to uncertainty in the application of IAS 32 to those instruments, such as financial sector regulatory securities, that have been specifically designed to have features similar to both debt and equity.

The challenges identified are important to the users of financial statements that contain these instruments. Whilst these instruments are reasonably common within the financial sector, it is not apparent that they are sufficiently widespread elsewhere to require a new standard that could impose significant additional conversion and disclosure requirements on all entities that report under IFRS. We suggest that further outreach is conducted to determine what percentage of IFRS filers are actually impacted by the issues identified.

Question 2: The Board's preferred approach to classification would classify a claim as a liability if it contains:

a) **an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or**

b) **an unavoidable obligation for an amount independent of the entity's available economic resources.**

This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50. The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

We disagree with the Board's preferred approach to classification as we do not believe that both features are relevant to the entity's current financial position.

The 'timing' feature (obligation to transfer economic resources at a specified time other than at liquidation) reflects the fact that liabilities are present obligations requiring the entity to transfer economic resources. However, the 'amount' feature (obligation for an amount independent of the entity's available economic resources) does not seem to fit with the existing definition of a liability. It takes into account potential claims even if they do not require the transfer of economic resources other than at liquidation. This goes against the underlying assumption that financial statements are prepared on a going concern basis and does not provide useful information about present obligations of the entity.

The use of a new term – independent of the entity's available economic resources – also presents potential problems as it is not clearly defined nor is it intuitively obvious what it

means. This could further confuse users of accounts. For instance, in the UK it might be mistaken for an entity's distributable profits, which are separate but related to the retained profits of an entity. In the discussion paper itself it has been used to describe a form of net asset calculation (in section 3.17), but the share price is also described as a proxy for it (in section 4.53).

We agree that additional disclosures could be helpful to the user of accounts as the binary distinction between liabilities and equity cannot capture all of the features or potential impacts of complex financial instruments. We recommend that the Board restricts the extent of new disclosures to complex financial instruments though. Simple liabilities and ordinary shares are already well understood by users of accounts so additional disclosure requirements around these instruments may simply clutter the financial statements and add unnecessary ongoing cost to their preparation.

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?

Subject to the issues noted above in question two, we agree with the principal that (a component of) a financial instrument should be classified as a financial liability if it is has at least one settlement outcome that has the features of a non-derivative liability.

We note though that this would cause a reclassification of some instruments, such as perpetual cumulative preference shares, from equity under IAS 32 to liabilities under the Board's preferred approach. We do not believe that would provide more relevant information on an entity's current financial position as such shares do not represent a present obligation.

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?

We agree that the puttable exemption would be required under the Board's preferred approach as the issues that necessitated the exemption under IAS 32 would remain 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?

We agree with the Board's approach to classifying a derivative on own equity in its entirety.

We welcome the Board's attempt to consider the conceptual and practical challenges that have been encountered when applying IAS 32 to derivatives on own equity, in particular over the meaning of the 'fixed for fixed' criterion (now independent of the entity's available economic resources). However, there does not appear to be a clear set of principles behind those factors which are considered to be an acceptable link to an entity's available economic resources and those which are not. For example, the time value of money is simply described as being inherent in any entity's available economic resources with no further analysis. Whilst considering some of the common variables in derivative pricing is helpful, without a clear set of principles it is likely that it will just invite more questions about other forms of variability.

The approach to currency appears unnecessarily restrictive in group financial statements. The idea that the residual interest in an entity is determined in that entity's functional currency is well established, but a group has no functional currency. Many listed groups have significant foreign currency operations and choose to raise funds in those currencies, rather than the functional currency of the parent. We therefore believe that the Board should consider developing a notion of closely related foreign currency for derivatives over equity instruments similar to that used in determining whether foreign currency embedded derivatives need to be bifurcated from the host contract in IFRS 9.

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 disagree that the accounting for a written put on own shares should be the same as for a convertible bond. Whilst the outcomes are similar once they have been exercised, during the period that they are outstanding the impact on the financial resources of the entity are very different. Accounting for a written put by recognizing a liability equal to the strike price, with the de-recognition of an equal amount of equity is potentially misleading in the statement of financial position in that it understates the actual outstanding equity of the entity and overstates its liabilities.

We believe that information on alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a liability is best provided through disclosure of the alternative outcomes, rather than through additional classification and measurement requirements.

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 believe that further subdividing the face of the statement of financial position into additional categories will provide useful information to the user of accounts. Balance sheet classifications are well understood and provide useful liquidity information through the split of current and non-current assets and liabilities. To add further categories of liability, based on the nature of the claims, may simply clutter the statement of financial position and so result in ineffective communication. If the Board feels that this information is necessary, we believe it would be better provided through additional note disclosures.
We agree that existing disclosure requirements provide sufficient information about the timing feature, so no additional presentational requirements need to be developed.

We prefer Alternative A in paragraph 6.38 as it is not clear that the additional information provided by separating one instrument measured at fair value through profit and loss (FVTPL) from another which is also measured at FVTPL justifies the additional cost.

Question 8: The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

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

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

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

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

We agree that it might be useful to users of financial statements to have additional information about how returns are distributed among equity instruments. However, as many equity instruments involve some form of discretion in their cash flows, we do not believe that a prescribed attribution approach can be appropriate for all possible types of equity instrument. As calculations would not be based on contractual cash flows they may not produce meaningful attributions in some circumstances. We therefore believe the cost would likely outweigh the usefulness of the information produced.

Question 9: The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

a) **information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).**

b) **information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).**

c) **information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).**

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

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

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

We agree that providing information about the priority of financial liabilities and equity instruments on liquidation would be useful to the users of solus financial statements. However, we do not believe that such information is meaningful in group financial statements given liquidations are often carried out at an individual company level. Where a group has issued equity and/or liabilities out of multiple entities within the group (potentially across different legal jurisdictions) it is not practical to rank those securities in the group financial statements – in the event of liquidation they will represent claims against different pools of assets within the group. For large groups, it is therefore likely that this would result in pages of additional disclosure requirements that do not necessarily provide meaningful information.

We agree that additional information about potential dilution of ordinary shares would be useful to the user of accounts.

We believe that information about the terms and conditions for both financial liabilities and equity instruments is useful to users of accounts. However, we do not believe that the financial statements are the appropriate place for this information as it is often available from other sources. Moreover, the information is either likely to be too simple – in the case of a standalone company with a simple capital structure – or too complicated – in the case of a large, multinational banking group – to provide useful additional information to the user of accounts that outweighs the costs of preparing it.

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 that economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument. If economic incentives are considered it would result in a more subjective approach to the classification of financial instruments, and could result in identical instruments being classified separately at different points in time if economic incentives have changed.

We agree that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained as it reduces the possibility of terms that will never be exercised being structured in financial instruments to try and achieve an accounting result.

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 that the scope of any replacement standard should be consistent with that of IAS 32 as we are not aware of any practical implementation issues related to the scope of IAS 32.