International Accounting Standards Board (IASB)
30 Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

26 March 2024

Dear Member of the Board,

Re: IASB Exposure Draft Financial Instruments with characteristics of equity: Proposed amendments to IAS 32, IFRS 7 and IAS 1

BusinessEurope welcomes the opportunity to comment upon the Exposure Draft Financial instruments with characteristics of equity (the ED).

We have two principal areas of disagreement with the proposals included in the ED: those relating to the effects of the relevant laws or regulations and those relating to the obligation to purchase an entity's own equity instruments. We think that the proposals in these areas will result in information which misrepresents the economic situation of the entity and thus mislead users of the financial statements.

In our view, the proposal to effectively ignore relevant laws or regulations when determining the classification of financial instruments runs completely counter to the generally accepted accounting practice of considering all relevant facts and circumstances when analyzing accounting transactions. It also contradicts certain requirements of the Conceptual Framework and the way entities currently apply IAS 32.

The proposals relating to certain obligations to purchase own equity instruments, commonly referred to as NCI Puts, will result in counterintuitive accounting effects and will mislead all but the most sophisticated user of the financial statements. We see no merit in persisting with an accounting approach the effects of which will either be ignored or will induce users into an erroneous understanding of an entity's performance.

Our disagreement is explained in more detail below in the responses to the specific questions contained in the ED.

If you require any further information about our comments, please do not hesitate to contact us.

Yours sincerely,

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APPENDIX

Question 1—The effects of relevant laws or regulations (paragraphs 15A and AG24A–AG24B of IAS 32)
The IASB proposes to clarify that: (a) only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts (paragraph 15A); and (b) a contractual right or obligation that is not solely created by laws or regulations, but is in addition to a right or obligation created by relevant laws or regulations shall be considered in its entirety in classifying the financial instrument or its component parts (paragraph AG24B). Paragraphs BC12–BC30 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We do not agree with the proposals included in paragraph 15A.

Paragraph 4.60 of the Conceptual Framework states: "All terms in a contract-whether explicit or implicit-are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute…"

Existing, and retained, paragraph 15 of IAS 32 states that an instrument shall be classified as a financial asset, a financial liability or an equity instrument in accordance with the substance of the contractual arrangement and the relevant respective definitions.

Proposed paragraph 15A (a) refers to paragraph 13 of IAS 32 which states that 'contract' and 'contractual' refer to an agreement "that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing."

In the light of these three principles or requirements, it seems conceptually inconsistent to require those contractual rights or obligations created solely by statute, laws or regulations to be ignored when determining the classification of a financial instrument.

The jurisdiction and its laws are inseparable from a contract, providing essential context and substance for the analysis of financial instruments, as is acknowledged by the requirement that a contract be, in general, enforceable by law to have substantial existence for accounting purposes.

At present, in our experience, most entities logically take the relevant statutes of their jurisdiction into account when analyzing the nature of financial instruments, and in this context the “all-inclusive” approach of paragraph BC14 of the ED is valid.

Consequently, we disagree with the conclusions of BC15 and think that to prohibit taking these into consideration, as proposed, would represent a major departure from current understanding of IAS 32 and current accounting practice in general.

We think that a more appropriate approach would be to require all relevant information to be taken into account and then, perhaps, to provide further guidance upon how the effect of certain statutes might be assessed, such as the case of legally imposed dividends in some jurisdictions. This would ensure that potentially important substance is not ignored summarily, but considered and dealt with properly.

Question 3—Obligations to purchase an entity's own equity instruments (paragraphs 23 and AG27B–AG27D of IAS 32)

The IASB proposes to clarify that:

(a) the requirements in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instruments also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments (paragraph 23).

(b) on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would, therefore, be removed from a component of equity other than non-controlling interests or issued share capital (paragraph AG27B).

(c) an entity is required to use the same approach for initial and subsequent measurement of the financial liability—measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right (paragraph 23).

(d) any gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraph 23).

(e) if a contract containing an obligation for an entity to purchase its own equity instruments expires without delivery:

    (i) the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial liability.

    (ii) any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss. However, the entity may transfer the cumulative amount of those gains or losses from retained earnings to another component of equity (paragraph AG27C).

(f) written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled—consideration is exchanged for own equity instruments—are required to be presented on a gross basis (paragraph AG27D).

Paragraphs BC62–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We strongly oppose the requirements as proposed in the ED since they will not provide relevant and reliable information to users of financial statements. As explored further in the following part of our comment letter, we are concerned that the accounting effects will mislead investors and trigger wrong investment decisions, thus jeopardizing the acceptance of IFRS in the global financial community.

Fact pattern:
The accounting topic described is a pervasive one. In the negotiation phase of M&A deals, potential sellers and buyers quite often have different assessments regarding the future development of the acquisition target. This is due to the fact that potential sellers have more information about the target company or are simply over-optimistic regarding the business plans in order to negotiate a higher transaction price. On the other hand, potential buyers do not want to overpay and are cautious regarding the materialization of optimistic business plans of an unknown company (a situation of information asymmetry). In order to bridge this information gap and share risks and opportunities regarding the target, sellers and buyers frequently agree on a future minority stake of the former owners of the target. In this way, the former owners remain to some extent entrepreneurs and participate in the economic development of the target. This commitment demonstrates to the buyer that they really believe in their business plans.

In the long run, sellers usually want to dispose of the minority stake since they do not control the target any longer and the buyer intends to fully incorporate the target into its operations. Therefore, M&A contracts quite frequently include put options for former owners of a target company (resulting in non-controlling interests in the consolidated financial statements of the buyer). The exercise price of these put options is often based on the fair value of the target at a future point in time. The reason behind this approach is that it helps to achieve a fair sharing of risk and opportunity between the former owners and the future owners of a target. In this example, the former owners are not employed, therefore the regulations in IAS 19 regarding remuneration are not applicable.

The buyer usually does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, i.e. the seller of the target company still has present ownership interest and receives dividends until the option is exercised.

Applying the ED proposals to the fact pattern:
From the accounting perspective of the buyer, the put option of the seller (the written put) represents an obligation to purchase an entity's own equity instruments. Therefore, the proposals in the ED would be applicable for these kinds of transactions.

As a consequence, the buyer would be required to record a financial liability (in line with the current requirements in IAS 32) immediately upon the closing of the transaction to provide for the possible exercise of the put option by the seller at a point in the future which is currently not fixed.

According to the proposals in the ED **(Question 3b)**, the initial amount of this liability would be removed from a component of equity other than non-controlling interests (NCI), in other words, from the parent company's equity. Other than for cases in which the parent repurchases its shares, we oppose this requirement since it is counterintuitive. The reason for recording the liability is to provide for the exercise of the put option by the minority shareholder. When the minority shareholder exercises the option, no NCI exist anymore. Therefore, we do not think it is helpful to present the NCI as well as the liability in the balance sheet at the same time. This would be a mix of two mutually-exclusive scenarios: (1) the booked NCI represent the continuing entitlement of minority shareholders regarding their stake in the business also going forward and (2) the booked liability embodies the payment obligation towards the minority shareholders in case they decide to give up their interest in the company. Accounting for both scenarios results in an overstatement of the position of the minority shareholders and in an understatement of the equity attributable to the shareholders of the parent company, thus distorting the picture of the business given to investors and potentially negatively affecting the valuation of the parent company.

The information would be more meaningful if the liability were booked against NCI (with any excess booked in retained earnings), thus giving investors a clear picture of what will happen in the balance sheet when the minority shareholder exercises its put option.

We agree with the proposals in the ED **(Question 3c)** to measure the liability at the present value of the redemption amount and to ignore the probability and estimated timing of the counterparty exercising the redemption right (assuming instead that exercise occurs at the earliest point of time). While this approach simplifies the calculation of the liability and reduces diversity in practice, we note that the term "redemption amount" has no clear definition. We are aware that measuring the redemption amount is sometimes difficult, especially when elements like average pricing mechanisms, contingent discounts or premiums and the like are part of the agreement. Therefor we urge the Board to provide more guidance on how to incorporate these elements into the measurement of the liabilities in question.

We fully disagree with the proposal in the ED **(Question 3d)** to recognise any gains or losses arising on remeasurement of the financial liability in profit or loss (P&L).

Firstly, the current proposals in the ED represent a mixture of different accounting approaches. The initial recording of the NCI put liability is booked in a way so that it is P&L-neutral. The subsequent valuation of the liability is booked through P&L. The derecognition of the liability (if the put option is not exercised) is booked in a way which is P&L-neutral again. In addition, consider a written put for a fixed price over a fixed number of own shares which can initially be exercised in five years. This instrument fulfills the fixed-for-fixed criteria and is an equity instrument. Yet the unwinding of the discount would be recorded in the P&L. We cannot see a convincing argument for such a conceptual inconsistency.

In our view, the transaction is a transaction between owners in their capacity as owners, as defined in IFRS 10.23 and IFRS 10.B96. These types of transactions are generally recorded without affecting P&L. We think that the IASB should remain consistent with its accounting concepts in order to avoid creating the impression that the IFRS are becoming more and more rules-based instead of principles-based.

Secondly, a remeasurement of the liability to its current fair value by recording an expense in the P&L misleads investors who base their investment decisions on the net income of a company. The following example clearly illustrates the investor's pitfall.

An investor has two investment opportunities:

<u>Opportunity 1: Buying shares of Company A</u>

Company A acquired 95% of company B. The former owners of company B retained a minority stake amounting to 5% and have present ownership rights. In addition to that, they have a put option to sell their 5% stake to company A at fair value in the next 3 years. Company A is very successful in integrating company B into its operations and the expected synergies at company B materialize and will positively impact net income in subsequent years. As a consequence, the fair value of company B increases. In the consolidated financial statements of company A, this development results in the **increase of the written put liability** which is booked through P&L (as proposed in the ED) and **reduces net income** immediately.

<u>Opportunity 2: Buying shares of Company C</u>

Company C acquired 95% of company D with the same conditions as in Opportunity 1 above. However, company C is not successful in integrating the business of company D. Sales of company D decrease, cost synergies cannot be achieved. The fair value of company D decreases from year to year. In the consolidated financial statements of company C, this development results in the **decrease of the written put liability** which is booked through P&L (as proposed in the ED) and **increases net income**.

<u>Investor's pitfall</u>
The outcome on the financial statements does not give a faithful representation of the economics of the respective transactions. The company with the higher net income is the company who actually failed to integrate the new business. If investors base their investment decisions on IFRS accounting figures they take exactly the wrong decision regarding efficient and profitable capital allocation.

Investors are misled and economically successful companies are disadvantaged. We do not think that this is the right approach to maintain the current high level of acceptance of IFRS in the global financial community.

We agree with the proposal **(Question 3() i)** that if a contract containing an obligation for an entity to purchase its own equity instruments expires without delivery, the carrying

amount of the financial liability would be removed from financial liabilities and be included in the same component of equity as that from which it was removed on initial recognition of the financial liability. If a written put option is not exercised, minority shareholders still have a stake in the target company. Accordingly, NCI should be presented in the balance sheet also going forward. This accounting result is achieved if the liability is initially booked against NCI (as stated in our comments above) and not (solely) against any other component of equity. Such an approach provides a holistic accounting concept which automatically achieves an economically sound accounting result (as opposed to the proposals in the ED Question 3b).

As mentioned above, we believe that gains and losses regarding the redemption liability should not be recorded in P&L. To remain conceptually consistent, we are also convinced that when an equity instrument expires without delivery, any gains or losses from remeasuring the liability should not affect P&L. That is why we agree with the proposal in **Question 3 (e) (ii)**. We would like to highlight that this accounting result is systematically achieved if our proposals above are applied and not the proposals outlined in the ED (Question 3d). A recording of liability remeasurements in the P&L during the lifetime of the option and a P&L neutral derecognition of the liability without P&L reversals of prior remeasurements when the written put option expires would be counter-intuitive and not provide a sound and holistic accounting concept.

Suggested approach:

To address the mentioned issues and provide accurate information to our investors, we suggest the following approach:

In case of a written put option on non-controlling interests the Parent Company assesses whether the prerequisites for the transfer of present ownership interest are fulfilled at the balance sheet date. If the Company is not the beneficial owner of the shares underlying the put option, the exercise of the put option will be assumed at each balance sheet date and treated as equity transaction between shareholders with the recognition of a purchase liability at the respective exercise price. The non-controlling interests participate in profits and losses during the reporting period.

This accounting approach:

(1) adheres to the general concept that transactions between owners in their capacity as owners are recorded without affecting P&L
(2) informs investors about the expected purchase price of the additional shares currently owned by non-controlling interest shareholders
(3) avoids the investor's pitfall as mentioned above and better reflects the economic substance of the transaction

After analyzing the annual reports of companies with large market capitalisations, we have found that this accounting approach is widely adopted. We strongly believe that it provides more meaningful information to users of financial statements compared to the proposals in the ED.