



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

4 January 2019

Dear Board Member,

Re: Financial Instruments with Characteristics of Equity (DP/2018/1)

BusinessEurope welcomes the opportunity to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP/2018/1 – the DP). We highly appreciate the Board's effort to provide clarification about the classification of instruments as equity or liabilities. We recognise that the current model laid out in IAS 32 is – in some cases – difficult to apply and does not provide for a shared understanding.

As laid out in our detailed comments below, we think that the Board touches upon some very difficult matters. The new proposed model consisting of the two criteria, i.e. the timing feature and the amount feature, tries to solve the issues identified. However, BusinessEurope is of the view that the main difficulties that arise from the application of IAS 32 do not require a new model but simply an enhanced model of the current IAS 32 that includes some more clarifications. In addition, we think that it would be sufficient to rely on the timing feature alone as the criterion to distinguish between equity and debt. This is based on the reasoning that – upon liquidation – every investor in an entity is subject to the available resources of the entity.

Furthermore, we would like to point out other areas that remain problematic but have not been discussed in the DP.

Please find our detailed comments in the appendix. If you require any further information on our comments, please do not hesitate to contact us.

Yours sincerely,

Pedro Oliveira
Director
Legal Affairs Department



APPENDIX

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?

BusinessEurope agrees that the classification of complex financial instruments under IAS 32 is challenging and can lead to diversity in practice. We welcome the Board's efforts to improve the existing guidance and consider that the issues described are pervasive enough to require standard-setting activity.

We believe that improvements to presentation and, to a lesser extent, disclosures are needed rather than a fundamental revision of the model, and that additional information would help users to address the challenges related to IAS 32, but at the same time we urge the board to consider the potential impact of additional information on the disclosure overload and the related projects.

Furthermore, we emphasize that there is also an issue on the "asset-side", i.e. on the holder's side of such instruments. This is because the classification of financial assets depends partly on the classification of these instruments as equity or debt instruments. In effect, the classification of the instrument determines whether such instruments may be measured at FVOCI (in case of an equity instrument) or must be measured at FVPL (in case of a debt instrument). Hence, when assessing a new classification model for equity, the consequences for the holders of financial instruments (i.e. the asset side) must be taken into account and assessed. If more instruments were to be classified as liabilities, volatility within the P/L of the holder would be likely to increase and some long-term investments might seem less attractive.

In addition, we note that some of the challenges, such as the recognition of changes in the NCI Liability in P/L, Equity or OCI would require only clarification rather than a new model for the classification of these instruments. In this sense, we agree that there are challenges that need to be addressed, and that clarification is needed, but remain highly convinced that any new classification model must handle these matters in a way that provides benefits that clearly outweigh the costs and potential disadvantages.



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 summarized 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 appreciate the Board's efforts to improve the current model for classification of equity. However, we have serious concerns regarding the proposed model. If the Board wants to clarify the classification, we think that this could be achieved by an enhanced IAS 32-model. We support the inclusion of the "timing" criterion as laid out in the Board's preferred approach but do not agree with the exclusion of contractually specified liquidation from this criterion (as stated in footnote 24). A limited-life entity provides the holders of its stock with the same equity risk as a normal non-limited-life entity. Hence, we think that such instruments should be classified as equity rather than liabilities as this depicts the characteristics and risks in a way that is more understandable and faithful to the circumstances.

The model proposed would ignore an entity's ability to defer payments indefinitely. This in turn might raise inconsistencies. For example, when an entity has an obligation to repurchase its own shares - but only at a point in time which it can defer indefinitely - the obligation would be classified as a financial liability (see IN22(a)). A call option on own ordinary shares would in effect be a very similar instrument but would be classified as equity (i.e. the call option would not be on the balance sheet until exercised).

We therefore think it would be sufficient to use only the first criterion (an unavoidable obligation to transfer economic resources at a specified time other than at liquidation) to distinguish between equity and liabilities. To provide an example, consider a bond that has been issued by the entity with a stated maturity. The bond is repayable in full at maturity (including accrued interest) but the repayment requires a resolution of the board. The entity has therefor the right to defer payment until the date of liquidation. The characteristics of such an instrument are those of an equity instrument since it ultimately exposes the holders of such an instrument to the same risks as the holders of ordinary shares. In the case of the winding up of such an entity, the holders of the bond would be entitled to an amount which could be dependent on the residual.



We like to point out that using a new terminology and classification rule requires preparers, auditors and users to reconsider current classification decisions, which would create additional costs and uncertainties.

We consider that presentation and disclosure constitute a significant part of this project, but we believe that that users of financial statements are aware of the different types of equity and liabilities and their priority. We urge the Board to carefully weigh the potential benefits of additional notes against the risk of unnecessary information overload and increase of complexity.

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 stated above, we think that improvements can be made to the standard without changing the fundamental model. The following comments are made on the hypothesis that the Board does wish to make fundamental changes to IAS 32.

As a key remark to the reasoning laid out in the Discussion Paper, BusinessEurope thinks that it is very important to consider that the fair value of shares (e.g. listed shares) does not necessarily correlate with the available resources within one or even multiple periods. The share price as the best estimate of fair value is affected by factors that do not necessarily affect the resources of the entity. Hence, the reference to the fair value of the entity needs to be assessed with care. We agree that the share price in theory and in the long run must represent the resources of the entity. However, in reality the development of share prices and the available resources can be largely unrelated.

We understand the rationale behind the Board's view that a liability is characterized as an unavoidable obligation to transfer economic resources at a specified time other than liquidation and at an amount independent of the entity's available economic resources. We note that the condition "other than at liquidation" would lead to a change in classification for some instruments, e.g. investments in limited life companies would be classified as equity while those investments are classified as liabilities according to the



current IAS 32 (as laid out in our answer to question 2). We strongly agree with this outcome but point out that it would require the deletion of the scope restriction (footnote 24 on page 32 of the DP) requiring that the liquidation must not be predetermined.

As mentioned in our answer to Question 2, we think that the timing feature alone would provide a sufficient basis for the classification. Payments that can be deferred indefinitely are ultimately subject to the entity's available economic resources, thus being exposed to same ultimate risk as normal equity instruments. For instruments that contain both an unavoidable obligation and an obligation that may be deferred indefinitely, the same classification model as that for compound instruments could apply as well. One example would be a loan that pays interest based on a fixed coupon but the capital repayment can be deferred by the entity indefinitely. While the interest payments would be classified as a liability, the capital repayment would be equity.

As far as the second feature is concerned, we think that this still needs more explanation to be of use, both from a conceptual and practical point of view. The example mentioned in 3.14 (a share-settled bond) is classified as a liability on the basis that the nominal amount could exceed the entity's available economic resources. However, the redemption of the bond would be capped at 100% of the shares issued by the entity. Hence, the redemption amount would not exceed the available resources. We think the Board must further clarify its rationale for the application of the criteria. The same applies to the example in 3.15 (an irredeemable share with fixed dividends) or 3.24(b) (a fixed amount on liquidation). In our view, the classification outcome should be equity to faithfully depict the characteristics and risks of the instrument.

Finally, we think that the Board should consider a model which uses only the "timing feature" for classification and uses the "amount feature" for the purpose of disaggregation in presentation or disclosure.

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 welcome the Board's effort to redefine the model used to classify equity and liabilities. We recognize that it is very difficult to determine one model that can be used to all the various types of instruments. Therefore, we agree with the Board's preliminary view to retain the existing exception and the disclosure requirements in IAS 1.136A. We also think that the Board should take the opportunity to identify the practical difficulties in identifying the most common issues and address these difficulties within FICE.



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:
- (c) 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
- (d) 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 believe that the Board's preliminary view is consistent with the principles for classifying non-derivative financial instruments using the timing and amount features. We welcome the Board's efforts to clarify existing guidance on derivatives on own equity. We support the Board's approach to maintain the current practice of classifying derivatives in their entirety. This is a well understood practice and reduces complexity compared to a single-leg approach. Having said this, we see an issue when multiple derivatives are being combined in one contract. Sometimes it is difficult to separate the two instruments, especially when one derivative would be classified as a debt instrument, the second one as equity. We wonder why a derivative financial instrument should not be subject to the guidance on compound instruments if it contains both an equity and a debt component (IAS 32.28 requires only non-derivative contracts to be separated into a liability and an equity component and IFRS 9.B4.3.4 requires separation only if a non-derivative host contract exists). We believe that this could enhance the faithful representation of financial information provided to users but acknowledge that the case of combined financial derivatives might be one that is not encountered very often and therefore could be of limited importance.

As for the example provided in 4.18, we do not understand why the exchange of 100 own shares (to be delivered by the entity) against 110 CU (in a foreign currency) would not meet the definition of equity under the Board's preferred approach. The instrument would not require the entity to pay an amount that is independent of the entity's economic resources and there is no obligation to make any payments other than at liquidation. We encourage the Board to provide more clarification as a deep understanding of the classification principles is vital to achieving a consistent approach.



We agree with the Board that derivatives that are net cash-settled or are affected by a variable that is independent of the economic resources of the entity should be classified as either a financial asset or a financial liability provided however that the entity is not able to defer payments indefinitely.

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 the most effective in providing the information, and why?

With regard to the preliminary view expressed in 5.48(a)-(b), we agree that the basis for an assessment should be the package of contractual rights and obligations. It is our understanding that the outcome of the approach would not differ from the application of the current IAS 32 requirements. We think that the current requirements are also well understood and the areas of difficulty are located in some details rather than the overall approach. We would mention that the separate treatment of the redemption amount and the retained rights and the premium seems overly complex as the the outcome is identical.

We are concerned that the accrual of interest in the example stated in 5.30ff is recognized in profit or loss. We are aware that there is a current practice of allocating the interest expense on such instruments directly to equity. This is based on IFRS 10.23 stating that a transaction among shareholders may not affect profit or loss. We urge the Board to weigh carefully the pros and cons of the prescription of either method. When determining an approach, the board should consider whether the transaction described in the DP is a transaction among shareholders. The example provided could in substance be seen as the emission of shares and the subsequent buy-back. Such a buy-back would only be on the face of the balance sheet if the option is exercised. In this particular case, we would also ask for a discussion of why the embedded derivative is not closely related to the host contract. It seems likely that a separation may be difficult to argue under the current guidance. In our view, it remains a question of interpretation whether such transactions constitute transactions among shareholders, even if the amounts



attributable have been reclassified from equity to liabilities. In our view, the retention of an accounting policy choice to be made by the entity seems a good way to limit the impacts of a revised IAS 32.

In addition, we see the main pain points the following:

- when reclassifying equity to liabilities, what part of equity should be reclassified (parent equity or NCI)?
- If NCI, could the NCI account be negative?
- How to account for distributions to shareholders where the attributable part of equity is presented as a liability (i.e. would dividends paid to NCIs that are reclassified presented as interest expense)?

The assessment based on the package of contractual rights and obligations should be the case not only for derivatives that extinguish equity instruments but also for instruments that could become part of an entity's equity. We think that the board touches on a wide-ranging issue. The question of whether two or more separate contracts are to be treated as one financial instrument is also relevant on the asset side. Since the classification of financial assets follows in general the classification on the issuer side, this issue must be part of the discussion. In our view it is then necessary to provide guidance on the "bundling" of contracts. Questions arise on whether the guidance on "linked transactions" applies or contracts can be "bundled" irrespective of the timing and, potentially, the counterparties. This in turn impacts the asset side as the separation of embedded derivatives is prohibited as long as the host contract is a financial asset within the scope of IFRS 9.

Regarding financial instruments with alternative settlement outcomes that do not contain liability components, we are not aware of any practical issues.

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?

BusinessEurope agrees with the Board's preliminary view expressed in 6.54 that no additional presentation requirements are needed as the current requirements in IFRS standards are already sufficient.

In our view, the presentation requirements of IAS 1.55 are sufficient to deal with the question of separate presentation on the face of the balance sheet. In our view, this obliges companies to present such instruments (e.g. instruments whose returns are



dependent on the available economic resources of the entity) in a clear and understandable way, provided that such transactions are material. We are of the opinion that such transactions are likely to be immaterial and hence doubt the merits of having detailed presentation requirements.

We note that the IASB rejected the idea of separating components of a derivative contract, although IFRS 9.B4.3.4 would require the separation of embedded derivatives to distinguish between equity and debt instruments. However we do see an issue when it comes to partly independent derivatives, i.e. derivatives that have equity as well as liability characteristics. We understand that such standalone derivatives do not fall under the guidance for embedded derivatives. However, it may be useful to split contracts containing multiple derivatives into equity derivative and liability derivative components in order to present the two effects correctly and in an understandable way. This in turn could mean that the guidance could be amended in such a way that even a derivative contract could be a host contract that forms part of a hybrid contract. We wonder whether this issue would be worth a more detailed discussion.

Regarding the presentation of changes in the carrying amount within OCI, we would mention that there is an unfinished debate about whether changes in the carrying amount of some instruments (e.g. NCI Put liabilities) should be presented directly in equity. We think the Board's proposal provides useful information in general. However, we think the board should examine more types of instrument and assess whether presentation in OCI without subsequent recycling provides adequate information. It seems intuitive that only instruments that – separated or in their entirety - depend on the entity's available economic resources should be subject to this presentation requirement. We ask the Board to elaborate further on the issue, if the proposals were implemented.

With regard to the question of separating embedded derivatives only for disclosure purposes, we fear that the effort required to provide such information would outweigh the benefits. In addition, it may be confusing to present information about embedded derivatives separately within the statement of financial performance that are not accounted for separately in the statement of financial position. Hence, alternative A seems to be the only reasonable alternative.



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?

BusinessEurope does not agree with the Board's view. We are of the view that the presentation of the aggregate results (i.e. for all equity instruments) is sufficient to inform users of potential returns. This is because: a) investors usually are well informed about the different types of equity instruments an entity uses (e.g. by information provided over Investor Relations services or which are required by law) and b) the amounts actually to be distributed are commonly not derived from IFRS results but rather from a local GAAP perspective of the parent company. The latter would then require a proper reconciliation between the results attributed to these instruments under IFRS and the potential actual dividends. We therefore fear that the inclusion of such information could be misleading and confusing if there are multiple instruments outstanding, and unnecessary if there are only few instruments in question.

Further, it may raise the question of why the distribution of dividend-linked instruments that are presented as liabilities, would not be contained in such a disclosure or presentation.

We agree that IAS 33 should be applied unaltered, not only for non-derivative, but also for derivative, equity instruments.

We think that the attribution proposals are complex and onerous, both for preparers and users, and should not be pursued. However, we have the following comments to make on the approaches proposed.



The full fair value approach:

With this approach, the board proposes to attribute the changes in the fair value of equity derivatives to the related components of equity. In our view, this does not provide useful information, as it shows a share in the entity's comprehensive income that would not be attributable to such instruments if they were converted. Instead, it shows the opportunity cost borne by the existing shareholders. In our view, the resultant measure does not provide information from which existing and potential shareholders could estimate a possible dividend return. Instead, it would show a return based on non-IFRS measures which makes it - in our view - unsound.

The average-of-period method/end-of-period method:

The same critique applies to the other approaches. Measuring derivative equity instruments at their fair value and attributing the performance of the entity in relation to the fair values does not depict the performance of the entity that would be attributed to these instruments if they were converted. This is because it does not take into account the fact that different types of equity instruments may have different mechanics of dividend allocation.

Notes disclosure

As laid out above, we do not see a necessity for enhanced information about potential distributions, hence we suggest that the Board does not to pursue this matter any further.

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?

(a) Liquidation priority

Considering the concerns raised above, notes disclosure seems the only adequate way to distinguish between the different types of liabilities and equity. However, we question whether this information is useful. This is for two reasons:

1. The information about the seniority is usually provided to all holders of such instruments, i.e. all investors should already be aware of the hierarchy their instruments are subject to; and
2. For holders of debt instruments, the results of the issuing entity in isolation (i.e. the parent entity or any subsidiary) would appear to be more relevant than the consolidated figures, since the repayment of the amounts outstanding depends on the resources available to the legal entity rather than to the group. We fear that the presentation on a consolidated level could misstate the actual assets that can be used to settle the obligations.

(b) BusinessEurope agrees with the Board that some users of financial statements are interested in the potential dilution in a way that exceeds the information currently provided under IAS 33 and IAS 1. However, shareholders usually have access to such information from different sources. The Board should therefore endeavour to keep the duplication of information to a minimum. We think that the presentation of the total number of potential shares is sufficient to most users.

(c) Terms and conditions

BusinessEurope is not aware of any issues concerning the lack of disclosure of the terms and conditions of equity instruments and liabilities. With regard to the proposed disclosure of the terms and conditions affecting the settlement amount, we are of the view that the amount on the face of the balance sheet and the changes therein provide sufficient information about the variability. In addition, we estimate that most companies do not issue vast amounts of instruments whose terms are such that detailed information needs to be provided to users. Further, information about the terms and conditions could be very extensive and contribute to the disclosure overload. We suggest that the Board bear in mind what is already required by legislation and identify what further information about the terms and conditions would be of real use.



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?

- (a) We agree with the Board's preliminary view. We believe that considering economic incentives would increase uncertainty regarding the classification of financial instruments as liability or equity instruments. It would furthermore require clearer definitions and explanations of economic incentives to be developed (e.g. regarding which economic incentives should be considered and what would be the consequence of a change in economic incentives). We note that, as of today, economic incentives are already taken into account when splitting a compound instrument. This is then reflected in the initial carrying amounts of the liability component and the equity component is valued as a residual. If economic incentives were to be included in the assessment, this would in our view require frequent reassessment since these incentives might change over time (e.g. because of changes in the liquidity of the entity, through changes in access to equity markets and so on). Frequent reassessment would only cause confusion and uncertainty and may have negative effects on the terms of the entity's financing.
- (b) We do not object the retention of IAS 32.20.

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 in principle with the board that the classification criteria should, a priori, deal with the contractual terms. However, we wonder if it would be worth discussing some of the issues raised in more detail. For example, if an entity acquires a certain stake in another entity and is subject to MTO-requirements, then with the first deal (i.e. the purchase of the shareholding which triggers the MTO), there is a logical consequence of the second deal which is already included in the economic rationale of the purchasing entity. The second deal could also be regarded as part of the first deal, even if it not



included in the contractual terms. It may be beneficial to clarify such surrounding requirements. The issue of MTOs again raises the question of the definition of a contract. In this respect, does a contract exist if one of the parties has not explicitly agreed to that contract? Tender offers are usually a one-sided contract where the issuing entity publishes an offer to all non-controlling shareholders. A contract (by legal terms) does not exist until a shareholder has accepted the offer.

In addition, the contract that is subject to the classification criteria is always embedded in the legal framework around it. This may make a difference when terms are imposed by law and as a consequence are not explicitly stated in the contract. As an example: a contract may be classified as an equity instrument because the terms of contract do not provide the holder with the right to put the instrument back to the issuer. If the legal framework overrides this contractual term and in effect, the holder has the right to put the instrument back, then the classification outcome may change.

We think it would be beneficial to have further discussions on this matter to identify the challenges in practice.

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