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Chairman
PDC 02

Paris, 11 January 2019

Mr. Jean-Paul Gauzès
Chairman
EFRAG
35 square de Meeûs
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Belgium

Re: Discussion Paper on Financial Instruments with Characteristics of Equity

Dear Mr. Gauzès, Cher Jean-Paul,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Discussion Paper on Financial Instruments with Characteristics of Equity.

ANC is pleased to share its views and provide the EFRAG with a copy of the comment letter sent to IASB.

Please do not hesitate to contact us should you want to discuss any aspect of our comment letter.

Yours sincerely, Bien amicalement.

Patrick de Cambourg

Patrick de CAMBOURG

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Chairman

PDC N°01

Paris, 11 January 2019

Mr. Hans Hoogervorst
Chairman
IFRS Foundation
7 Westferry Circus
Canary Wharf

London E14 4HD
United Kingdom

Re: Discussion Paper on Financial Instruments with Characteristics of Equity

Dear Mr. Hoogervorst, Dear Hans,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Discussion Paper on Financial Instruments with Characteristics of Equity. This letter sets out comments raised by interested stakeholders involved in ANC's due process. Our Board has reviewed and approved this letter on January 11th 2019.

ANC welcomes the holistic approach taken by the IASB, which actually addresses identified concerns, improves disclosures and carries forward the existing exceptions in IFRIC 2 and on puttable instruments. The "timing" criterion pertaining to both the IASB's preferred approach and IAS 32 is providing relevant information in assessing the liquidity of the entity.

Stakeholders are however concerned that the suggested approach implies an extensive work for preparers reassessing their currents instruments (with potential unexpected results) for achieving an outcome that is supposed to be similar to the current one under IAS 32, i.e. that provides a thin benefit for users. In that regard, issuing a new standard may not result in a positive cost/benefit ratio.

As a consequence, ANC suggests retaining and improving IAS 32 in order to avoid reconsidering all current accounting treatments and instruments. ANC thus encourages IASB to explore further some issues in order to fix certain issues which currently create problems. Among the improvements and issues that we consider may deserve further analysis we suggest:

- removing IAS 32 provision on variable number of shares corresponding to a fixed amount;
- streamlining current rules on alternative settlements;
- extending disclosures on equity instruments other than ordinary shares;
- not expanding the attribution of income and expenses to equity instruments in the statement of equity;
- clarifying the status of "exception" which prevents puttable instruments from a symmetrical treatment by holders of such instruments;
- considering IFRS 10 when addressing written put options on non-controlling interests;
- clarifying that contractual terms cannot be considered independently of the legal environment.

These points are further detailed below.

1 The issues to be addressed deserve standard setting [Q1]

The current standard has been raising numerous application issues that, absent a detailed guidance, could not be solved by the IFRS-IC.

Among others, issues identified in our jurisdiction relate to:

- The settlement of a fixed amount by delivering a variable number of equity instruments that is assimilated to a debt (IAS 32.16(b)) even when caps actually protect the entity from insolvency;
- The possible inconsistent outcomes when applying IAS 32 rules (§20 and §25) to alternative settlement options;
- The accounting treatment for written put options on non-controlling interests ("NCI puts");
- The possible classification's asymmetry by the holder and by the issuer of the same instrument;
- The possibility when focusing on contractual terms only to ignore legal obligations leading to cash outflows for the entity.

Furthermore, we concur with IASB that a binary distinction cannot provide all necessary information on financial instruments so that additional disclosure are also required.

We believe that these issues deserve further standard-setting.

In our view, any approach should be assessed based on its ability to:

- solve issues previously raised to IFRS-IC;
- not weaken current straightforward accounting treatments that hence do not require a costly reassessment;
- ensure that contracts with the same substance are accounted for in the same way;
- provide more information in the notes on equity instruments other than ordinary shares and if relevant reconsider IFRS 7 objectives and requirements for liability and compound instruments.

2 Merits of the IASB preferred approach [Q2]

ANC welcomes the holistic approach taken by the IASB, which also improves disclosure.

We also concur with IASB carrying forward the conclusions in IFRIC 2, therewith not requiring reconsidering them under the approach developed in the discussion paper. This interpretation is key for cooperative entities in Europe and especially in France. Only mentioning in the introduction of the discussion paper that this interpretation will be retained may prove not sufficient and we therefore suggest introducing the reasoning and conclusion of IFRIC 2 in the standard itself.

ANC agrees that classification alone in a binary model does not meet all the information needs of users, and that additional disclosures and presentation solutions are required. We therefore welcome additional disclosure by requiring more information on potential dilution effects and on some features that affect the classification.

ANC believes that the 'timing' criterion, covered by both the IASB's preferred approach and IAS 32, is indeed providing relevant information in assessing the liquidity of the entity.

ANC is concerned that adding the “amount” feature criterion cumulatively with the timing feature to define equity:

- may be complex to implement since it refers to concepts that are new and thus possibly subject to new interpretations;
- for instruments settled in cash, will only capture instruments that will be settled upon liquidation. We fail to see any benefit in classifying such claims as financial liability since upon liquidation all claims are settled in cash. Moreover financial statements are prepared on a ‘going concern’ basis.
- will result in classifying as liabilities instruments settled in a variable number of shares that the entity has the ability to issue to settle the claim while we believe such instrument should meet the definition of equity.

The board’s preferred approach has merits, but stakeholders are concerned that it implies an extensive work for preparers reassessing their currents instruments (with potential unexpected results) for achieving an outcome that is supposed to be similar to the current one under IAS 32, i.e. that provides a thin benefit for users. In that regard, creating a new standard may not result in a positive cost/benefit ratio.

As a consequence, ANC suggests retaining and improving IAS 32 in order to avoid reconsidering all current accounting treatments and instruments. ANC thus encourages IASB to explore further some issues in order to achieve a broader change in the standard. Among the improvements and issues that we consider may deserve further analysis we suggest:

1. removing IAS 32 provision on variable number of shares corresponding to a fixed amount [Q3, Q5];
2. streamlining current rules on alternative settlements [Q6, Q10];
3. extending disclosures on equity instruments other than ordinary shares [Q9];
4. not expanding the attribution of income and expenses to equity instruments in the statement of equity [Q8];
5. clarifying the status of “exception” which prevents puttable instruments from a symmetrical treatment by the holder [Q4];
6. considering IFRS 10 when addressing written put options on non-controlling interests [Q5, Q7];
7. clarifying that contractual terms cannot be considered independently of the legal environment [Q11].

3 Further improvements suggested

3.1 Removing the IAS 32 provision on variable number of shares corresponding to a fixed amount [Q3]

IAS 32.16(b)(i) sets that a non-derivative instrument that will or may be settled in the issuer’s own equity instruments is rather a financial liability if it includes a contractual obligation for the issuer to deliver a variable number of its own equity instruments. An IFRS-IC decision added that, even when the instrument includes an option actually capping that variable number, it does not change the classification of the instruments but an additional derivative has to be separately recognised.

IASB justifies that if the entity has performed badly so that the value of its assets falls below the amount of the claim it will not be able to deliver enough shares worth the amount of the claim and will therefore go into bankruptcy. We concur with the aforementioned analysis, but we would like to highlight that in most jurisdictions mandatory convertible bonds must contain a cap on the number of shares to deliver, such that the entity will always have the ability to issue enough shares to settle the claim. In those cases, under the IASB’s preferred approach, the instrument will be classified as a financial liability and the cap as equity, but with little value. Since the cap in this

instrument expose it to neither solvency nor liquidity risk, we believe such instrument should be classified as equity instead of liability. We welcome though the new disclosures on the potential dilution effect that such instrument generates.

Since the standard's provision relating to a "fixed amount corresponding to variable number of shares" does not practically exist in the contracts and leads to an inconsistent application of IAS 32, we suggest removing it.

3.2 Streamlining current rules on alternative settlements [Q6, Q10]

The current IAS 32 standard provides rules to assess the classification of instruments:

- with alternative settlement outcomes that are contingent i.e. controlled neither by the issuer nor the holder [IAS 32.25]. Applying IAS 32.25, for an instrument to be classified as equity, the issuer should have the ability to avoid paying cash in all genuine scenarios
- with alternative settlement outcomes that are controlled by the entity [IAS 32.20]. Applying IAS 32.20 (as interpreted by IFRS-IC), for an instrument to be classified as equity, the equity settlement outcome should be preferable to the cash alternative only in some scenarios that are genuine and not in all of them.

Under certain circumstances, these rules might lead to contradictory outcomes. Absent a clear conceptual guidance, an instrument will hardly be equity where contingent settlement options exist, or conversely will almost always be equity where the entity controls alternative settlements.

As a result, the mere existence of an option at the issuer's discretion, irrespective of the substance of the instrument, often drives the classification. For instance, hybrid perpetual bonds with a purchased call are classified as equity even when they do contain step-up provisions after the call date, dividend pushers and cumulative provision that result in those instruments being almost always repaid at the call date. Similarly bonds convertible in the entity's own shares at the issuer's discretion are classified as equity even when the conversion option has little value to holder.

ANC therefore suggests aligning more closely IAS 32.20 with the accounting provisions in IAS 32.25. This also could be further investigated through a broader analysis of the "substance" and "indirect obligation".

3.3 Extending disclosures on equity instruments other than ordinary shares [Q9]

Would another route than streamlining current rules on alternative settlements as suggested above be followed, we propose adding specific disclosures regarding alternative settlements in cases where an instrument is eventually classified as equity (e.g. providing information on the entity's ability and incentives to choose an equity outcome).

By and large, ANC welcomes the suggested introduction on further disclosure on equity instruments other than ordinary shares. In order to enhance this information and prevent from a disclosure overload (on contractual terms, subordination…), we also suggest to "group instruments into classes that are appropriate to the nature of the information disclosed" (as suggested in IFRS 7.6) instead of a one by one basis.

With regard to improving disclosures on debt instruments, we rather suggest amending IFRS 7 in the frame of the current disclosure initiative project.

Moreover, it may be challenging to provide relevant information on the order of priority of claims on a consolidated basis.

3.4 Not expanding the attribution of income and expenses to equity instruments[Q8]

ANC is not in favour of expanding the attribution of income and expenses to equity instruments since it would add complexity and operational challenges with little benefits on information provided. Applying fair value to comprehensive income is not consistent with the historical approach retained in equity.

3.5 The status of "exception" prevents puttable instruments from a symmetrical treatment by the holder [Q4]

ANC welcomes the IASB decision to retain the puttable exception even if we would have preferred a conceptual approach that could provide principles instead of exceptions.

We do not share the view expressed in the DP that finite life entities' shares do not pass the timing and amount test cumulatively to meet the definition of equity.

IAS 32.BC 67 mentions that the "puttable exception" is an exception to the definition in the standard. We believe definitions result from principles but also from their exceptions which are both sides of the same coin. Would IASB not incorporate exceptions to principles into the definition of liabilities and equities, we encourage IASB to assess whether the classification criteria from the issuer's perspective should be the same as from the holder's perspective. A further clarification of the concepts ("classification", "presentation", "definition") would help removing the current classification's asymmetry by the holder and by the issuer of the same instrument.

Would such an asymmetry be maintained, it would require a conceptual justification of the different objectives then assigned from the entity's perspective compared to the holder's perspective. The 'amount' criterion may, for example, be the most relevant from an investor's perspective since investors do pay attention to the potential variability of the expected return of their investment. According to that view, puttable instruments that meet the amount criteria could be eligible to be measured at fair value through OCI from an asset's perspective.

Investors often hold puttable instruments (such as collective investment undertaking) in their portfolios. IFRS-IC has confirmed an accounting treatment according to which puttable instruments not only will not benefit from the § 4.1.4 equity treatment, but also would not pass the SPPI test and therefore would have to be measured at fair value through P&L. This could increase the volatility in the P&L deterring long term investors from using such tools.

Solving this conceptual issue would facilitate the current debate on long-term investment in Europe.

3.6 Consider IFRS 10 when addressing written put options on NCI [Q5, Q7]

Consistent with a classification providing relevant information on liquidity and solvency, ANC acknowledges that written put are recognised as a gross financial liability, based on the possible obligation to deliver economic resources.

ANC suggests considering IFRS 10 in the analysis of written put options on NCI. With such an analysis a transaction with NCI is a transaction among shareholders which justifies recording changes in the written put options on NCI directly in equity instead of P&L. Basically, transactions with (non-controlling) owners are not representative of the entity's performance and thus should not be reflected in the P&L. They may impact the allocation of returns on that performance among shareholders and therefore may lead to changes in the allocation of equity.

Would the IFRS 10 route not be followed, we would prefer the compromise on an OCI treatment (as currently suggested in the DP) compared with recognition of the changes in the value of the put in the P&L.

ANC is of the view that OCI is a compromise between two measurement approaches and cannot, by itself be a genuine conceptual solution. OCI is generally required when the adequate measurement in the balance sheet differs from the adequate measurement in the P&L (so called "dual measurement") and has eventually to be reversed ("recycled" in the P&L). We therefore usually do not favour conceptual solutions leading to a non-recycling OCI.

However, considering that there are similarities in changes in a liability for an NCI written put with changes in a liability due to "own credit risk" under IFRS 9, ANC concurs with IASB and acknowledges that a non-recycling OCI may also apply to NCI written put options at fair value.

ANC would like to highlight that a redemption obligation with an exercise price that will not pass the 'amount' test, will not be eligible to changes being recognised in OCI. This is a widespread issue for NCI which exercise price often consists of an EBITDA multiple when the related subsidiary is not listed and when the multiple of EBITDA cannot be considered as a proxy of the fair value of the instrument. For that specific case, we suggest the following alternative approach which, in our view, could result in more relevant information for the users:

- Recognise a gross liability for the fair value of the redemption obligation , with changes in the carrying amount recognised in OCI; and
- Recognise through P&L a derivative instrument corresponding to the difference between the fair value and the calculated exercise price of that redemption obligation, if any.

3.7 Contractual terms cannot ignore their legal environment [Q11]

IFRS standards originating from a "common law" system aim at being applied in numerous jurisdictions and consequently under different legal systems. They naturally resort to principles, generally referring to the "contract's terms".

Contractual terms cannot be considered independently of the legal environment of the contract written by an issuer. An issuer shall consider the "substantive rights and obligations" include in an instrument, whether they arise from a contract, law or regulation. This is in fact very consistent with the principles of IFRIC 2.

As an example, in most jurisdictions, market securities listing rules require an entity that takes control of another entity to make a tender offer to the residual minority shareholders to buy back their shares in cash. In our view, such an obligation should lead to the recognition of a gross financial liability as soon as the business combination takes place and not only at the date the tender offer is made.

Yours sincerely, Kind Regards,

Patrick de Cambourg

Patrick de CAMBOURG