The Association of
Accountants and
Financial Professionals
in Business

28 December 2018

Mr. Hans Hoogervorst, Chair
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Re: Discussion Paper 2018/1 – Financial Instruments with Characteristics of Equity

Dear Mr. Hoogervorst:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the International Accounting Standards Board's (IASB or Board) Discussion Paper, *Financial Instruments with Characteristics of Equity* (DP).

The IMA is a global association representing over 100,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

Generally, the Committee supports the Board in addressing the complexities involved in classifying issued financial instruments as liabilities or equity. This is a topic that preparers, auditors, and users often find confusing and difficult to apply the standards for complex instruments.

In the DP, the IASB is not proposing a comprehensive overhaul of the model for distinguishing liabilities from equity but it is substantially more than surgical amendments to address the problematic areas. We are concerned that incorporating major changes to the classification scheme to create a more "perfect" model may create other issues. The Committee believes that if users find that the current classification guidance primarily meets their needs (aside from addressing their need for additional disclosures) a better approach may be to provide specific, narrow amendments to address certain problems. If users note that the issues with the current classification guidance are more extensive, a broader approach may be warranted.

With respect to the model proposed in the DP, the Committee generally agrees that the model should contain a settlement criterion (i.e., to be considered equity, the entity cannot be required to settle the instrument by transferring assets prior to liquidation) and an indexation criterion for non-perpetual instruments.

However, the Committee does not agree with the Board's view that perpetual financial instruments (that is, instruments the entity can unilaterally avoid settling by transferring assets or other equity instruments prior to liquidation) could be classified as liabilities if the settlement outcome is independent of the entity's economic

resources. We believe that users are not better served by presenting instruments that will not be redeemed until liquidation as a liability. In addition, we are concerned that the indexation criterion, assessing whether the settlement amount is independent of the entity's economic resources, will not be readily understood and will result in numerous practice questions. The Board defines the term "available economic resources" in such a way that it is unclear if the term means the same thing as the fair value of the entity's common shares. If the term is intended to mean the same thing as the fair value of the entity's common shares, we believe the Board should simply refer to the fair value of the entity's common shares instead of introducing a new term that could be read to mean something different. We agree that an indexation assessment is warranted but encourage the Board to consider ways to make this assessment practical while still adhering to a principle.

The Committee's views on other aspects of the Board's preliminary views are contained in our responses to questions posed within the DP in the Appendix to this letter.

Sincerely,

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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?

The Committee generally agrees with the Board's description of the challenges and their causes. Entities commonly issue financial instruments to finance their businesses. Because of the differences in measurement and presentation in accounting for liabilities versus equity, distinguishing whether the entity's issued financial instruments are liabilities or equity becomes very important. Further, due to the multiple characteristics that may be incorporated into these issued financial instruments, the analysis using the guidance in IAS 32, *Financial Instruments: Presentation* can be complex and the rationale for a certain classification is not always clear. Thus, we are supportive of a project to improve distinguishing liabilities and equity.

As noted below, we particularly welcome the focus within the DP on disclosures. IFRS standards currently lack significant disclosures for certain equity instruments. Enhanced disclosure will be of great benefit to users.

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?

The Committee agrees that instruments that contain an unavoidable obligation to transfer economic resources in the form of assets prior to liquidation (i.e., criterion (a) above) should be classified as liabilities. We have other observations about criterion (b) as noted below. However, the Committee believes that there should be a step in the analysis that comes before these two criteria. The entity should first assess whether it has an obligation to settle the financial instrument prior to liquidation by transferring economic resources or other equity instruments. If the entity has no obligation to settle the financial instrument by transferring economic resources or other equity instruments the financial instrument should be classified as equity and the two criteria noted above are not applicable. For example, preferred stock (with discretionary dividends) that will only be settled at liquidation, regardless of whether the payout in liquidation is fixed or variable, should be classified as equity in our view. We believe that classifying perpetual preferred stock as a liability does not provide useful information to users. Based on the presumption inherent in the preparation of the financial statements that the entity will continue as a going concern (unless there is evidence to the contrary), presenting an obligation for amounts due only upon liquidation does not faithfully represent the entity's economic position.

As noted above, for non-perpetual issued financial instruments, the Committee agrees with criterion (a). The Committee has reservations about the second criterion. We agree that in analyzing the classification of a non-perpetual issued financial instrument, how the settlement amount is determined, that is the formula calculating the number of other equity instruments to be provided (i.e., the index), should be a determining factor in the classification. However, the requirement to assess whether the amount is independent of the entity's available economic resources will not be readily understood and will raise many practical questions. This criterion would be replacing the "fixed-for-fixed" concept that currently exists in IAS 32. The "fixed-for-fixed" concept, while sometimes providing results that are questioned, is readily understood. The proposed "independent of the entity's available economic resources" principle appears vague and it is not clear how this principle will be used to classify instruments with the complex terms we see today (many of which have become standard in ISDA contracts).

Many derivative instruments that will be settled by delivery of an entity's equity instruments require delivery of a fixed number of equity instruments (assume the equity instruments provide a pro rata share of the residual net assets upon liquidation) except for certain adjustments to that number upon the occurrence of remote events (e.g., remote tax or economic events). How would these adjustments for remote events affect the analysis? What is the threshold for determining when an amount is independent of an entity's economic resources? Without understanding how the proposed model addresses practical issues such as these we cannot support the proposal.

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 noted in our response to Question 2 we believe that perpetual non-derivative financial instruments, with no settlement provisions prior to liquidation, should not be subject to the two criteria noted above.

We also note that in the case of two financial instruments the Board's classification approach results in different outcomes that do not seem consistent with the model. In paragraph 3.23(c) and (d), the Board concludes that a perpetual share with a cumulative dividend (flat or increasing) should be presented in its entirety as a liability. However, in paragraph 3.24(b), the Board concludes that a perpetual share with a noncumulative dividend and a liquidation preference would be a compound instrument and a portion (the present value of the redemption on liquidation) would be presented as a liability. While the financial instruments differ in that one requires the payment of cumulative dividends (at least as of the time of liquidation) and the other does not, it seems that the same approach would be applied to the two instruments. If the dividend rate on the cumulative preferred instrument is below the discount rate that would be applied to that instrument, the issuance proceeds would exceed the present value of the fixed redemption amount, similar to the case of the noncumulative preferred share. In that case (which admittedly may be rare), the classification outcome should be the same.

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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?

Yes, we agree. The conditions that led to the exception being introduced in 2008 are still applicable. These conditions will continue to apply in the case where part (a) of the proposed definition of a liability in the DP (and included in IAS 32) continues to apply.

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?

The Committee agrees with the Board's preliminary view that derivatives on own equity, other than derivative that include an obligation to extinguish an entity's own equity instruments, should be treated as one instrument in its entirety and not componentized into individual legs of the future exchange. In general, the Committee also believes that derivatives on own equity that must or can be net cash settled prior to liquidation at the direction of the counterparty should not be classified as equity.

The Committee also mostly agrees that the individual legs of the instrument should be appropriately set in terms of shares and currency in order to be classified as equity. Further, we generally agree with the discussion in Section 4. However, a majority of the Committee believes that the view expressed in paragraphs 4.47 and 4.49 to 4.51 that the currency leg must be in the entity's functional currency is overly narrow. These members believe that equity classification for a derivative instrument should not be precluded if the cash payment leg is denominated in a currency that is the functional currency of a subsidiary in a situation in which the instrument, written or purchased by parent, required delivery of subsidiary shares or the currency used by an exchange on which a significant portion of the entity's shares trade.

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?

The Committee is split in its views on this proposal. For derivative instruments requiring physical settlement by purchasing the entity's equity instruments, some of the Committee members support the Board's views for the reasons stated. Other Committee members do not support the Board's view. These members question the basis for what appears to be an inconsistent treatment with other equity and non-equity derivatives. That is, other derivatives are treated as a single unit of account and the different legs of the instrument are not recognized separately. Further, some Committee members object to the extinguishment of equity as proposed in the DP. These members believe this is not representationally faithful to the economics and contradicts other areas in IFRS Standards as the equity instruments subject to the future purchase (or potential future purchase) continue to be legally outstanding, often with full rights to the holder, until purchased. Further, the discussion in the DP appears to provide a view that combines the instrument that permits the holder to put a share to the entity with a share. But this is not predicated on any contractual tie between a specific share and the instrument. In the case where shares are readily available, the holder of the instrument with the put right may not be required to hold and actually may not hold any shares prior to the instrument's maturity raising questions about the basis for the DP's view to combine the share and instrument.

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?

The Committee is of split views with respect to the proposal to recognize the subsequent measurement of certain equity derivatives in other comprehensive income (OCI). Some support the proposal for the reasons stated and believe that changes in measurement due to an entity's own equity should be recorded outside of profit or loss. Other Committee members believe the use of OCI should be rare and that the described circumstance does not justify remeasurement within OCI. They believe that the entity will become better or worse off by entering into the contract and that such changes are no different than other changes in contracts that are recognized in profit or loss.

Question 8

The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?
The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?
The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

(a) a full fair value approach (paragraphs 6.74–6.78);

(b) the average-of-period approach (paragraphs 6.79–6.82);

(c) the end-of-period approach (paragraphs 6.83–6.86); and

(d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25.

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

Committee members in general agree with the Board's preliminary view to attribute an entity's performance to equity instruments other than ordinary shares. We believe that such equity instruments should not be precluded from remeasurement (with changes recognized in the statement of changes in equity) and that such information could be very beneficial to users where an entity has multiple types of instruments within equity. The existing attribution requirements in IAS 33 appear to be a logical starting place for this proposal.

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?

The Committee agrees with the Board's preliminary view regarding disclosures.

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?

The Committee observes that within the new definition of a liability in the 2018 Conceptual Framework, the Board states that an obligation is a duty or responsibility that the entity "has no practical ability to avoid." While this was intended for other situations it appears to open the discussion for considering economic compulsion in assessing whether a financial instrument contains an obligation. The Committee favors some consideration of economic compulsion in the classification of financial instruments where it would otherwise seem the entity could avoid redemption or provide dividends (especially if the Board accepts the Committee's view that perpetual instruments should not be subject to indexation criteria for classification). The Committee

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acknowledges that if the Board were to incorporate consideration of economic compulsion, a number of issues would need to be resolved to make such a provision operational.

We were a little confused by the Board's guidance that an issuer not consider economic incentives that might influence its decision to exercise its rights in determining whether a financial instrument should be classified as a liability or equity with the recommendation to retain the requirements in paragraph 20 of IAS 32, which requires an assessment of the substance of the right to settle in equity instruments. Such guidance could lead to the issuer concluding that, when the fair value of the equity instruments that would be delivered substantially exceeds the amount of cash required to settle the financial instrument, it should ignore the equity settlement feature.

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?

A current practice issue is assessing classification of instruments where statutory requirements require a transfer of economic resources. The contract governing the instrument may be silent, may repeat the statutory requirement, or may be beyond the statutory requirement. These are challenging issues in practice with practical implications that should be addressed in any final standard.