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Mr Hans Hoogervorst
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Discussion Paper DP/2018/1 Financial Instruments with the Characteristics of Equity

Dear Mr Hoogervorst

On behalf of RSM International Limited, a worldwide network of independent audit, tax and consulting firms, we are pleased to comment on the International Accounting Standard Board's discussion paper DP/2018/01 *Financial Instruments with the Characteristics of Equity* ('the DP').

We are supportive of the Board's efforts to address the various application challenges in IAS 32 *Financial Instruments: Presentation;* however, we do not agree with the preferred approach to equity/financial liability classification as set out in the DP and do not recommend that the Board develops an exposure draft on the basis of the DP.

We support a two-stage approach to developing a full solution;

i. In the short term, address the issues identified in the DP by improving the existing guidance within IAS 32 or making specific limited amendments to its requirements where necessary.
ii. In the longer-term, revisit the principles underlying equity/financial liability classification, which should be aligned with the definition of a liability in the revised conceptual framework before undertaking a more comprehensive review of IAS 32.

Our comments and detailed responses to the questions set out in each section of the DP are detailed hereafter.

We would be pleased to respond to any comments the Board or its staff may have about our response. If you have any questions or comments please do not hesitate to contact me (+44 (0)207 601 1842) or Gary Stevenson (+852 2583 1220).

Yours faithfully,

Marion Hannon
Global Leader, Quality &Risk
RSM International

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Appendix
Section 1 – Objective, Scope and Challenges

Question 1

Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.
(a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?
(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

We consider that the challenges arise from a lack of a clear principle in IAS 32 for financial liability/equity classification, as highlighted in 1.1(a) of the DP, that can be applied to an ever-evolving range of financial instruments in issue. In particular, application of the 'fixed for fixed' rule can be challenging due to the limited guidance in IAS 32 and consequently interpretation has evolved through GAAP.

We agree that the challenges are important to users to the extent that they result in divergent classification outcomes for similar instruments in practice or where instruments are classified as equity in accordance with IAS 32, which have many of the characteristics of liabilities and do not appear equity-like to users. This distorts information on the extent to which an entity's debts restrict the economic resources available to it to operate and develop its business and pay discretionary dividends to its owners.

The proposals in the DP result in classification outcomes that are similar in a majority of cases to those in IAS 32. We consider that the benefits of the new approach in the DP may not outweigh the additional implementation costs therefore as entities would need to reassess all their existing classification outcomes based on the conditions in the DP and new challenges are likely to arise as entities understand, interpret and apply the new requirements. There is also a concern from those affected about the potential impact on capital adequacy requirements. We do not agree with some of the revised classification outcomes in the DP, for example, classification of irredeemable cumulative preference shares as financial liabilities due to an obligation for a fixed amount that arises only on liquidation, which we consider is inconsistent with the going concern basis of preparing financial statements.

Section 2 – The Board's Preferred Approach

Question 2

The Board's preferred approach to classification would classify a claim as a liability if it contains:
(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or
(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure. Do you agree? Why, or why not?

We do not agree for with the preferred approach to classification of financial liabilities as set out in the DP. The conditions (a) and (b) above do not align with the definition of a liability in the revised conceptual framework. We also consider that the amount feature should be limited to events other than liquidation as this would be consistent with the going concern basis of preparation of the financial statements.

Should the Board move forward with its preferred approach, we consider that further clarity will be required on the meaning of 'the entity's available economic resources' and 'amounts independent of the entity's available economic resources' if the approach is to be applied successfully in practice. For example, the DP states that the entity's EBIT is an independent variable whereas its share price is a dependent variable. The rationale for these conclusions is unclear.

We agree that presentation and disclosure can be a more useful way to communicate information about the other features of claims. See our comments below on the specific proposals in sections 6 and 7 of the DP.

Section 3 – Classification of Non-derivative Financial Instruments

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?

We do not agree for with the preferred approach set out in the DP for the reasons set out under question 2 above.

Question 4

The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

We agree that the puttable exception should be retained due to the continued existence of the matters at 3.31, which gave rise to it. However, some of the puttable conditions will need to be revised to align these with the revised financial liability conditions if the Board moves forward with the preferred approach in the DP.

Section 4 – Classification of Derivative Financial Instruments

Question 5

The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows:

(a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

(b) a derivative on own equity is classified as a financial asset or a financial liability if:

- **(i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or**
- **(ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.**

Do you agree? Why, or why not?

We agree that derivatives over own equity should be classified in their entirety as the two legs are not independent of each other.

We consider that the Board should provide additional guidance in IAS 32 to support the application of the 'fixed for fixed' rule rather than introducing a new classification approach for derivatives over own equity. This guidance should cover circumstances when variability in the amount of cash or in the number of equity instruments would not breach the rule. The approach in the DP is likely to give rise to a significant number of new application issues in relation to the amount feature, which is not clearly explained and is likely to be challenging to apply in practice.

In addition, the DP would classify foreign currency rights issues as financial liabilities as foreign currency would be considered an independent variable. Under IAS 32, foreign currency rights issues are classified as equity instruments if certain conditions are met applying the exception in that standard. We consider that the exception should be retained as the reasons and conceptual basis for introducing it in 2009 remain valid. The holder of the right receives it as an owner of equity instruments. Transactions with owners in their capacity as owners are recognised in the statement of changes in equity and not the statement of comprehensive income.

Section 5 – Compound Instruments and Redemption Obligation Arrangements

Question 6

Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

(a) Do you think the Board should seek to address the issue? Why, or why not?
(b) If so what approach do you think would be most effective in providing the information, and why?

We agree that arrangements which give rise to similar rights and obligations should be accounted for in the same manner regardless of how they are structured and consider therefore that the preferred approach at 5.48(a)-(b) is appropriate.

We agree that the Board should address the accounting for financial instruments with an alternative settlement outcome that are controlled by the entity (the issuer) such as reverse convertible bonds to ensure consistent accounting for these instruments. We consider that such instruments should be accounted for as equity instruments if the entity (the issuer) has an unconditional right to avoid the liability settlement outcome. For these instruments, we would favour disclosure about the entity's right to choose alternative settlement outcomes due to the complexity of separating embedded derivatives.

Section 6 – Presentation

Question 7

Do you agree with the Board's preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

We agree that there are benefits to providing information about financial liabilities that are not affected by independent variables. However, we consider that disclosure rather than presentation could meet the information needs of users and would be less complex for entities. In addition, we are not convinced that the

further analysis in 6.53(a)(i)-(iii) and in particular part (iii) is beneficial as users may find it difficult to understand these distinctions between different instruments.

We disagree that income and expenses arising from these instruments should be presented in OCI for the reasons set out at 6.44 and instead recommend separate presentation in profit or loss or in the notes.

We consider that the alternative at 6.38(a) is preferable, i.e. only present or disclose these embedded derivatives separately if they are separated from the host contract, as this would be in line with the general accounting requirements, which are the same for stand-alone derivatives and separated embedded derivatives.

Question 8

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

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

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

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

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

We consider that the attribution of total comprehensive income to different classes of equity instruments is too complex and the costs would outweigh the benefits due to the inherent limitations of each of the three proposed approaches. Instead, we recommend enhancing disclosures for each class of equity instruments.

We note that many entities are outside the scope of IAS 33 and will thus incur higher implementation costs. That standard excludes anti-dilutive equity instruments from EPS calculations whereas the DP proposes attributing returns to all equity instruments, hence the costs will be increased for many entities currently within the scope of IAS 33. Further, obtaining reliable fair value measurements for all derivative equity instruments for the purposes of attribution appears to be too burdensome on entities.

Section 7 – Disclosure

Question 9

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

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).
(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).
(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

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

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

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

We generally support improved disclosures about equity instruments and agree there should be a 'level playing field' compared to disclosures about financial liabilities.

Priority of financial liabilities and equity instruments on liquidation
We consider that providing information about the priority of financial liabilities and equity instruments on liquidation is inconsistent with the preparation of financial statements on a going concern basis. We therefore disagree that such information should be presented on the face of the statement of financial position. If users want this information, we consider that it should be provided in the notes.

Potential dilution of ordinary shares
We agree that the information at 7.22(a) and (b) would be useful and recommend that any significant assumptions applied in determining the number of shares to be delivered at settlement, based on the current conditions at the end of the reporting period, be disclosed.

We consider that the reconciliation at 7.22(c) is too complex and recommend instead that the maximum number of additional potential ordinary shares be disclosed for the current and comparative periods for each instrument with a narrative explanation of any significant changes.

Terms and conditions
We agree that additional information about the terms and conditions of equity instruments would be useful for the reason noted above.

Section 8 – Contractual Terms

Question 10

Do you agree with the Board's preliminary view that:

(a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?
(b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

We generally agree that economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or equity instrument. Economic incentives will change over time. The assessment of economic incentives will often be highly judgmental and complex for the reasons set out in 8.21. In addition, different issuers may have different considerations. All of these factors would make classification more challenging in practice and would also reduce comparability. However, we also see merit in considering the approach in IFRS 2 for share-based payment transactions where the entity has a settlement choice. A financial liability would be recognised if the choice of settlement in equity instruments has no commercial substance or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement (i.e. there is a constructive obligation to settle in cash).

We consider that a different approach should be applied to the options of the holder of a convertible bond and those of the issuer referred to in 8.15 and 8.16. Options of the holder are beyond the control of the issuing entity and therefore classification by the issuer should be based only on the contractual terms. Whereas for options of the issuing entity, which are within its control, classification by the issuer should also consider the commercial substance and constructive obligations as discussed above.

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We agree that the requirements in paragraph 30 of IAS 32 for indirect obligations should be retained. However, we believe that these requirements could be improved by incorporating the guidance in IFRS 2 referred to above.

Question 11

The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

We agree that classification should be based on an assessment of the contractual terms of the instrument as this is aligned to the current approach in IFRS 9.

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