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Comments on Discussion Paper "Financial Instruments with Characteristics of Equity" (FICE)

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30 Cannon Street
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Dear Sir/Madam:

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

I am pleased to submit my feedback on the questions raised in the above Discussion Paper ("DP") issued by the International Accounting Standards Board ("Board"). These comments are made solely in my personal capacity and do not represent the views of my employer, Singapore Management University or any other organization or entity that I am associated with. I have answered Questions 1 to 6 to focus on the more fundamental issues of the DP.

Question 1: Objective, Scope and Challenges

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?

The structure of the DP is appropriate in that it presents the conceptual challenges first before delving into the application challenges. However, the DP has not sufficiently explained the conceptual challenges in a robust manner. The DP does not place sufficient weight on the principles of the Conceptual Framework of Financial Reporting of March 2018 (hereinafter referred to as CF) to analyse the conceptual issues. The DP states in paragraph 1.28 that "Currently, IAS 32, other IFRS Standards and the Conceptual Framework use various features to distinguish liabilities from equity, often without a clear basis for selecting the distinguishing features".

Paragraph 1.28 criticizes the CF and other standards for not having a clear basis for selecting the distinguishing features that separate a liability from equity. Even if the CF is an imperfect document, its role is to guide standard-setting activity and it is important to have comparable principles drive all standards. Perhaps, the development of the DP was concurrent with the development of the CF, making it difficult for a timely consultation of the CF.

In the Basis of Conclusion of the CF, it states that "The 2018 *Conceptual Framework* does not address classification of financial instruments with characteristics of both liabilities and equity because the Board did not want to delay other much-needed improvements to the *Conceptual Framework*. The Board is exploring how to distinguish liabilities from equity in its research project on Financial Instruments with Characteristics of Equity. If necessary, the *Conceptual Framework* will be updated as one possible outcome of that project….."[1]

The circularity is unsettling. Without a frame of reference to guide the DP in examining the conceptual roots of the issues at hand, the arguments in the DP may serve only to rationalize and not challenge existing practices. For the CF to be possibly updated by a standard, it raises concerns as to the independence and authority of the CF to guide standards.

I strongly recommend that the Board review the DP in the light of conceptual understanding of elements of financial statements. As a start, the approach in the DP should be at least compared with the definition of assets, liabilities and equity in the CF. As an on-going project, the FICE project will do well to compare and explain differences with the existing guidance in the CF to establish accountability.

(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 challenges of the issues are important to users of financial statements because they affect the important classifications that determine measures of an entity's solvency. With increasing complexity in financial instruments, the challenges are pervasive enough to require standard-setting activity.

However, I would encourage the Board to do a holistic and robust review of IAS 32 with a view to making fundamental changes to fix the conceptual challenges from which many application challenges arise. The Board's decision "to articulate the principles for the classification of financial liabilities and equity instruments with a clear rationale, without fundamentally changing the existing classification outcomes of IAS 32"[2] is of concern to me. It does seem unusual that there is a preliminary stance in the DP that there will be no change to the outcomes. If there is no intention to change or challenge outcomes, the purpose and effectiveness of the whole exercise is questionable. It should be the principles that drive the outcomes and not the other way around. However, I appreciate the Board for making its intentions clear in this project but would nonetheless encourage the Board to review its project objective before pressing on with the standard-setting activity on this project.

Some of the challenges are recognized in the DP but the analysis can be sharpened further. One example is the case of the put option written on non-controlling interests (NCI put) with a strike price at fair value. There is a tension between the balance sheet and the income statement effects. Paragraph 1.32 compares the NCI put with a simple bond but recognizes that the put is different in that the amount of cash the entity is obliged to transfer is at fair value. If taken as a liability, the changes in fair value would have to be reported in the income statement. The DP compares the put option with a simple bond and the economic returns with those of ordinary shares. Without a frame of reference on what equity and liability is, it is a pre-supposition that the put option is similar to a bond in its future cash flows and similar to equity in its returns. In this context, the tension is inevitable. If the pre-supposition changes

[1] Paragraph BC0.15, CF March 2018
[2] Paragraph 1.37, DP June 2018

to another view, the conclusion would be different. Hence the pre-supposition in DP should be justified and not taken as a given. Each instrument should be analysed as a whole in the spirit of IFRS 9 *Financial Instruments*. Analyzing returns and instrument separately creates unnecessary complexity. It is also difficult to understand changes in fair value of the put option as “contributions from holders of equity claims” or “distributions to holders of equity claims”[3]

The put problem appears to be more of an application issue than a conceptual challenge. Existing standards and the CF are sufficient to deal with some of the application issues. The NCI put options are financial liabilities in line with IAS 32 and the CF. It follows then that the changes in financial liabilities are to be recognized in the income statement in the same manner as other written put options. If relevance of information is most critical, we have to focus on getting the information across that depicts best the economic substance of the transaction in a comparable manner with other transactions that share the same characteristics of the elements of financial statements.

Question 2: The Board’s Preferred Approach

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 DP’s preferred approach deals with classification of liabilities rather than their definition *per se*. It is unclear if there is to be a change in the definition of a financial liability and whether new content will replace IAS 32’s definition statements. However, from the DP’s critique of the “fixed-for-fixed’ criterion of IAS 32 *Financial Instruments: Presentation*, one would assume that “classification” replaces the “definitions” of IAS 32. In any case, the classification criteria presents a different paradigm from that of IAS 32. Part of the confusion in reading the DP is figuring out whether the “classification” criteria replaces or extends the “definitions” in IAS 32.

As indicated in Question 1, the starting point for the analysis of classification should be an authoritative definition of the elements of financial statements. Without a clear understanding of what an item is, it is an unproductive exercise to try to classify that item.

[3] Paragraphs 4.68 and 4.69, CF March 2018.

We should begin with the definitions of liability and equity in the Conceptual Framework of March 2018. The definitions from the CF are presented below:

"A liability is a present obligation of the entity to transfer an economic resource as a result of past events."[4]

For a liability to exist, three criteria must all be satisfied[5]:
(a) the entity has an obligation;
(b) the obligation is to transfer an economic resource; and
(c) the obligation is a present obligation that exists as a result of past events.

"An economic resource is a right that has the potential to produce economic benefits"[6].

Rights[7] correspond to an obligation of another party or are other rights (e.g. rights to use an asset.) The CF also states that an entity cannot have a right to obtain benefits from itself[8]. Thus, a liability in the CF cannot refer to an obligation to transfer its own equity. Hence, any obligation to transfer equity, whether of a fixed amount or a variable amount, cannot be a liability under the CF of March 2018. Thus, the CF's definition of a liability does not support IAS 32 definition of a financial liability as "a contract that may be settled in the entity's own equity instruments"[9].

With regards to the Board's preferred approach to classifying a claim as a liability, the following problems arise:

(i) The objective of Section 2 of the DP is unclear. Is the objective to arrive at broad principles that govern the "classification" of all liabilities? Is there a need for classification criteria at a general level when the CF has set out definition statements that relates to the same matter?

(ii) The classification framework in the DP is too broad and over-arching and includes other liabilities that are not traditionally viewed as financial instruments (e.g. income taxes and retirement benefits). However, the analysis in Section 2 is mainly focused on financial instruments in spite of its over-arching classification criteria.

(iii) Identifying "relevance" and "consequence" in paragraph 2.2 are empirical questions. Granted, the Board's views in Section 2 may be close to the general consensus of what "relevant" information is. The Board may wish to consider the following issues in the analysis:

- Timing of future cash flows is clearly important to the users of financial information (paragraph 2.6). However, the distinction in timing is not so

[4] Paragraph 4.26, CF March 2018
[5] Paragraph 4.27, ibid
[6] Paragraph 4.4, ibid
[7] Paragraph 4.6, ibid
[8] Paragraph 4.10, ibid
[9] Paragraph 11, IAS 32 *Financial Instruments: Presentation*

much between "specified" and "in liquidation" – this distinction is too wide to be helpful to users – but between current and non-current and the specific timing within the non-current period.

- Type of economic resources that an entity is required to transfer is highlighted as being relevant information to users (paragraph 2.8(a)). An investor or lender is most concerned about the obligations to transfer cash as that would deplete the economic resources and affect solvency. However, let's consider the scenario of the share-settled bond which entails a non-cash transfer (paragraph 2.11(b)). The solvency risk in this scenario is considerably reduced because there is no obligation to pay cash at some future date. Instead, the dilution risks for equity increase. The information on the dilutive effects of these obligations are not reflected in the balance sheet. Instead, present classification would show these obligations as liabilities, notwithstanding the fact that they do not give rise to future cash outflows. Sufficiency of economic resources is not impacted through the issue of equity shares of a variable or fixed amount. This point cannot be over-emphasized enough. The obligation to issue shares at some future date, whether variable or fixed, is of greater concern to equity holders of an entity than it is for debt holders. However, present classification requirements in IAS 32 and the proposed DP classification criteria would classify the obligation to issue variable number of shares as liability and not equity. Based on the tenets of "relevance" and "consequence", the distinction between "fixed" and "variable" is not important.

(iv) The framing incorporates a measurement variable ("amount independent of the entity's available economic resources"). Typically, measurement issues follow from but do not lead to the definition of an item. In essence, the nature of an item is not determined by its amount. It is unusual to frame a definition of an item in terms of its measurement.

(v) The framing in the DP is less holistic than in IAS 32. Like IAS 32, the DP includes in its classification an *obligation to transfer* economic resources. Unlike IAS 32, the DP excludes the *obligation to receive* economic resources in its classification of a claim as a liability.

The definition of a financial liability in IAS 32 states that "a financial liability is any liability that is (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potential unfavourable to the entity; or…."

The word "exchange" allows for two-directional movements versus the one-directional meaning of "transfer". IAS 32's definition would mean that financial liabilities include written put options and forward contracts. However, it is not clear if this exclusion is intentional in the DP.

(vi) The two features of "timing" and "amount" in the Board's preferred approach complicates the understanding of what a liability and equity is with reference to the pure and simple definition of these items. Arguably, the definitions in the CF are more intuitive. As indicated above, classification will not be meaningful without a clear understanding of the definition of liability and equity.

(vii) The two-by-two matrix is not intuitive and is likely to complicate application in practice. Stakeholders, in particular, lenders and creditors are concerned primarily with how present obligations affect future cash flows. Most stakeholders understand equity as being residual risk, absent of the present obligations for future cash flows that are inherent in liabilities. However, the two-by-two matrix does not present the connections between "timing" and "amount" with conceptual understanding of liabilities and equity.

(viii) "Equity is the residual interest in the assets of the entity after deducting all its liabilities."[10] Hence, it is equity and not liability that is the residual. The definition of equity in the CF and IAS 32 does not support a "narrow view of equity". Instead, liabilities have to be identified with clarity and the residual category is equity. Paragraph 2.45 states that a "particular strength of the Board's preferred approach is that it can provide the same information as a narrow equity approach while also providing other relevant information about an entity's financial position and financial performance; and it can provide this information more directly via classification and presentation".

The DP should not be led by a presumption that a "narrow equity approach" is superior to the "residual" approach. Having liability as the residual class of items is not necessarily reflecting economic reality and certainly will be in conflict with the common view from accounting history. The informative-ness of the "narrow equity approach" is unsubstantiated and the neutrality of the view is questionable. This view also contradicts the principles of the CF.

(ix) The DP appears to lean towards a liability classification. Besides upholding the "narrow view of equity" in paragraph 2.45 (discussed in the point above), paragraph 2.40 states: "In particular, using only one of the prior distinctions for classification would result in more instruments being classified as equity, increasing the need to provide useful information about a greater variety of equity instruments through some combination of presentation and disclosure"[11]. This stance raises concerns on neutrality and asymmetric prudence[12].

Hence, in the light of the above issues, the Board will do well to apply a fresh-start approach on the FICE project without a constraining objective to retain outcomes of IAS 32.

[10] Paragraph 4.63, CF March 2018
[11] Paragraph 2.40, DP June 2018
[12] Paragraphs 2.16 and 2.17 CF March 2018 explains that exercise of prudence does not imply a need for asymmetry.

Presentation and disclosures will not redress fundamental issues relating to definition and classification.

Using a fresh-start approach, I propose that any settlement through equity (whether of a fixed or variable amount) should be recognized as equity. Hence, I do not support the classification of equity-settled claims as financial liabilities.

Question 3: Classification of Non-derivative Financial Instruments

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 explained in Question 1, I propose that the classification criteria be re-evaluated in the light of the revised CF of March 2018. In Question 2, I have explained my basis for not supporting the classification of equity-settled claims (whether of a fixed or variable amount of shares) as financial liabilities.

Hence, I do not agree with the conclusion in paragraph 3.14 with respect to the classification of a share-settled bond.

I also do not agree with the conclusion in paragraph 3.15 with respect to the classification of an irredeemable fixed-rate cumulative preference shares as financial liabilities (as opposed to the present IAS 32 classification of these shares as equity). Paragraph 3.15 is controversial for the following reasons:

(a) The host instrument, the preference share is itself an equity instrument and is not subject to mandatory redemption.

(b) If the host instrument is an equity instrument, the dividend coupons would be "distributions to holders of equity claims"[13]. It would not qualify as an expense.

(c) The substance of fixed rate dividends on preference shares is different from interest payments. Using IFRS 9 principles, interest is "consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin"[14]. Under IFRS 9 classification of financial assets, instruments that lack the "SPPI" characteristics (solely payment for principal and interest on principal) would

[13] Paragraph 4.69, CF March 2018.
[14] Paragraph 4.1.3 IFRS 9 Financial Instruments, July 2017.

not qualify as pure debt instruments. Clearly, the dividend payments is not merely a payment for time and credit risk but also a payment for profit participation and residual risks. Dividends in arrears are also not subject to interest payments (i.e. interest on interest) as in a bond issue. Dividend payments are distributions to the equity claimants and presenting them in the income statement as if they are interest distorts performance measures.

Presenting the preference shares as financial liabilities implies their priority to payment in liquidation over other equity claimants (e.g. irredeemable non-cumulative preference shares). In the worst case scenario, if dividends are in arrears, the preference shareholder is at risk of losing not only the dividends in arrears but the entire invested amount. Historically, preference shares without mandatory redemption clauses are viewed as different from bonds and other financial liabilities and are closer in nature to ordinary shares, except for the absence of voting rights and priority in liquidation. Classifying the preference shares as financial liabilities conveys information that there are greater similarities with pure debt instruments than there are with equity instruments. The nature of preference shares and pure debt are radically different in terms of their legal and economic features. The proposed classification of irredeemable cumulative preference shares as liabilities would create confusion to stakeholders.

Question 4: Puttable Exceptions

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?

I agree to retain the puttable exception for the reasons explained in the DP and IAS 32.

In particular, it would cause undue hardship to an issuer of puttable instruments who did not issue any equity instruments. However, the present exception relates to a binary situation – whether the puttable instruments are the most subordinated class or not. However, the Board may wish to address a scenario where there is a more subordinated equity class but in a scale that is much smaller than the class of puttable instruments issued. For example, ordinary shares were issued to meet the minimum requirements for legal purposes but do not support the scale of economic activities of that entity. Would there be room to allow for the puttable exceptions in such cases?

Question 5: Classification of Derivative Financial Instruments

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 preliminary classification criteria are unwieldly and the principles underlying the criteria are not immediately apparent to the reader.

As explained in Question 2, my view is that any instrument that is equity-settled (whether in fixed or variable quantities) should be accounted for as equity instruments. Hence, I encourage the Board to adopt a fresh-start approach to the existing requirements.

Derivatives should be classified according to its net settlement. Hence, I agree that the individual legs of the exchange should not be separately classified.

Question 6: Compound Financial Instruments and redemption obligation arrangements

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?

I agree with the principle in paragraph 5.2 that comparable information should be provided regardless of how an entity has structured its rights and obligations. Structuring may take the form of the separation of a derivative from the related non-derivative financial liability, different combination of contracts and terms of conditionality. I agree that the overriding principle must be that the same accounting treatment should apply to transactions that have the same economic substance.

I agree with the proposal in paragraph 5.48 (a) to (c) with the exception of criteria relating to derivative classification principle (fixed-for-fixed issues as explained in response to Question 2).

With regards to the disclosure requirements, I agree that the Board may review the feedback from respondents of the DP before proceeding further on its review for potential solutions.

I trust that the above feedback is useful for your purposes.

Yours sincerely,

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