EFRAG
35 Square de Meeûs
1000 Brussels
BELGIUM

11 December 2018

Dear Sirs

**IASB Discussion Paper:**
**'Financial Instruments with Characteristics of Equity' (DP/2018/1)**

1 We are writing to provide input to EFRAG's Draft Comment Letter ('DCL') on the above Discussion Paper.

2 We were pleased to co-host the outreach event that was held at our offices on 4 December, at which an outline of some tentative views of the FRC were presented. While the FRC's response is yet to be finalised, the following reflects our current thinking. This letter is confined to the most significant points.

**Scope**

3 We agree with the view expressed in the DCL that the topic addressed in the Discussion Paper is important and merits standard-setting activity. We also agree, however, that the approach adopted—that of providing a rationalisation for existing requirements, principally those contained in IAS 32—seems likely to provide only a limited degree of clarification and change in practice, while imposing significant cost and complexity through the introduction of new terminology and concepts, which may in turn lead to further issues of interpretation. Therefore, the IASB should not proceed to develop an Exposure Draft based on the proposals in the Discussion Paper without significant revision and refinement.

4 We also agree with the view expressed in the DCL that significant improvements in the presentation and, especially, disclosure requirements in respect of debt and equity instruments are desirable. The IASB could therefore explore the possibility of such improvements without necessarily taking forward the proposals as regards classification. However, as noted below, consistent with the DCL, we do not support the Discussion Paper's proposals for attribution within the financial statements of amounts to different classes of equity instruments.

5 The DCL states (in paragraph 14 of Appendix 1) that the scope of the project should not be a fundamental review starting from 'a blank sheet of paper'. In our view, such an approach should not be discounted, despite the challenges that it would involve and the failure of past attempts. Conceptual clarity is preferable to an accumulation of rules. While a fundamental review might suggest radical change, that cannot be known until such a review is concluded, at which time it could be assessed whether the benefits of taking it forward exceeded the costs. However, any decision to undertake a fundamental review should be made in the light of the IASB's other agenda priorities.

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## The criteria for classification

*The 'amount' test*

6 The DCL, despite raising significant reservations, including those on terminology, broadly accepts that classification as debt or equity should be driven by the 'timing' and 'amount' tests. We agree that the essential ideas that these tests attempt to capture are of fundamental importance, but have misgivings that all claims that do not meet the 'timing' test but only the 'amount' test should be reported as liabilities.

7 The IASB's Conceptual Framework requires that a liability represents a present obligation to transfer economic resources. While the current Conceptual Framework was completed without prejudging the outcome of the FICE project, it is difficult to understand why a claim that does not contain such an obligation should be reported as a liability, and what the consequential changes required by such a stipulation would be. Using the 'amount' test as a central part of the debt/equity distinction also seems to lead to a great deal of complexity. It seems probable that this could be reduced if it were instead used to drive disclosure requirements (both for claims that would be reported as liabilities and those that would not.)

*Liquidation*

8 The 'timing' test, as set out in the Discussion Paper, expressly excludes claims payable only on liquidation, but the 'amount' test does not. So the 'amount' test includes claims that are payable only on liquidation (and it is apparent that this is what the Discussion Paper intends). The DCL expresses some disquiet about the reference to 'liquidation' in paragraph 35(b), but mainly by raising questions about alternatives to liquidation such as restructuring. However, a stronger point should be made which is that financial statements that are prepared on a going concern basis should not pay any regard to what might or might happen in the case of liquidation—except, possibly, as supplementary disclosure.

*Fixed for fixed*

9 We agree with the DCL that any credible approach should ensure that where an entity is obliged to provide shares to a fixed value in exchange for a fixed cash sum, that claim should (consistently with the current requirements of IAS 32) be reported as a liability.

10 Despite the reservations expressed above, the amount test secures this.

11 But there are alternative solutions.

(a) One is to specify that an obligation to issue shares is a liability, as it provides an economic resource (shares) to the recipient. This would be consistent with the approach that the DCL commends for consideration by the IASB that all derivatives on own equity should be reported at Fair Value through Profit or Loss (FVPL). However, this would represent a significant departure from the usual understanding of the Conceptual Framework (and similar Frameworks that have been issued in the past). It would also require that 'conventional' share options—that is obligations to issue a fixed number of shares in exchange for a fixed amount of cash—are liabilities and should therefore be reported at fair value with changes recognised as income or expenses.


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(b) Alternatively, the focus of the distinction could be on the nature of the claim that exists at the reporting date rather than how that claim will be settled. This might support the conclusion that, if an entity has received €10,000 before the reporting date and as a result is obliged to issue equity in the future, then the claim at the reporting date is a liability. This would be similar to the reporting of a performance obligation under IFRS 15, which is stated at the amount received, even where it is clear that the obligation will be settled for a lower amount.

12 We do not intend to imply a firm preference between the three approaches set out above. Each of them would require further thought and development.

**Attribution to classes of equity**

13 We very strongly agree with the concerns expressed in the DCL about the proposal to attribution of amounts to different classes of equity. The objectives, and hence the significance, of this is extremely unclear.

14 In particular we are concerned that the various methods set out in the Discussion Paper of attributing comprehensive income of a period between derivatives and ordinary shares all rely on fair value. But financial statements do not purport to report or reflect the fair value of equity, and it is therefore difficult to see why an attribution of comprehensive income, which reflects changes in the book values of assets and liabilities, would be meaningful.

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We shall send you a copy of the FRC response to the Discussion Paper as soon as it is finalised, which may be in the next few days.

We hope these comments are helpful to EFRAG in finalising its comment letter on the Discussion Paper.

Yours sincerely

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