

## Financial instruments with characteristics of equity

Discussion Paper issued for comment by the International Accounting Standards Board in June 2018

Comments from ACCA

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Further information about ACCA's comments on the matters discussed here can be requested from:

Yen-pei Chen  
Manager, Corporate Reporting and Tax  
[yen-pei.chen@accaglobal.com](mailto:yen-pei.chen@accaglobal.com)  
+ 44 (0) 207 059 5580

Richard Martin  
Head of Corporate Reporting  
[richard.martin@accaglobal.com](mailto:richard.martin@accaglobal.com)  
+44 (0)20 70595748

## GENERAL COMMENTS

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ACCA welcomes the opportunity to provide views in response to the IASB's Discussion Paper (DP) on financial instruments with characteristics of equity. This has been done with the assistance of members of ACCA's Global Forum for Corporate Reporting.

ACCA's overall view on the classification of instruments as liabilities or as equities, is that we consider that the Board would be better staying with the principal elements of the definition of liabilities in the recently revised Conceptual Framework(CF). This means that:

- we are unsure that the second 'amount' criterion is needed for the definition, and
- instead of an unavoidable obligation to transfer resources, the test should be that there is no practical ability to avoid such a transfer. This would bring in the concept of economic compulsion.

The DP includes important proposals for enhancing disclosures and for presenting the different categories of instruments in the Statement of Financial Position and in the income statements which we broadly support.

We recognise that developing a standard meeting the various conceptual and practical challenges will be very difficult. As an alternative, the Board might consider retaining the main elements of IAS32 but address some of the practical problems that have arisen in its application.

## AREAS FOR SPECIFIC COMMENT

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### Q1

**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?**

In our view, IAS32 works reasonably well in general. However, ACCA appreciate the challenges faced by the IFRS Interpretations Committee in responding to application issues relating to complex financial instruments, in the absence of clear underlying principles for distinguishing between financial liabilities and equity. In general, ACCA supports a more principles-based approach to standard-setting.

The conceptual challenges need to be resolved, and this indicates that a standard-setting solution is required. However, the approach proposed in the DP of providing a

standard-setting solution seems hard to reconcile with the Board's wish to avoid changing current classification outcomes as much as possible. Furthermore, while there is a current discrepancy in the definition of liabilities between IAS 32 and the CF, the proposals in this DP would widen that difference. It may be that the Board should look to retaining the main provisions of IAS32 on classification, but try and address some of the practical issues that have arisen.

We note that the application issues identified in paragraph 1.36 seem limited to very specific circumstances. There is a risk that the differences between these proposals and the CF described above could result in additional conceptual challenges. The benefits of resolving the current application issues would need to be carefully weighed against the risk of new application challenges.

Another factor driving this review of IAS 32 are investor demands for more detailed information, especially about equity instruments (as noted in paragraphs 1.40 to 1.41). Enhancing presentation and disclosure (such as suggested in sections 6 and 7 of the DP) would go some way to responding to these demands without classification changes. However, these would also imply a standard-setting solution.

Any new standard defining own equity instruments would raise the issue of whether symmetry of classification of equity instruments held as assets by other entities would be appropriate.

## **Q2**

**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 are not convinced that the second 'amount' criterion should be part of the definition of a liability.

We have some concerns about the discrepancy between the IASB's preferred approach to the CF. Firstly, while the criteria proposed centres around the existence of an

‘unavoidable obligation,’ the CF refers to an ‘obligation [...] that an entity has no practical ability to avoid.’<sup>1</sup> Secondly, the preferred approach introduces a new criterion for financial liabilities (‘an unavoidable obligation for an amount independent of the entity’s available economic resources’ - the ‘amount’ criterion) which does not feature in the CF.

The Board should consider staying closer to the CF in defining liabilities (and so distinguishing them from equity) by referring to no practical ability to avoid the transfer of economic resources. This is also reflected in our answer to Q10.

The concept of ‘an amount independent of the entity’s available economic resources’ is new, and may give rise to divergent interpretation. While the term ‘economic resources’ is described in detail in the Conceptual Framework<sup>2</sup>, the notion of ‘available economic resources’ is a significant change from current IAS 32 terminology, which is much more specific (‘cash,’ ‘financial assets,’ ‘financial liabilities,’ and ‘own equity instruments.’). As such, there are risks that the concept can give rise to new uncertainty in practice, especially where both legs of a derivative are settled with entity’s own shares. Where the obligation is to deliver own shares, the company would have to be in possession of such shares or have the right to issue them, otherwise there would be an obligation to transfer economic resources in order to purchase the shares. This issue does not seem to be sufficiently addressed in the DP.

Further, the concept of ‘an amount independent of the entity’s economic resources’ is subject to a high degree of judgement. In particular, challenges could arise in practice when interpreting whether an amount ‘changes as a result of changes in the entity’s available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity’ (paragraph 3.18 of the discussion paper) – an example of this is contingent convertible bonds.

Although we question the use of the ‘amount’ criterion in classification, we believe that it would provide a useful basis for determining when separate presentation is needed (as covered by Q7 below).

The focus on contractual obligation seems too narrow, leading to a risk that the substance of transactions is not fully captured. We believe that interactions with legal obligations should be considered (as discussed under Q11). Further, purely focusing on contractual obligations would make IAS 32 inconsistent with other standards: for example, obligations outside of contract terms are considered in IAS 37 and IFRS 15<sup>3</sup>.

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<sup>1</sup> Conceptual Framework for Financial Reporting, paragraph 4.29

<sup>2</sup> Conceptual Framework for Financial Reporting, paragraphs 4.4 – 4.25.

<sup>3</sup> IFRS 15, paragraph 24: ‘a contract with a customer may also include promises that are implied by an entity’s customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.’

We also note that the extent to which classification alone would provide useful information about an entity's funding liquidity and cash flows (paragraph 2.50) is likely to be limited.

We agree that disclosure would be the best way to help users assess entities' funding liquidity and balance-sheet solvency and returns.

### **Q3**

**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 stated above, we have concerns with the two-criteria definition.

We agree with the IASB's proposals on non-derivative financial instruments with alternative settlement outcomes. This provides the clearest accounting treatment in our view. Another method would necessitate a consideration of the economic incentives to determine the most likely settlement outcome, which could lead to divergent practice and might imply reclassification of instruments if those probabilities were to change.

### **Q4**

**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?**

ACCA agrees with the IASB's decision to retain the puttables exception, as this is a pragmatic solution to avoid wider issues that would arise under the preferred approach, including for cooperatives and finite-life entities. However, the puttables exception does run contrary to the Board's efforts to provide a conceptual basis for classification. The IASB may wish to consider a more consistent and principles-based solution to the issues in the longer term.

## **Q5**

**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 have noted in answer to Q2 above our concerns with the second 'amount' criterion for defining a liability in the Board's preferred approach and similar concerns would apply to the classification proposed for derivatives.

We welcome the IASB's efforts to clarify the classification of derivatives, by replacing the 'fixed-for-fixed' condition with a set of more principles-based conditions. We also welcome the IASB's proposal to classify a derivative on own equity in its entirety.

However, if retained, the second criterion set out in (b)(ii) would seem to set a different threshold for derivatives than for non-derivatives, in terms of considering what constitutes 'independence of the entity's available economic resources.' This is problematic for partly independent derivatives (see paragraphs 4.30-4.35, pp.61-63).

In particular, foreign exchange rates are considered to be a variable that is independent of the entity's available economic resources: but what is foreign currency is determined in relation to the group's functional currency. A multinational group operating in numerous different currencies, the determination of the group's functional currency may be arguably theoretical.

## **Q6**

**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 have noted our concerns with the Board's preferred approach above.

Subject to that, ACCA agrees with the IASB's preliminary views set out in paragraphs 5.48(a)-(c). This approach should ensure that arrangements with the same liability and equity outcomes are classified consistently according to their economic substance. Paragraph 5.48(b) would, in our view, provide the appropriate accounting outcome in line with the current accounting treatment for convertible bonds, which is well understood.

For financial instruments with alternative settlement outcomes that are controlled by the entity, information about the different settlement outcomes should be resolved by disclosure.

#### **Q7**

**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 with the Board's proposal to present separately financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources, independent and partly independent derivatives, in the statement of financial position. We also support the presentation of income and expenses arising from such financial liabilities in OCI without recycling.

As for separate presentation requirements discussed in paragraphs 6.37-6.41, we believe that separate presentation requirements should apply only to embedded derivatives that are separated from the host and hybrid instruments that do not contain any obligation for an amount independent of the entity's available economic resources, as described in paragraph 6.38(a).

**Q8**

**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 do not support the proposal for the separate presentation of equity instruments. In our view, the attribution of total comprehensive income to classes of equity is complex, leading to potentially counter-intuitive outcomes, while the benefits of the additional information provided are unclear.

**Q9**

**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:**

- 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).**
- 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).**
- 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 proposed disclosures would go some way to addressing the justified information demands from investors, and in particular provide a greater level of detail about equity instruments. In particular, the priority of claims on liquidation would provide particularly useful information at an individual entity level – although clear disclosure in this area will be more challenging at a consolidated group level.

We agree that dilution disclosures should be provided not only by listed entities under IAS33, but also by other entities that have potentially dilutive instruments.

It is debateable whether more granular information about the contractual terms, such as interest rates and the maturity of specific financial instruments, would be decision-useful for users. Disclosures relating to the terms and conditions of liabilities and contingent liabilities are already required under IFRS 7<sup>4</sup>. The IASB may wish to consider strengthening the disclosure requirements around terms and conditions for equity instruments, to address the information needs which users of financial statements have expressed.

As noted in paragraph 7.29 of the DP, appropriate aggregation will be important.

**Q10**

**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?**

As noted in our response to question 2 above, the classification criteria should, consistently with the Conceptual Framework, refer to obligations which the entity 'has no practical ability to avoid.' This will ensure that economic compulsion – rather than economic incentives – is appropriately reflected in classification decisions. This is needed in order to ensure that financial statements show more of the economic substance of the instruments and rather than only their legal form.

While we generally agree that economic incentives should not be considered for classification purposes, we do consider that if just the 'timing' criterion is used then economic compulsion also has to be considered in defining liabilities. We recognise that determining the level of compulsion needed for an obligation to be classified as a

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<sup>4</sup> IFRS 7 paragraph 14

liability may well raise difficulties in standard-setting and also requires judgement in its application. Indirect obligations requirements in IAS 32 may help to address some of the issues around economic compulsion.

#### **Q11**

**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?**

As noted under Q3, we believe in order to ensure faithful representation, the wording of the preferred approach should be expanded beyond contractual terms, to reflect statutory requirements and substantive constructive obligation as envisaged in the CF 4.31.

Legal requirements outside of contract terms (for example, mandatory tender offers, as described in paragraph 8.29, p.131) should be considered for classification purposes. The legal framework is particularly relevant to the classification of financial instrument contracts to be settled with own equity. It is also important for entities (for example, in the oil and gas industry) that have financial liabilities arising from agreements with governments, and therefore are subject not only to the terms of the financial contract itself, but also to obligations in legislation.

Care will be needed, if the Board expands the preferred approach to reflect legal obligations, to identify an appropriate scope for the legal obligations which should lead to a claim being classified as liability. For example obligations arising from legislation providing recourse for minority shareholders may not be relevant.