



EFRAG DRAFT COMMENT LETTER ON IASB DP FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Issued 3 December 2018

ICAEW welcomes the opportunity to comment on the EFRAG draft comment letter on the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity* published on 28 August 2018, a copy of which is available from this [link](#).

We are currently in the process of finalising our response to the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*. Although we are not yet able to confirm our detailed comments on the IASB's proposals, we expect to outline a number of concerns with the proposed preferred approach.

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MAJOR POINTS

1. We are currently in the process of finalising our response to the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*. Although we are not yet able to confirm our detailed comments on the IASB's proposals, we expect to outline a number of concerns with the proposed preferred approach and more generally with the way in which the IASB has chosen to tackle this project.
2. Overall, we are not convinced that the preferred approach would result in a significant improvement in the accounting for financial instruments with characteristics of equity compared to IAS 32 *Financial Instruments: Presentation*. That said, we believe the discussion paper does identify some solutions to a number of current issues in IAS 32 which, either as a temporary measure or not, could be helpfully developed.

ANSWERS TO SPECIFIC QUESTIONS

3. At this time we have provided answers only to the questions outlined below.

Question 1

Are constituents aware of any other challenges with IAS 32 that have not been identified by EFRAG and the IASB.

4. In our draft response to the IASB we have not identified additional challenges with IAS 32 other than those already identified by the IASB and EFRAG.

Question 2

In paragraph 33 EFRAG agrees that information provided in the financial statements about claims on an entity should help users to assess the entity's liquidity and solvency. These information needs are also identified in the Conceptual Framework for Financial Reporting. The DP suggests providing information on both these factors by considering both 'timing' and 'amount' when distinguishing equity from a liability. EFRAG has considered whether it provides the most useful information to consider both these dimensions when distinguishing equity and liabilities. Do you think that information about both liquidity and solvency should be provided through the classifications of claims on an entity? If so, do you agree with using both the 'timing' and the 'amount' features when distinguishing equity from a financial liability from equity? If not, how should the distinction be made?

5. We do not believe that information about both liquidity and solvency should be provided through the classifications of claims on an entity. In particular, as discussed below, including in liabilities claims that arise only on liquidation is not only inconsistent with the going concern basis, but is unhelpful in trying to assess whether the entity has sufficient funds to meet current obligations.
6. In our draft response to the IASB we also outline our concerns with the proposal to use both the 'timing' and the 'amount' features when distinguishing equity from a financial liability with characteristics of equity. In our view, doing so results in an overly complex approach and would not result in a significant improvement in the accounting compared to IAS 32. In particular, we note that:
 - a) It introduces new terminology which is difficult to understand and, in our view, would be challenging to apply in practice both at transition and on an ongoing basis. For example, the introduction of the 'amount' feature which states that a financial instrument is classified as a liability when it is 'independent of an entity's available economic resources.' We do not believe that the IASB has articulated the concept of an

‘amount independent of the entity’s available economic resources’ or clearly explained how it would be applied in practice.

- b) It uses concepts in a way that is not consistent with the Conceptual Framework. For example, the interrelation of the ‘amount’ feature with the concept of financial statements produced on a going concern basis which results in some instruments being classified as a liabilities even though there is no amount payable other than at liquidation, and use of the term ‘derecognition’ in relation to own shares with a written put option.
 - c) It results in certain outcomes which are more complicated to account for and understand compared to IAS 32. For example, the proposal for written put options results in three entries (DR: own shares, CR: liability, DR/CR: asset/liability or equity) with some movements taken to OCI, rather than two entries.
 - d) It introduces a new type of liability that expands the use of OCI which, in our view, is not well understood.
 - e) It introduces a complicated analysis of reserves based on IAS 33 *Earnings Per Share*, which currently only applies to listed entities, for all entities.
 - f) It introduces complex, judgemental measurement for liability components which are initially recognised at little or no value but then could be remeasured if circumstances change so that repayment seems more likely.
7. In our draft response to the IASB we recommend that that the preferred approach outlined in the discussion paper is not pursued. We believe it is likely that the costs of implementation to all parties, including to the IASB in developing an accepted standard and making consequential amendments to other standards, seem likely to exceed any benefit. Nevertheless, the discussion paper identifies some solutions to certain specific issues in IAS 32 which could be helpfully developed. For example, the suggestion of additional disclosures on the terms and conditions of financial instruments has some merit. Also, improved disclosure on areas of significant judgement could be explored further. Additional guidance on how to deal with contingent settlement options and the order in which to analyse components could also represent an improvement to IAS 32.
8. While we would support the IASB going back to first principles to develop a solution, we do not believe that this is a high priority. In our response to the IASB’s 2015 Agenda Consultation, ICAEW classified the ‘financial instruments with characteristics of equity’ project as high priority in order to complete the revised Conceptual Framework, rather than to address any fundamental problems with IAS 32. However, in our view, there are other more pressing matters for the IASB to address in 2019, for example, the accounting implications of IBOR reforms. Making targeted improvements to IAS 32, particularly to presentation and disclosure requirements as noted above, would appear to be the most efficient way forward at this stage.

Question 3

The IASB decided that, while the objective of the FICE project is to respond to challenges in distinguishing financial liabilities from equity instruments when applying IAS 32, any potential solution should limit unnecessary changes to classification outcomes that are already well understood. Considering the IASB’s preferred approach described in the DP, do you expect significant classification changes? If so, please describe the type(s) and extent of instruments affected, the existing classification in accordance with IAS 32 and why the classification could or would change in accordance with the IASB’s preferred approach.

9. In our draft response to the IASB we note that under the preferred approach, a preference share that is callable by the issuer would have similar treatment to an irredeemable non-cumulative preference share that requires a fixed amount to be paid at liquidation ie, the classification outcome would change from equity to a liability under the preferred approach.

10. More generally, in our draft response to the IASB we have expressed concern over the expected different classifications outcomes already identified in the discussion paper, and questioned whether they would result in more helpful information. In particular, the removal of foreign exchange rights exemption and the classification of cumulative preference shares as a liability.
11. We understand that in developing the preferred approach, the IASB has sought to both clarify the rationale for distinguishing liabilities from equity instruments to help explain many of the existing classification outcomes arising from application of IAS 32 and also to address some of the application issues that exist in practice. We can sympathise with the IASB's reason for tackling the project in this way, particularly when the application of IAS 32 does not present significant classification challenges for the majority of financial instruments in practice. However, in our view, approaching it in this way has resulted in a preferred approach which represents an unhelpful half-way house between going back to first principles in order to develop a solution, and developing targeted improvements to IAS 32.
12. We do not find this to be a satisfactory outcome. Even when no change to the classification outcome is expected, the complexities with the approach would, in our view, result in significant implementation cost and effort (as well as standard setting to align with the Conceptual Framework and other standards) in order to reach the same outcome as under IAS 32.

Question 5

Do you consider that it is relevant to classify financial instruments that are only settled on liquidation (e.g. cumulative preference shares) as financial liabilities?

13. In our draft response to the IASB we outline our concerns with the proposal that under the preferred approach certain financial instruments that are only settled on liquidation would be classified as financial liabilities. In our view, the concepts outlined in the preferred approach are not used in a way that is consistent with the Conceptual Framework. In particular the interrelation of the proposed 'amount' feature with the going concern basis of accounting.
14. For example, under the preferred approach irredeemable fixed-rate cumulative preference shares would be treated as a liability because there is an obligation 'independent of the entity's available economic resources' even though there is no amount payable other than at liquidation. This is a significant change from IAS 32. We struggle with accepting that this instrument is a liability and whether this provides relevant information for assessments of balance-sheet solvency and returns since no amounts will be paid except at liquidation, and financial statements are prepared on a going concern basis.