Comment Letters
IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

Paris, 7th January 2019

Discussion paper DP/2018/1 : Financial Instruments with Characteristics of Equity

Dear Hans,

Mazars welcomes the opportunity to comment on the International Accounting Standards Board’s Discussion Paper (hereafter DP) Financial Instruments with Characteristics of Equity, issued in June 2018.

Financial Instruments with Characteristics of Equity (hereafter called FICE) is one of the key topics for producing useful and relevant financial reporting. We consider that the principles in IAS 32 are partially flawed and raise questions as evidenced by the questions sent to the IFRS IC, whose resolution is pending for the FICE project. We therefore fully agree that standard-setting on this topic is needed.

Three approaches have been consecutively considered during our internal process to prepare this comment letter. We think it is relevant to describe this process as it can help to better understand our final answer.

We first started by discussing the IASB preferred approach:

We agree with the Board’s twofold objective to provide clear principles to the debt/equity classification without dramatically changing the current outcomes of IAS 32. We therefore find the Board’s “reverse engineering” approach relevant.

We also welcome several proposals of the Board, as for instance the accounting treatment of the Non-Controlling Interest puts (with some concerns detailed in the appendix to this letter).

However, we consider that the DP’s approach raises concerns. Our main concern relates to the “Amount feature” that relies on the non-straightforward concept of Economic Resources, the assessment of which takes into account what occurs on liquidation. Indeed, we fear that the concept of the Economic Resources will raise a lot of interpretation questions as it encompasses both recognised and unrecognised items and because its definition needs, in our opinion, to be better articulated with the Conceptual Framework. Moreover, we consider that assessing the classification of instruments based on their outcome upon liquidation conflicts with the general going concern assumption when preparing IFRS financial statements.
We also have concerns about the concept of liquidation used in the DP. The definition of liquidation may vary among jurisdictions and sectors and will therefore entail judgment that would likely challenge the comparability of its implementation.

Finally, whilst we welcome the strengthening of the conceptual basis of the debt/equity classification, the new concepts introduced by the DP will trigger a lot of questions, requests for interpretation and implementation costs for a benefit that may not be directly observable by users as the classification outcome is not expected to change significantly. All in all, we are not convinced that the benefits sufficiently outweigh the costs for this approach to be developed further and implemented.

We then tried to consider an alternative approach:

We agree with the Board that both liquidity and solvency related-information is relevant to users. Should a classification approach be based on a single criterion, we would consider that liquidity should be the primary driver. In this case, solvency could be retained for presentation and disclosures. We therefore investigated further the Alpha approach and its impact on the debt/equity classification.

One of the main drawbacks of such an approach is that it largely facilitates the access to structuring opportunities if it does not come with a proper economic compulsion analysis\(^1\).

This alternative approach was also considered as disruptive. This foreseeable change was in itself an issue as we share the Board’s statement that it is not what market users are expecting.

Furthermore, we failed to reach a consensus on what the accounting classification of an obligation to deliver a variable number of own shares whose value equals a fixed amount of functional currency should be. Some were comfortable with an equity classification as, consistently with a liquidity-based approach, it does not trigger any obligation to deliver an asset of the entity. They considered that it is more a matter of dilution for which information should be provided in the Notes. Others considered that such instruments should be recognised as a liability either because the entity is using its own shares as a currency, or because the entity may fail to deliver the required amount if the own share price drops significantly\(^2\).

The above-mentioned drawbacks together with the lack of consensus on what we see as an emblematic feature of a liquidity-based approach led us to the conclusion that this alternative approach was not the best way to go forward.

We decided to drop that alternative approach and ended up with our initial thoughts already expressed in 2008:

We think that the best way forward with a positive Cost/Benefit ratio and without triggering a dramatic change to the current classification would be to capitalize on the experience of IAS 32 implementation by avoiding having to reconsider all the already existing analyses.

\(^1\) Please refer to our detailed answer to Question 10
\(^2\) Proponents of this view acknowledge that adding a cap to the number of shares to be delivered may however minimize this drawback but consider that fact more as a structuring answer than as a classification principle.
In this regard, we consider that the following fixes to IAS 32 are needed to improve the current classification requirements (please refer to paragraph 8 or our appendix for more details):

- the accounting treatment of NCI puts should be clarified,
- the impact of cash settlement alternatives on the classification of derivatives should be aligned with the one for non-derivative instruments,
- clarifying the consequences of some « standard » features on the “fixed for fixed” assessment,
- consider how the fixed for fixed criterion could be adapted to situations where the number of shares delivered, while not entirely fixed, does not vary in order to provide to the holder the value of a fixed amount of currency,
- the fixed for fixed rule should be adapted to foreign currency instruments,
- clarification should be provided on the requirement to perform a re-assessment or not.

Whatever the approach adopted by the Board, we are convinced that it is essential to address the two following transversal issues:

- clarify the scope of Indirect Obligations versus Economic Compulsion, and
- address the Legal versus Contractual rights & obligation issue.

Otherwise, this valuable attempt will remain incomplete and implementation diversity will remain.

More specifically concerning the disclosure part of the DP, we agree with the Board that additional disclosures should be required on the characteristics of liabilities and on Diluted/anti-diluted Earning Per Share among equity holders (linked to IAS 33, Earnings per Share). However, we draw the Board’s attention to the fact that providing such information/disclosures should be all together operational (meaning easy to implement without significant costs), relevant and easily understandable by users.

As a conclusion, we warmly welcome the Board’s efforts but think that even though a conceptual approach can be desirable from a theoretical point of view, the pragmatic cost/benefit ratio view should prevail. We therefore encourage the Board to perform impact assessment studies before issuing an exposure draft.

Our detailed comments to the questions raised in the Discussion Paper are set out in the Appendix.

Please do not hesitate to contact us should you want to discuss any aspect of our comment letter.

Yours sincerely,

Michel Barbet-Massin
Head of Financial Reporting Technical Support
Appendix

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?

(1) We agree with the challenges identified by the Board in paragraphs 1.23 to 1.37. (please refer as well to our proposed areas of focus mentioned in our cover letter).

(2) We agree that the challenges identified are pervasive enough to require standard-setting activity.

(3) We welcome the Board's “reverse engineering” approach and find it relevant as it is important to identify clear underlying principles even if some exemptions will for sure be needed.

(4) However, we draw the Board's attention to the cost/benefit ratio of any proposal.
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?

(5) We agree with the idea that the approach should provide information both on a liquidity and a solvency feature as both are needed and useful information for the users. We also agree that subordination rank information is more a matter of presentation/disclosure than a matter of classification.

(6) However, the Board’s preferred approach raises significant concerns:

Our main concerns relate to the amount feature:
1/ As the financial statements are built on the going concern assumption (CF § 3.9), we take issue with the fact that the relevant amount for assessing classification could be an amount upon liquidation.

2/ What the “economic resources of an entity” concept encompasses could be clarified and/or be more clearly articulated with the conceptual framework definition and the IAS 37 definitions of contingent assets/liabilities. Using the concept of economic resources in the equity/liability classification is a new approach that would require to be further explained:

✓ We think it would be useful to further explain how the “residual” definition of DP §3.17 is consistent with the definition of a right as per the Conceptual Framework § 4.43.
✓ Concerning the notion of “claims” included in the DP’s definition, we think it would be useful to explain how this concept is similar to and/or different from the claims referred to by the Conceptual Framework § 4.2 that cover both liability and equity elements.
✓ Concerning unidentified assets/liabilities, we think it would be useful to explain how they are to be articulated with the definition of contingent assets/liabilities given by IAS 37.10.
✓ Even if we agree with the fact that equity instruments issued by an entity are not economic resources of this entity, the footnote no*15 in § 1.29 b) of the DP does not seem completely in line with CF § 4.10. Indeed, the CF deals with equity instruments that are issued and repurchased.

3 CF § 4.4: "a right that has the potential to produce economic benefits"
3/ We understand from the DP that the fair value of ordinary shares might be a good proxy of the entity's economic resources. We welcome this idea as it could be a practical mean to implement this new “economic resource” concept without requiring too much interpretation guidance. However, we would encourage the Board to investigate for any potential unintended consequences (e.g. when a proxy of fair value is retained such as formula based on EBITDA).

4/ Despite all these concerns, we acknowledge that the “economic resource” feature permits to address in a more straightforward way some specific situations that otherwise would require using “Economic compulsion”.
This is especially the case for some cumulative perpetual instruments. As the concept of economic compulsion would probably be complex to implement, we consider that the amount feature might be a pragmatic and practical way to address those instruments.

The definition of “liquidation” is not straightforward across jurisdictions and industries
Some practical difficulties could occur when defining what “liquidation” stands for as its definition may be different from one legal jurisdiction to another. Some difficulties could also occur around the concept of “non-scheduled” liquidation: in specific sectors such as banking where the differences between the liquidation process and the resolution process need to be identified (see the limited life instrument discussion in question 3).

All in all, we are not convinced that the benefits sufficiently outweigh the costs for this approach to be developed further and implemented
Indeed, whilst we welcome the strengthening of the conceptual basis of the debt/equity classification, all these new concepts and/or definitions will trigger a lot of detailed analysis and work that will lead to a significant implementation cost compared with a benefit not directly observable for users as the classification outcomes are not expected to change significantly.

(7) For all these reasons, we tried to consider an alternative approach that would rely on a single classification trigger while the other one would apply for presentation and disclosure purposes

In that context, we concluded that we would prefer retaining liquidity as a single classification trigger and Solvency as a presentation/disclosure (similar to the Alpha Approach).

1/ At first glance, this approach could seem easier to understand and implement as this liquidity feature is already known and implemented by both preparers and users of the financial statements.

2/ However, such an approach would largely facilitate the access to structuring opportunities if it does not come with a proper economic compulsion / indirect obligation analysis and we acknowledge that these concepts are not easy to operationalise.

We also consider that this approach would be rather disruptive as it would really change the current classification outcomes.
We agree with DP § IN 9 that the market and the financial statement users in general are not expecting such revolution in the actual classification outcomes.

Finally, we failed to reach an internal consensus on what the accounting classification of an obligation to deliver a variable number of own shares whose value equals a fixed amount of functional currency should be.
Some were comfortable with an equity classification as, consistently with a liquidity-based approach, it does not trigger any obligation to deliver an asset of the entity. They considered that it is more a matter of dilution for which information should be provided in the Notes.
Others considered that such instrument meets the definition of a liability either because the entity is using its own shares as a currency, or because the entity may fail to deliver the required amount if the own share price drops significantly (e.g. if the total value of the entity is below the value to be delivered to the claim holder)\(^4\).

(8) We ended up with our initial thought already expressed in 2008:
We think the best way forward will be to keep the actual requirements of IAS 32 with some fixes as this would achieve the twofold goal of not changing dramatically the current classification and avoiding having to reconsider already performed analyses.

However, we acknowledge that identifying what is behind those fixes is a crucial point. To address this point, we consider the following fixes should be prioritised:

- ✓ the accounting treatment of NCI puts should be clarified, please refer to our answer to question 6 for further details on this topic,
- ✓ the impact of cash settlement alternatives on the classification of derivatives should be aligned with the one for non-derivative instruments (i.e. cash settlement alternative at the hand of the issuer do not prevent an equity classification),
- ✓ clarifying the consequences of some « standard » features on the “fixed for fixed” assessment (such as anti dilutive feature to protect the holder against situations such as share split or extraordinary dividend...),
- ✓ consider how the fixed for fixed criterion could be adapted to situations where the number of shares delivered, while not entirely fixed, does not vary in order to provide to the holder the value of a fixed amount of currency. For example, this would be the case of a mandatory convertible bond in which the issuer is certain to grant to the holder a minimum number of shares (an equity component) while introducing a component of variability in the total number of shares delivered,
- ✓ the fixed for fixed rule should be adapted to foreign currency instruments,
- ✓ clarification should be provided on the requirement to perform a re-assessment or not (for instance in the situation of pari passu clause),
- ✓ concerns mentioned in our answer to question 10 (economic incentive) and 11 (contractual vs legal rights and obligations) should be addressed.

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\(^4\) Proponents of this view acknowledge that adding a cap to the number of shares to be delivered may however minimize this drawback but consider that fact more as a structuring answer than as a classification principle.
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?

(9) On the principles please refer to our answer to question 2. We will therefore focus below on identified practical issues.

(10) We would like to draw the Board’s attention to the impact of the preferred approach on Members’ shares in Mutual entities.

This topic is very common in Europe and Canada and concerns co-operative and mutual entities especially in the banking, insurance and agricultural sectors.

The critical feature of these instruments that may not be adequately captured by the Board’s preferred approach is their asymmetrical risk profile upon liquidation. This feature is required by law and usually reflected in the contractual feature of the instrument.

The shareholders will contribute to losses but will not benefit from any potential up-side profit except in some jurisdictions for an annual return capped by law. If the liquidation net residual amount is above the nominal amount of such instrument, any excess will belong to third parties (it may vary from one jurisdiction to another but it can be the State or other mutual entities of the sector for example).

✓ IAS 32 disregards what happens upon liquidation. Therefore, this feature does not currently prevent an equity classification.

✓ Under the DP’s preferred approach, because of this asymmetrical return upon liquidation, the amount cannot be considered as fully independent and the instrument will fail the amount feature test. Consequently, these shares would not be classified as Equity.

We strongly disagree with this liability outcome as it does not provide relevant information to the users. Indeed, third parties benefit from this equity protection mechanism. This feature neither triggers a liquidity risk nor a solvency risk.

Moreover, ending with entities without equity instruments seems contradictory with the equity definition as a residual (DP § 3.36). We agree with DP § 3.37 a) that it will lead to a situation where the “usefulness of the statement of comprehensive income is reduced”.

We considered the best way forward to address this issue should the Board elect to retain and develop its preferred approach. We concluded that we would be very supportive of an amendment to IFRIC 2. Indeed IFRIC 2 was designed under the framework of IAS 32. We consider that it would be relevant to complement it so that it adequately captures the new amount feature of the Board’s preferred approach if this approach is finally retained.
(11) We are also concerned by the following issues:

✓ Corporates have huge concerns about the reclassification of perpetual cumulative instruments as a liability under the DP’s preferred approach.

- We understand the rationale of such classification as these instruments usually behave and are considered by most market participants as debt instruments. We would like to draw the Board’s attention to the significant impact such a change could have on the market, especially as covenants may be put under pressure following such reclassifications. We therefore strongly recommend the Board to perform an impact assessment of this new classification outcome and, in any case, provide sufficient time to entities to anticipate and when needed reconsider their balance sheet structure to avoid significant economic burden.

✓ Limited life entities

We wonder if this sort of entity would end up without any equity instrument whatsoever under the DP’s preferred approach, and to what extent it would be the most relevant information.

The definition of what is a liquidation is the key point here:

- Would they fail the timing feature as this feature refers to a non-scheduled liquidation as mentioned in the DP footnote 24 page 32?

- or shall this “scheduled” liquidation be disregarded for the timing feature assessment to better focus on the amount feature to assess the payment upon maturity?

✓ Some perpetual instruments whose interest payments are fixed but discretionary and non-cumulative, and whose nominal amount is redeemable only upon liquidation:

- We found the argument saying that the discount value of the nominal amount upon liquidation will be nil rather weak as the liquidation is so far from now under the going-concern assumption.

- This raises several implementation questions:
  - Should the debt component be remeasured if the entity’s financial position were to deteriorate?
  - What happens if the going concern assumption is no longer met?

- This type of accounting treatment could be rather procyclical at entity level. We encourage the Board to further investigate the consequences of such approach and perform adequate impact assessments.
(12) Even if such an exception could be seen as an exception to a new approach designed to be more robust, we fully agree with:

- retaining the puttable exception and IAS 1.136A
- the fact that IAS 1.136 should clearly state it applies to instruments defined by IAS 32.16 C & 16 D (i.e. obligation to deliver another party a prorata share of the net assets of the entity only on liquidation).

(13) We also recommend that the Board clarify the way IFRIC 2 will be adapted to the new standard.

In our opinion, IFRIC 2 currently deals only with the timing feature as it refers to the current IAS 32 requirements. If the Board retains the DP approach, it should consider amending IFRIC 2 on the amount feature to address what occurs upon liquidation.
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?

(14) We agree with the general principle of not accounting for derivatives on a gross basis that will lead to recognise each leg separately.

(15) We welcome the change introduced by the DP’s preferred approach for the settlement option at the hand of the entity.

(16) As for non-derivative instruments, we have concerns on the Amount feature. This is a new concept that will require guidance to avoid the trouble experienced in implementing the current fixed for fixed feature. We encourage the Board to carefully assess the cost/benefit ratio of this new concept compared to the current fixed for fixed condition.

(17) We wonder why the Board decided to remove the Rights issue exemption whereas all other exemptions (puttable instruments, IFRIC 2...) seem to be maintained?

(18) We note that partly independent derivatives will be fully classified as assets/liabilities whereas another approach could have been to consider split accounting. Should the Board retain the preferred approach, we agree that a split accounting approach would be probably too complex to implement.
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?

(19) We welcome the clarification of the accounting treatment given by the DP as it will help minimise divergence in practice. We consider that the outcome on NCI Puts at Fair Value is globally consistent with one of the most common practices we observe and will therefore probably be well accepted by preparers.

(20) However, we would like to draw the Board’s attention to the fact that the proposed accounting treatment for NCI puts at fixed price is very complex to understand. Indeed, accounting for a written call when you enter a written put is rather counter-intuitive for a lot of stakeholders.

(21) We have strong concerns about the consequences of the derecognition of NCI at initial recognition, as DP § 5.37 seems to state that it should impact the way performance is allocated on the face of the P&L between the group share and the NCI share.
This point needs to be clarified by the Board. Let’s take an example of a subsidiary in which the group holds 60% and an NCI put on the other 40% of the NCI shares. Even if this put may have no substance (e.g. a strike very deeply out of the money), what we understand from the DP is that:
- The 40% shares that are underlying the NCI put are derecognized whereas a liability and a call option are recognised.
- The Group performance should include up to 100% of the profit of the subsidiary from the put’s issuance.
This seems to us a huge structuring opportunity with a significant lack of substance, the minority shareholders having in most cases all the rights on the NCI performance until the put is exercised.

If we agree that a written put triggers an obligation to pay cash, we do not agree that an NCI and a put are equivalent to a convertible bond. This is especially true regarding P&L allocation.

(22) We consider that the Board should further clarify how to apply its preferred approach to NCI with regards to the amount feature test at a consolidated level. DP § 3.24 c) states that NCI will be dependent on the economic resources of the subsidiary. In our opinion, this point needs further clarification.
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?

(23) We agree that no further presentation requirements are needed in relation to the timing
feature (DP § 6.54).

(24) We agree with the presentation on a separate line items for instruments fully dependent on
the economic resources of the entity (DP § 6.53).

(25) Regarding the recognition of change in value in Non-Recyclable OCI, we consider that this
proposal is consistent with the own-credit risk on financial liabilities designated at fair value as
both are an illustration of counter-intuitive impacts. However, Mazars long standing position is
that in the end any realised gain or loss should impact P&L.

(26) We favour the criteria-based approach for instruments with a partly independent amount
obligation:
If the disaggregation approach could seem more satisfying on a conceptual level, we do not see
how it can be implemented correctly in practice. Therefore, we agree with the criteria-based
approach proposed in the DP.

(27) Regarding derivatives embedded in a Hybrid contract that is not separated from the host,
we consider that Alternative A is the only one that is operational.
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?

(28) Even if we understand the Board’s rationale underlying the proposals on Equity subclasses
and information on return attribution, we consider that the approaches considered by the
Board are too complex to be operational and useful to users.

(29) However, we agree that there is a need for more disclosures on this topic and especially on
dilution. This could be addressed through amending IAS 33.
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?

(30) We consider that disclosures should be an integral part of the project as all the information relevant for users cannot be communicated solely through the classification mechanism.

(31) From a pure theoretical point of view, we would find the information on priority upon liquidation relevant. But we have strong concerns on whether it could be feasible at a group level.

It seems to us really complex to set up at a group level for several reasons:

✔ Complexity increases with the number of subsidiaries

✔ Complexity increases with the number of intragroup agreements. Would the new disclosures require providing information on intragroup agreements that are not presented on the face of consolidated financial statements (intercompany loans and guarantees, cash pooling agreements …)?

✔ Laws on priority may differ depending on jurisdictions, adding complexity in determining the different rankings

Therefore, at this stage we would not recommend that the Board confirm this requirement as we do not consider it as operational.

(32) We are also concerned by the requirements to disclose information on all debt terms & conditions

If for listed instruments it can be easily solved by cross references, it could lead to operational difficulties for non-listed instruments for which information is not publicly available. For large groups, the list of financial liabilities can be very long and may end up with a significant risk of disclosure overload. We encourage the Board to further investigate this topic, trying to address the following questions:

✔ Do entities have to select only some key features (if yes, which ones?)

✔ How shall they disclose all these pieces of information?

Therefore, without more detail, we are not convinced that the cost/benefits ratio will be fulfilled.

(33) As previously said, Disclosure on Dilution seems relevant to us, but could be addressed by an amendment to the disclosure requirements of IAS 33 (please refer to question 8)
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?

(34) We fully agree with the challenge identified in DP § 1.36 e) i). In our opinion economic compulsion/incentive is needed to better understand the actual obligations of an entity.

(35) From a conceptual point of view, we see the economic compulsion/incentive as a mean to report the economic substance of a transaction. This is consistent with the approach retained by other IFRSs based on the principle of the highest and best use such as IAS 36 (impairment in relation to the higher of value in use and the set selling price) or former IAS 17 (consideration of the bargain purchase option in minimum lease payments under lease agreements).

(36) Whatever the classification approach retained by the Board, we consider that it is essential to end up with a clear and consistent position on this topic and we urge the Board to further investigate it. Currently IAS 32 is internally inconsistent on this topic leading perpetual instruments to equity classification while requiring considering indirect obligation in other situations.

(37) We would also find it useful to clarify the different concepts existing in the IFRS framework. Below is a first list of those concepts that we identified:
✓ Obligations established by “similar means” CF § 4.31
✓ Legal obligation derives from “other operation of law” : IAS 37.10
✓ “Constructive obligations” defined by CF § 4.31 and IAS 37.10.
✓ “Indirect obligation” defined by IAS 32.20
✓ And finally, the economic incentives quoted by the DP § 8.3.

(38) Investigating further this economic compulsion/incentive concept would probably lead the Board to look at the following questions:
✓ Should we have a continuous assessment?
✓ What would the threshold be?
✓ From which point of view should economic compulsion be analysed? The entity’s? Its creditors’? Its shareholders’ (with or without minority interests)?
✓ Any listed entity has an economic incentive to pay dividend as it may have a direct impact on its share price. However, nobody would consider that the consequence of that fact should be to classify ordinary shares as liabilities.

(39) We investigated several approaches to deal with economic compulsion. Below is a summary of our main conclusions to date.
✓ We considered using the WACC to assess whether an economic compulsion (such as an interest step-up) is genuine or not. But we lack a clear definition of WACC, and doubt that this indicator is the one considered by the management.

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5 See our answer to the previous DP in 2008.
We considered splitting the fair value of the instrument into two components and adjust them dynamically based on their relative fair value. If this approach seems conceptually interesting, it would be very complex to implement for entities and its cost/benefit ratio is not expected to be satisfactory.

We then considered the following approach:

i) Assess if there is at least one scenario where the entity would have an actual economic compulsion to pay (whatever its probability)

ii) If such a scenario exists then the instrument must be classified as a liability

That means it should consider any remote scenario where an economic compulsion could exist. This approach would be operational and seems consistent with CF § 4.37, but it would probably result in significant changes to the current accounting classification.

(40) To conclude, we understand and share the Board’s view that this topic is difficult to address in practice. But its impact on the debt/equity classification is so significant that the Board cannot simply disregard it just by saying that it is complex. We highly recommend that the Board further investigate this issue.

**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?*

(41) We are convinced that the classification should be based on rights & obligations of an entity and their impacts on cash flows.

(42) We do not see any conceptual reason to make such a huge difference between a contractual and a legal obligation. A relevant information is an obligation to deliver cash. The fact that this obligation stems from a legal or contractual requirement does not change the economic position of the entity.

(43) If having the law written in the contract or not has no impact on the rights and obligations of the entity, it should not impact the accounting classification either. In different jurisdictions, contractors may have different habits depending on the strength and stability of the law: in some jurisdictions everything that is contractual must be in the contract while in others contractors do not repeat the legal specifications which nevertheless apply.

(44) We acknowledge that the definition of a financial instrument relates to “contractual” rights and obligations, but it is in our opinion a secondary issue in this conceptual work on the definition of Equity.

(45) CF § 4.60 states that a legal obligation doesn’t need to be written in the contract to be taken into account as implicit obligations shall be considered as well. We acknowledge that the Conceptual Framework is not binding. However, any divergences with it should be justified as it can explain the Board’s rationale in diverging from the Framework in certain cases.