Accounting Standards Committee e.V.
Accounting Standards Committee of Germany
DRSC

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[*Entwurf einer Stellungnahme an den IASB, erstellt vom DRSC-Mitarbeiterstab, nicht vom IFRS-FA verabschiedet*]

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Mr Hans Hoogervorst
Chairman of the
International Accounting Standards Board
Columbus Building
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London E14 4HD

Berlin, ***[date]*** 2019

Dear Hans,

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

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the IASB Discussion paper DP/2018/1 *Financial Instruments with Characteristics of Equity* (herein referred to as 'DP'). We appreciate the opportunity to comment on the DP.

We are generally supportive of addressing the accounting for claims against an entity in light of the numerous requests submitted to the IFRS Interpretations Committee over recent years. In particular, the proposed clarification on the accounting for put options over ordinary shares is helpful. Further, we think that the suggested approaches with regard to presentation and disclosure are a good basis for further development.

We acknowledge that a generally accepted answer on the basic question "What is debt, and what is equity?" is hard to find as the views are highly diverse on what debt or equity is around the globe and across diverse stakeholder groups. Given the various types of claims against an entity, any approach based on the dichotomy is just a compromise. The only way to overcome the need for a compromise would probably be an accounting without any classification (claims approach); however, we are aware that there are many arguments, also from a preparer's perspective, against it.

That being said, we have considerable reservations as regards the preferred approach to classification, as referred to further below. In our understanding, the IASB's three key objectives for the research project on FICE had been

- to eliminate existing application problems (e.g. the accounting for NCI puts);

- to address the criticism of certain accounting results (e.g. puttables shares not subject to the puttables exception); and
- to enhance the information provided on both equity instruments and liabilities.

We wonder whether these objectives could not have been addressed with significantly less effort through narrow scope amendments to IAS 32. All in all we do not consider the preferred approach to be more suitable and robust than IAS 32. In particular, the preferred approach

- flip-flops between the entity and the proprietary perspective for classification, thereby undermining the conceptual validity of the suggested approach;
- leads to accounting results that call into question so far undisputed classifications and contradicts fundamental principles such as the going concern hypothesis, with potentially detrimental effects on regulatory capital (e.g. certain perpetual bonds);
- relies on the same exceptions as IAS 32 for certain accounting outcomes (puttable shares) rather than providing a model that encompasses the desired accounting outcome; and
- introduces new terminology that we believe introduces new and unnecessary complexity for stakeholders.

Our views in response to the ED questions are laid out in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Thomas Schmotz (schmotz@drsc.de) or me.

Yours sincerely,

Andreas Barckow

President

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Appendix – Answers to the questions in the DP

Question 1
Paragraphs 1.23–1.37 [of the DP] 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?

We basically agree with the analysis presented in the DP, and we think that the challenges mentioned in chapter 1 of the DP are pervasive enough to require standard-setting activity, including challenges arising from the application of IAS 32, such as the accounting for shares puttable at fair value or contingently convertible bonds. We further think the IASB is right in concluding there is a lack of transparency with regard to certain claims against the entity, be it due to insufficient disclosure requirements on equity claims or due to the traditional dichotomy that causes important characteristics not being reported sufficiently through classification, since the dichotomy cannot capture the complete variety of claims existing in practice.

On the other hand, we concede that others are of the opinion that IAS 32 works well in the vast majority of situations: Problems do exist, but they exist at the edges primarily. Any standard-setting activity should, therefore, be assessed against the enhancements that are expected to be achieved by it. We therefore acknowledge the balancing act between being helpful to those that wish to see their challenges addressed while, at the same time, not causing unnecessary disruption to other stakeholders. Against this background, we are not fully convinced that the preferred approach to classification is more understandable and leads to more intuitive accounting results – in short: is a 'better approach' – than the current requirements in IAS 32. In contrast, we deem some of the other proposals in the DP, especially the disclosure enhancements, to be promising and constituting a good basis from where to take things further.

In summary, we are of the opinion that a review of and any amendments to the requirements on reporting about claims against the entity should be made in two steps: Urgent amendments and quick fixes to IAS 32 *Financial Instruments: Presentation* including the enhancement of disclosures, clarifications on the accounting for shares puttable at fair value should be given priority. As regards the classification of claims, we recommend the IASB allow for more time and effort with the aim of developing a classification principle that is more robust and encompasses the desired accounting outcomes for transactions where IAS 32 relies on exceptions.

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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?

From a conceptual point of view, any approach to classification requires clarification as to how users' information needs should be prioritised to then assign the different levels of information to the means at hand. Clearly, a dichotomy has its limits, as it applies a two-class classification to economic phenomena that cannot be completely classified meaningfully into (just) two classes. We observe that any classification into a binary system is significantly driven by individual assessments made by various users or user groups with regard to the question what debt and what equity is from those individuals' point of view. This results in different stakeholders approaching equity differently and likely inconsistently to each other.

One solution would be to abandon any classification per se and listing the individual claims instead (the claims approach). We quote from our response on EFRAG's Discussion Paper *Classification of claims* (2014): *"The claims approach appears to bear a significant advantage vis-à-vis other alternatives, as – by classifying all claims as a single element – it avoids any arbitrary (and often potentially questionable) distinction between two or more classes of elements. However, we believe that for the claims approach to be decision-useful, it would require all balance sheet items to be recognised at fair value. Doing this consistently would, in essence, mean to present balance sheet information for the purpose of presenting or approximating the value of the reporting entity itself, which conflicts with the objectives of financial reporting as stated in OB7 of the CF ("General purpose financial reports are not designed to show the value of a reporting entity")."*

As the IASB has (tentatively) decided in favour of retaining the dichotomy, it needs to be considered what information cannot be captured through classification and, thus, must be provided for through other means, such as presentation and disclosure. Against this background, we agree with the IASB to split the issue into classification and other means of providing information.

When deliberating the IASB's preferred approach in more detail we struggled whether the approach to classification was meaningful. While we can easily support condition (a) above – the timing feature –, we question the validity of condition (b) – the amount feature. Most critically, we believe that there is an implicit flip-flopping in perspectives between the entity and

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proprietary perspectives to classification in the approach: Whilst condition (a) clearly starts from the entity perspective, condition (b) appears to emphasise the proprietary perspective more strongly. We acknowledge that a classification principle can be built either way; however: Once a perspective has been chosen, it should be adhered to in order not to cause inconsistent accounting outcomes. In our view, condition (b) could be waived if own shares were included in the definition of economic resources or financial assets. However, we acknowledge the IASB had already discussed this idea several times and ultimately rejected it.

Furthermore, we are of the opinion that the preferred approach bears a significant risk of adding complexity and cost by introducing new terminology, such as “independent of the entity’s available economic resources”. We question whether the efforts to be taken by preparers and other stakeholders in understanding and potentially implementing the preferred approach justify the benefits associated with the proposals and urge the IASB to consider how it can help stakeholders avoid or at least limit unnecessary efforts.

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?

When deliberating the IASB’s preferred approach for classifying non-derivative claims we firstly examined the two conditions, the timing feature and the amount feature. We note that the timing feature is already well established and accepted in practice as it is part of the classification requirements in IAS 32. We agree for a liability classification it should be relevant if an entity is required to pay cash before its liquidation.

Apart from our concerns on the amount feature mentioned in our answer on question 2, we believe that this condition introduces not just an additional layer of complexity, it might contradict the going concern hypothesis as laid out in the Conceptual Framework. We agree that the preferred approach will result in the same outcome as under IAS 32 in the vast majority of cases. However, there will be some changes in classification, e.g. with regard to irredeemable fixed-rate cumulative preference shares, as described in para. 3.15 of the DP. This type of instrument will be classified as a liability under the preferred approach while it is an equity instrument under IAS 32 requirements. The liability classification under the preferred approach results from the claim being for an amount independent of the entity’s available economic resources (the amount feature). In other words, even if the entity will never be required to transfer economic resources before its liquidation, the claim is classified as a liabil-

ity. The fact that, upon liquidation, the entity will have to transfer cash in an amount that does not change in accordance with changes of the available economic resources is decisive in this context. We believe this line of argument to be in conflict with the going concern hypothesis per the Conceptual Framework:

- Firstly, and according to the terms of the contract, the entity can defer payment into perpetuity as it is not obliged to pay anything before liquidation;
- secondly, and according to para 4.1 of the Conceptual Framework, "*it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations....*" Hence, if an entity has no intention to liquidate, why should it recognise an obligation?

Against this background we fail to see why such instruments should be classified as liabilities. Unfortunately, this issue is not addressed in the DP, and – if the IASB decides to keep the amount criterion – we recommend the Board having this contradiction resolved.

The ASCG performed outreach on the DP, and part of our constituency suspected that the implicit objective of having the amount feature was to limit the challenges arising from economic compulsion, since the bonds as mentioned above are deemed (and priced) as liabilities in the markets despite being accounted for as equity under IAS 32 by disregarding economic incentives. In general, they did not consider the amount feature being more appropriate than the fix-for-fix rule in IAS 32.

In addition to the above, the statement made in the DP that the new approach would not lead to fundamental changes does not seem convincing. A number of our constituents shared indicative results that point at the opposite. Certain hybrid claims that are currently classified as equity under IAS 32 would be classified as liabilities under the preferred approach involving consequences such as fair value measurement with changes recognised in P/L. We have been made aware of analyses of data extracted from Bloomberg showing that perpetual subordinated bonds that allow issuers to defer coupon payments indefinitely (as a part of such hybrid capital claims) with a minimum notional amount of EUR 120bn outstanding in total are expected to change its classification under the preferred approach. These claims are classified as equity under IAS 32 and have been issued in European and Non-European countries by entities with equity and/or debt instruments listed on a regulated market. It should be noted, that this figure just includes instruments for which "big data" are available. We expect the total amount of claims changing their classification to be significantly higher as for example comparable bonds issued via local or private placements are not considered in the figure above.

This change in accounting is likely to create significant consequences for market participants' behaviour, as many of those contracts involve special termination rights that will come into effect through reclassification. Particularly in countries with less well-developed capital markets, access to these types of financing would be severely hampered, which could also have a significant economic impact. Furthermore, the rating of entities affected might worsen as rating agencies might change their assessment of the entities' leverage based on new classification rules. Similar effects are expected for non-rated companies as in these cases the financial statements as published are of greater interest to investors.

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Question 4
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?

We agree that instruments that are classified as equity by way of the puttable exception in IAS 32 should continue to be classified as equity instruments. We assume that the term "puttable exception" in question 4 includes the instruments described in paras 16C and 16D of IAS 32, although these are not "puttable instruments" (in contrast to the instruments dealt with in paras 16A and 16B of IAS 32).

However, we note the IASB stating in para 3.35 of the DP that "*the classification and presentation principles of the Board's preferred approach do not address the challenge that arises when all an entity's claims meet the definition of a liability and no claim qualifies for classification as equity.*" Further, the Board explicitly lists in para 3.36 a number of concerns arising from the absence of any equity claim. The IASB thus implicitly states there should be at least one equity claim, as the complete absence of an equity claim is deemed problematic. We further understand this view to be the main reason for keeping the puttable exception in effect even under the new classification concept.

With this line of argument the IASB, de facto, adds another criterion to the preferred approach. In our view, this implicit criterion contains the condition that every entity shall have at least one claim that is classified as equity. However, the puttable exception as currently worded does not result in all entities having one equity claim at least since the conditions in paras 16A and 16B of IAS 32 seem to be far too narrow, which may be illustrated by the following: In Germany, there are more than 390,000 entities with the legal form of a partnership (general or limited) where the shares are redeemable. Most of the larger partnerships with revenues well above EUR 1bn each are family-owned businesses with debt instruments listed on a regulated market, hence, they must prepare financial statements according to IFRSs. For most of these entities the puttables exception is highly relevant and appears to be working as intended. Many smaller partnerships, however, are failing to meet some of the criteria necessary to qualify for the exception. These entities then are either trying to tap the unregulated market instead of the regulated market (in order not having to prepare IFRS financial statements) or are seeking to a qualified audit opinion (i.e. they do not apply IAS 32).

Thus, the question definitely remains open how to address the challenges that arise when all an entity's claims meet the definition of a liability and no claim qualifies for classification as equity. If the IASB were striving to avoid that situation, it may consider, firstly, having the puttable exception replaced by another principle, and in order to cover all relevant circumstances, e.g. by stating that the most residual claim is always equity, and secondly, making that third criterion explicit.

However, it should be borne in mind that this additional criterion would add further complexity to an approach that is already containing a high level of complexity. Another option would – as suggested by the IASB – be to keep the exception as an exception from the basic principle; however, we think the need for exceptions indicates a weakness of the approach, which

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left us with mixed views on a final recommendation to the IASB in this respect, taking the preferred approach as given.

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?

We agree with the IASB's proposal to classify derivatives on own equity in their entirety instead of splitting them into the individual legs of the exchange. A requirement to separately classify these individual legs would present a significant conceptual and operational change in current accounting practice; furthermore, the additional information value by accounting for the legs separately would probably not justify the efforts in doing so. In addition, we agree that the IASB's preliminary view for classifying derivatives on own equity is a logic consequence of the preferred approach developed in chapters 2 and 3 of the DP.

We further note that foreign currency rights issues are proposed to cease being classified as equity under the preferred approach. In principle, we welcome the IASB's intention to limit the number of exceptions to a principle. We further agree that the liability classification seems to be a logical consequence of the preferred approach.

However, we doubt that the preferred approach will lead to an appropriate classification outcome in this case. When developing the guidance in para 16(b)(ii) of IAS 32 in 2005, the IASB noted that "classifying [such] rights as derivative liabilities was not consistent with the substance of the transaction" (BC4F of IAS 23), a conclusion we definitely agree with. In the absence of a discussion indicating the contrary in the DP we further believe that the reasons that led the IASB in reaching that conclusion in 2005 are still present today.

Therefore, the IASB should either consider keeping the exception or rework the preferred approach. From a conceptual point of view, we prefer having the preferred approach reworked as we deem exceptions to a principle indicate that the principle is not robust enough. In addition, we repeatedly note the complexity of the preferred approach in general increases when detailing it further for derivatives on own equity. For example, specifying the amount feature as "the net amount of the derivative is affected by a variable that is independent of

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the entity's available economic resources" appears to be hard to use in practice. We would like to point out that we do not deem complex accounting principles to be a problem fundamentally; however, if replacing the underlying concept in IAS 32 with a different but equally or even more complex approach resulted in similar challenges (such as the need for exceptions), the new classification approach should be advised against.

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.

Do you think the Board should seek to address the issue? Why, or why not?

If so what approach do you think would be most effective in providing the information, and why?

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Although we support the basic idea of similar contractual rights and obligations being classified consistently, regardless of how an entity has structured those rights and obligations, we think the IASB is going too far in the DP. We acknowledge that, for example, convertible bonds can be duplicated by a combination of two single instruments being an ordinary bond and a conversion option; however, in the absence of perfect markets the convertible bond and the bond-and-option combination will never be exactly identical in legal and economic terms. Therefore, the idea of accounting like things alike has its limits.

The line of thinking behind the proposal to account for put options on own shares and convertible bonds identically appears even more arbitrary and less realistic to us: The accounting procedure presented in chapter 5 of the DP for put options on own shares introduces an implicit call option on shares that are – in fact – already or still outstanding. Whilst we conceded that this approach might have merits from a purely conceptual point of view, the reinterpretation of the actual circumstances into the opposite seems to be anything but understandable and practicable. Therefore, we disagree that the accounting for a written put option on own shares that is issued together with ordinary shares should be the same as the accounting for a convertible bond.

As to the second part of question 6 we believe that the alternative "separation of embedded derivatives from equity host instruments" could have merits, as it would best reflect the characteristics of such instruments. In addition, the users of financial statements would be able to see the dilutive effects directly from the balance sheet. On one hand, this seems consistent with the objectives pursued by the IASB with the research project and may therefore be sup-

ported. On the other hand, the proposal seems to be in conflict with the general notion of equity contained in the DP, i.e. presenting equity from an entity perspective, as a balance sheet presenting information about dilution would carry elements of the proprietary perspective; we are therefore reluctant to recommend the IASB going forward with the separation of embedded derivatives from equity host instruments. The reason is not that the ASCG disagrees with the proprietary perspective per se. However, we are strongly of the opinion that both the entity and the proprietary perspective cannot serve as a basis for financial statements at the same time. In the DP, the Board – in accordance with its conceptual framework – takes the entity perspective as its starting point, but does not consistently pursue it in the development of its ideas that follow.

Another practical issue to be considered in this context is that such a requirement would present a fundamental change of current accounting conventions. Furthermore, we fail to see whether the effort required for preparers to implement such requirement is reasonable, appropriate, and balanced by the benefits derived from it.

Please see also our comments on question 11 (legal vs contractual obligations).

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?

We understand the separation requirements as introduced in the DP as a means to isolate effects that some regard as counterintuitive, as these effects are resulting from claims being classified as liability although they carry characteristics of equity and are, thus, "felt" as equity from the point of view of a number of stakeholders. It might be concluded that the need for such additional information arises from a classification that is not generally supported by all stakeholders. In other words, the additional information provided either through presentation or disclosures is needed as the classification and its consequences (e.g. fair value changes are recognised in the statement of performance) might send the wrong signals to some users. If one continues this thought, one inevitably comes back to our initial intervention: Any classification is just more or less good a compromise that cannot depict economic phenomena to all users equally well. Therefore and repeatedly, we fail to see whether the preferred approach in general shall result in better accounting outcomes as IAS 32. Both approaches (as probably all classification approaches) are just a compromise for neither of which a generally accepted consensus can be reached.

If the IASB were to proceed with the preferred approach nonetheless, we support requiring additional information to compensate for the limits of that classification approach. However,

we note that also in this case the assessment of the IASB's ideas need to be considered against the background of the perspective assumed (i.e. entity vs. proprietary), which we think the IASB does not follow consistently in the discussion paper. On the basis of the entity perspective, which we think the IASB is assuming, the separation of value changes of liabilities that behave like ordinary shares in OCI (without recycling) appears appropriate as these effects are not indicators of the entity's performance. However, the reasoning for this proposal is not explained convincingly enough in the DP. We even noted views in our constituency that there were no counterintuitive effects that would require separation.

Against the background of these reservations, we welcome the criteria approach of the IASB for the separation of effects from value changes of partly dependent derivatives, as this is easier to implement in practice. Furthermore, the disaggregation approach is a disproportionate alternative to the criteria approach. For the same reasons, we do not support a requirement to separate all embedded derivatives from their host contracts, irrespective of their treatment under IFRS 9.

As to how the information on the separated effects should be provided, we are not convinced that this separation should be made on the face of the balance sheet and the income statement. We rather support disclosing these in the notes to the financial statements.

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?

We agree 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. We further share the IASB's assessment that the disclosure requirements in IFRSs do not result in appropriate information about equity instruments. Concluding, we agree these requirements should be enhanced.

Notwithstanding this, we do not support the IASB's suggestions on the distribution of the entity's earnings to equity instruments on the face of the balance sheet. Instead, we are of the opinion that these information deficits should be addressed through notes disclosures exclusively. Further, we disagree with the earnings allocation to derivatives classified as equity under any approach of a) to c) above – the main reason being the implicit notion suggested by the allocation, that the holders of such derivatives are already considered as holders of the equity instruments subject to the exchange transaction on the respective derivative's settlement. Furthermore, we oppose changing a fundamental principle of accounting according to which equity instruments are not subject to re-measurement, neither directly nor indirectly (as proposed in alternatives a) to c)). Consequently, we would only agree to provide this information via notes disclosures (alternative d)).

The enhancements that the IASB might consider by amending IAS 33 *Earnings per share* include disclosures on anti-dilutive derivatives and information on theoretical (possibly future) equity claims, e.g. in the case of derivatives. In this context, the users should be informed about any potential dilution in the future on the basis of instruments that are currently issued.

As regards non-derivative equity claims, we note that IAS 33 (being the basis on which earnings are allocated to non-derivative equity claims according to the DP) also has some defects that should be addressed. In particular, we would like to point out that the term 'preference shares' as introduced in IAS 33 as well as in IAS 32 and the DP is not defined and used in the same way globally. Instead, the term has different meanings in different jurisdictions, which may lead to confusion when applying this terminology for accounting purposes. This is amplified by the fact that none of the above-mentioned IFRS documents is actually defining the term. IFRSs just define 'ordinary shares' [IAS 33.5] and only provide (various) examples and scenarios of preferences shares, thereby acknowledging that "preference shares may be issued with various rights." [IAS 32.AG25]

Furthermore, it should be noted, that the applied principle of 'subordination' of preference shares in IAS 33 differs from that used in IAS 32 and the preferred approach in the DP:

- To distinguish ordinary from preference shares, IAS 33 focuses on their rights to receive dividends (by ordering the claims in dividends), i.e. ordinary shares participate in profits for the period only after other types of shares, such as preference shares, have participated. [IAS 33.6]
- To distinguish debt from equity instruments, IAS 32 and the DP also consider the requirement of a transfer of economic resources at liquidation (by ordering the claims in the entity's resources), i.e. terms and conditions that indicate the priority within the entity's capital structure (eg liquidation preference) are relevant. [IAS 32.18 lit. a and AG 25 et seq.; timing feature according to paragraph 2.17(a) in the DP] (For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share.)

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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?

Generally speaking, we believe information about the priority of financial liabilities and equity instruments on liquidation be useful and meaningful to users. In any case, such information should only be provided in the notes, rather than on the face of the balance sheet.

Notwithstanding the above, we do not think such disclosure to be meaningful in all instances. For example, such information could be misleading in the context of consolidated financial statements, since a group of legal entities is not itself a single legal entity that is subject to claims on liquidation. Such claims are always based on legal obligations vis-à-vis a legal entity and not a hypothetical one. Further, providing such information for a group would implicitly assume a winding up of the entire group bottom-up in a liquidation waterfall scenario, which might be the case but need not be (and in most cases will not be). If a group was in financial distress, it seems more likely that claims would not be settled by liquidating group entities but by disposing of them; furthermore, if entities were to be disposed of, disposals do not need to occur bottom-up.

Disclosures on terms and conditions as well as on potential dilution seem helpful to users. In relation to the latter we recommend requiring entities to distinguish between options that may currently be exercised and those that can only be exercised at a future date. Furthermore, we observe that there might be numerous claims against an entity whose terms and conditions might already be subject to disclosures. As a note of caution, we remind the IASB of the aims pursued in its disclosure initiative in that new disclosure requirements should only be required if necessary to understand the financial statements as a whole.

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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?

We agree that 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. Having discussed the pros and cons including the relevance of any probabilities, we concluded that for financial information to be clear and verifiable economic incentives should be disregarded. Furthermore, consideration of probabilities representing economic incentives might have unintended consequences that should be avoided.

However, economic incentives may come in various forms, including indirect obligations caused by legal restrictions to certain settlement alternatives or conditions making certain settlement alternatives becoming economically disadvantageous in every circumstance. We recommend clarifying this in a principles based manner in para 20 of IAS 32.

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?

We believe that, as a matter of principle, all terms and conditions that determine the relevant economic characteristics of a financial instrument should be considered when analysing it for classification purposes. We acknowledge that the contractual obligations form the best basis for that. However, as the relevant economic characteristics of a claim are often determined by legal and regulatory requirements in addition to those explicitly mentioned in the contract, an entity should not make its assessment solely on the contractual features.

An example for these claims is the partners' shares in a partnership under the German Civil Code. Those shares represent an obligation of the entity to pay – upon the partner's exit – an amount to the exiting partner they would receive if the entity had been liquidated at the time of his exit. According to most court decisions this clause is meant to represent an obligation to transfer cash in an amount equal to the pro rata share of the exiting partner in the entity's fair value. Therefore, the partners' shares in such entities are considered puttable at fair value. It should be noted that this clause must be adhered to even if the partners' option and their right is not stated in the contract. In this respect we believe that the notion "contractual

rights and obligations" should be referring to rights and obligations that arise from the existence of a contract, regardless of these rights or obligations being worded in the contract itself.

We acknowledge the issue might become more complex when an instrument changes its economic characteristics upon a regulator's or a lawmaker's decision. For example, a debt instrument may – upon a regulator's decision – change its characteristics in a way that makes the claim becoming an equity instrument under relevant accounting requirements (bail-in instruments). We note that, unlike with a puttable share, the party to decide upon the economic outcome of the claim is not a party to the contract which the claim is based on. The question that then needs to be clarified would be on which assumptions the classification at initial recognition of a bail-in-instrument shall be made? In our view, such instruments should be classified at initial recognition based on the terms applicable at issuance of the claim, i.e. any possible future regulator's actions or omissions should not be taken as genuine and, therefore, be disregarded until the regulator's action or omission triggers the change in the claim's characteristics.

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