

Mr Hans Hoogervorst  
IFRS Foundation  
7 Westferry Circus  
Canary Wharf  
London E14 4HD  
United Kingdom

7 January 2019

602/636

Dear Mr Hoogervorst

**Re.: IASB Discussion Paper 2018/1 'Financial Instruments with Characteristics of Equity'**

The distinction between equity and liabilities is of fundamental importance to financial reporting. This distinction impacts, for example, how an entity's financial position and financial performance are depicted, as well as other information provided about liabilities compared to equity, such as through measurement and disclosure requirements. Therefore, the IDW welcomes the IASB seeking to address the conceptual and current application challenges regarding IAS 32 in its Discussion Paper 2018/1 'Financial Instruments with Characteristics of Equity' (FICE). We appreciate the opportunity to comment.

**General Remarks**

IAS 32 *Financial Instruments: Presentation* defines financial assets and financial liabilities, whereas, in contrast, equity is the residual interest in the assets of the entity after deducting all liabilities (both financial and non-financial). Although the standard does contain some principles for distinguishing financial liabilities from equity instruments, which have become well-established in practice, we agree with the IASB on the lack of a clear conceptual basis. In consequence, a growing number of financial instruments – especially those that are derivatives or contain derivative features on own equity – continue to cause application problems in practice, which the IFRS Interpretations Committee

Institut der Wirtschaftsprüfer  
in Deutschland e.V.

Wirtschaftsprüferhaus  
Tersteegenstraße 14  
40474 Düsseldorf  
Postfach 32 05 80  
40420 Düsseldorf

TELEFONZENTRALE:  
+49 (0) 211 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:  
+49 (0) 211 / 4 54 10 97

INTERNET:  
[www.idw.de](http://www.idw.de)

E-MAIL:  
[info@idw.de](mailto:info@idw.de)

BANKVERBINDUNG:  
Deutsche Bank AG Düsseldorf  
IBAN: DE53 3007 0010 0748 0213 00  
BIC: DEUTDE33XXX  
USt-ID Nummer: DE119353203

GESCHÄFTSFÜHRENDER VORSTAND:  
Prof. Dr. Klaus-Peter Naumann,  
WP StB, Sprecher des Vorstands;  
Dr. Klaus-Peter Feld, WP StB;  
Dr. Daniela Kelm, RA LL.M.;  
Melanie Sack, WP StB

(IC) has been unable to resolve in the past given the current guidance in IAS 32.

Therefore, the IDW welcomes the IASB issuing the Discussion Paper. However, we question whether the Board's approach to resolve the practical and conceptual issues is achieving its objectives, especially regarding the proposed approach on presentation in the statement of financial position and the statement of comprehensive income. From our point of view, there are only two reasonable approaches to overcoming the current application issues and other challenges related to IAS 32. These are:

- a) Developing a completely new and comprehensive approach to distinguishing (financial) liabilities from equity – applicable to all financial instruments issued, without any significant exemptions; or
- b) Focusing on the resolution of the existing practical issues within the guidance in IAS 32, i.e. developing new requirements for (embedded) derivatives on own equity as they are the most challenging financial instruments in practice and the major source of application issues and IFRIC submissions on IAS 32. (In this context, we believe that one means to avoid structuring opportunities and an increasing complexity for any new requirements for derivatives on own equity would be to measure them all at fair value through profit or loss, adjusted by meaningful disclosure requirements.)

The Board's preferred approach proposed in the Discussion Paper seems to be a mix of the above-mentioned approaches. We have the impression that the approach was backward-engineered with the objective of resolving the issues described in the Discussion Paper without causing collateral damage to the classification outcomes of less contentious instruments. In our view, this is a missed opportunity in terms of the core classification model for the Board to reconsider fundamentally the distinction between liabilities and equity. Our main concerns regarding the Board's preferred approach are the following:

- Under the new principles entities will nevertheless have to reconsider nearly all their financial instruments. Entity-specific processes and systems will need to be developed or modified, potentially involving significant implementation costs without a clear benefit to users of financial statements. Given the intention of the Board not to change the classification outcome it is debatable whether the new approach will pass a cost-benefit analysis.
- New application issues and inconsistencies could arise, especially regarding those requirements of IAS 32 carried forward largely unchanged. This is aggravated by the fact that the two conditions (timing

and amount) create new and additional structuring opportunities in more than one dimension.

- Implications for the Conceptual Framework and other standards (amongst others, especially IFRS 2 and IFRS 9) have not yet been explored. We suspect that certain significant and some substantive consequential amendments to other IFRSs and the Conceptual Framework may be necessary to avoid unintended consequences. This will no doubt require significant standard-setting activities, and hence, resources at both staff and Board level.

Irrespective which approach the Board finally adopts for progressing the FICE-project, from a stakeholder's perspective it is crucial that any new requirements result in a common understanding and provide more clarity regarding the distinction between equity and liabilities. As stated in the Conceptual Framework, the overall objective must be to provide useful information, i.e. information that is both relevant and a faithful representation of the substance of the economic phenomenon. If the Board intends to substantially change the concept of IAS 32 with only limited consequences for the accounting outcome as currently proposed, it must be thoroughly assessed whether the benefits of those changes justify the costs that will incur.

In view of the above, we would like to comment on the specific proposals as follows:

### **Section 1 – Objective, scope and challenges**

#### **Question 1**

*Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.*

- 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?*
- 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?*

As mentioned above, the distinction between equity and liabilities is of fundamental importance to financial reporting. We are aware of significant application issues today in distinguishing between equity and liabilities according to IAS 32, especially in relation to the fixed-for-fixed criterion and convertible compound instruments (e.g. convertible bonds). Therefore, we are generally

supportive of revising the standard and we agree with the description of the challenges and their causes in the IASB's Discussion Paper.

In our view, the approach taken by the Board seems to be at first glance very ambitious and holistic. However, in detail we have the impression that this Discussion Paper provides only new wine in old wineskins. We question whether the Board meets its own ambitions in terms of resolving the existing application issues of IAS 32 in a way the information provided in financial statements will be improved, by simultaneously being cost-beneficial.

## **Section 2 – The Board's preferred approach**

### **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?*

The Board's preferred approach introduces two new classification criteria and, in this context, new terminology. From our point of view, the proposed approach seems to be straightforward prima facie. However, the new terms may give rise to new interpretation issues, e.g. around the meaning of 'available economic resources' and what the term liquidation means in times where in some industries, like financial services, liquidation is avoided by resolution or insolvency. In addition, the definition of the term 'liquidation' varies among jurisdictions.

The fact that specific requirements of IAS 32 (e.g. puttable exception, IFRIC 2) need to be carried forward creates concerns whether the Board's proposed approach is robust enough to reflect the economic characteristics of a very diverse and dynamic universe of financial instruments in terms of what is equity and what is not.

We acknowledge that the new classification criteria of the Board's preferred approach might support the existing classification model under IAS 32. However, this approach may not be equally appropriate for both non-derivative and derivative financial instruments. An example illustrating our concern is the application of the timing feature to derivatives on own equity. We question whether mixing the determining factor for funded instruments (i.e. the timing feature) and that for derivative instruments (i.e. the amount feature, which seem to be inspired by the fixed-for-fixed criterion) is a significant improvement over the current model and less prone to structuring. On the latter, we have significant doubt as stated above.

Moreover, the new classification criteria and terminology associated with the Board's preferred approach will require preparers and auditors to reconsider past classification decisions, i.e. they will need to reaffirm the current classification of financial instruments under the new principles, since whether it remains unchanged will not always be obvious. Consequently, entities will have to develop or adjust their processes and systems, incurring significant additional implementation costs.

We fully support the Board's preliminary view that information about features of claims that are not immediately reflected in the presentation of those claims should be provided through meaningful disclosures. Therefore, we agree that subordination is more a matter of disclosure than a matter of classification.

Improving presentation and disclosure of information about financial instruments is a significant part of the FICE-project. Moreover, we believe that enhancing IAS 32 with reasonable disclosure requirements would be one way of significantly improving the standard to meet users' expectations without changing the classification model. We question whether fundamentally new classification principles are needed to remedy the current shortcomings of IAS 32 if there is the risk of introducing new shortcomings. However, we acknowledge that the current guidance on derivatives on own equity in IAS 32 creates practical issues and hence, another way forward might be to focus on the fixed-for-fixed criterion, in addition to improved disclosures.

### **Section 3 – Classification of non-derivative financial instruments**

#### **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?*

Generally, we believe that the Board's preferred approach regarding the classification of non-derivative financial instruments is in line with the Conceptual Framework. However, we have some concerns over both, the timing feature as well as the amount feature.

Regarding the timing feature, we have the following remarks:

- The reference to liquidation is not necessarily required, as claims generally exist or arise in such a case due to legal regulation. According to the Board's preferred approach, law, regulation and any other legal instrument issued by an authority that might affect rights and obligations set out in a contract still play no role regarding the classification of financial instruments (we refer to section 8 of the Discussion Paper). If this is true, the timing feature would be irrelevant, because upon liquidation generally everything is regulated by law and therefore in the Board's view not relevant for accounting purposes. In other words, it would be sufficient to focus on a contractual obligation to deliver cash or another financial asset, as currently in IAS 32.
- Further, we question why the IASB has chosen a criterion based on liquidation which seems to be at odds with the fundamental principle of the IASB's Conceptual Framework that financial statements have to be prepared on a going-concern basis.
- Moreover, we would like to point out that the term 'liquidation' will need to be clearly defined by the IASB for IFRS reporting purposes, as there could be also 'grey areas' in the law in several jurisdictions. For example, the objective of the European Bank Recovery and Resolution Directive (issued 15 May 2014) is to avoid the liquidation of institutions that are failing or

likely to fail, if they might jeopardise financial stability, interrupt the provision of critical functions, and affect the protection of depositors. In such a case, the national resolution authority should place the institute under resolution and apply specific resolution tools rather than resorting to normal insolvency proceedings. However, although legally different to a liquidation, the circumstances that gave rise to a resolution are likely to be similar to those that usually cause a liquidation.

Regarding the amount feature, we question whether it would be in line with the Conceptual Framework to account for specific financial instruments (e.g. perpetuals) as a liability even though there is no expectation or even requirement of resulting in an outflow of resources embodying economic benefits of the entity.

In addition, we believe that there is an apparent conflict with the going-concern assumption as laid down in the Conceptual Framework and the applicability of the amount criterion in case of payments at liquidation as proposed in the Discussion Paper. We further question whether the new terminology does not create additional application issues, particularly the term 'economic resources'.

Depending on the ultimate model the Board agrees upon the practical issues around limited life entities and perpetual instruments should be analysed and potentially addressed.

#### **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?*

In general, we support the retention of the puttable exception under the Board's preferred approach, as the new approach does not solve all the issues that gave rise to the introduction of this exception in IAS 32 at that time.

More specifically, the Board may be aware that interests in German partnerships are puttable by law. Albeit the Board's preferred approach does not even consider legal requirements in specific cases (we refer to our answer to question 11), we suspect that the exception is still needed for those partnerships, because specific terms of exercising the put are rather defined in the statutes than by the law governing the put right.



## **Section 4 – Classification of derivative financial instruments**

### **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 welcome the Board's proposal to consider a derivative on own equity in its entirety for classification purposes, i.e. not separately classifying the individual legs of the exchange.

However, in general, the proposed approach seems to be very complex and not necessarily suitable for derivative financial instruments. Moreover, we suspect that the Board's preliminary view for classifying derivatives on own equity will not always result in reasonable outcomes (e.g. for put instruments on non-controlling interests (NCI), where grossing up is still needed) and, in addition, would offer structuring opportunities, since economically similar transactions could be presented differently (e.g. if own shares are used only as 'currency' on settlement compared to net cash settlement).

Derivatives on own equity are the most challenging financial instruments in practice. The IDW is supportive of an alternative approach which would include all derivatives into the scope of IFRS 9 *Financial Instruments* with the result of measuring them at fair value through profit or loss and presenting the equity transaction when these instruments are settled and (potentially) effective funding to the entity is provided. In our view, in absence of a robust classification principle for derivative financial instruments, this would be one way to avoid an increasing complexity of the requirements regarding derivatives on own equity.



In addition, such an approach would have clear merits of being conceptually robust and avoiding structuring opportunities that we have seen especially in relation to the current fixed-for-fixed guidance for both stand-alone derivatives and combined instruments. If this approach would be further explored, we note that meaningful disclosures of terms and conditions of derivatives on own equity are likely to be more useful to users of financial statements than trying to cater for the different terms under a complex presentation concept.

### **Section 5 – Compound instruments and redemption obligation arrangements**

#### **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?*

We are not convinced by the Board's proposals regarding compound instruments and redemption obligation arrangements.

According to the Board's preliminary views – based on the aim to achieve consistency between the classification of all arrangements that have the same settlement outcomes – the accounting treatment for written put options on own equity and convertible bonds should be the same, although the two instruments are different in nature. In our view, such transactions are not necessarily similar. For instance, investors will have different claims on liquidation: the investor in a convertible bond will have a claim to cash over the outstanding balances while the investor in puttable equity instruments will have a subordinated claim to the residual interest.

Furthermore, we are concerned about the proposed recognition of put options with a debit in equity as it requires the derecognition of the underlying equity interest (e.g. NCI will be immediately derecognised in equity when the put is written). This may not be appropriate, especially if it is neither clear nor highly likely that the equity is actually impacted (e.g. in case of net cash settlement). In addition, such requirement would likely impact the current derecognition guidance in IFRS 9 together with the guidance in IFRS 10 on transactions with owners of equity.

## **Section 6 – Presentation**

### **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 support the IASB's preliminary view that presentation should better reflect different terms and conditions of financial instruments that are relevant for an understanding of their possible impact on the entity. Therefore, we strongly support separate presentation in the statement of financial position, since the current IFRS only have limited guidance on presentation based on the different features of financial instruments issued. In this context, we observe some diversity in practice.

However, we do not agree with introducing new items in other comprehensive income (OCI) since we still think that the OCI lacks a clear conceptual basis. Recognising additional items in OCI will rather add complexity for users of financial statements without creating benefits that could not also be achieved by additional disclosures. The need for presenting specific income and expenses in OCI also implies a weakness in the underlying principle.

### **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?*

Providing additional information, especially about equity instruments other than ordinary shares, would contribute to a better understanding of an entity's financial position and financial performance. However, we are not convinced about attributing profit or loss and OCI to all equity instruments other than ordinary shares. In our view, better disclosures might be a more cost-beneficial way to meet users' information needs about equity instruments. Notably, we think that information on profit attribution should not be dealt with in IAS 32 or its successor standard but rather by amending or replacing IAS 33 *Earnings per Share*.

On the proposed approach to attributing earnings to derivative equity instruments, we are concerned that some of those approaches would implicitly require measurement of own equity directly which would be at odds with the underlying key concept of equity being a residual.

## **Section 7 – Disclosure**

### **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?*

In general, we agree with the Board's preliminary views on additional disclosures.

For example, the information about the priority on liquidation is certainly relevant to users. However, there are concerns on whether providing such detailed information, potentially per instrument, would be operational at group level. The Board must strike a balance between aggregation of that information and potential loss of informational value.

We appreciate the necessity to provide information about dilution that could arise from any potential increase in the number of issued ordinary shares. However, with consistency within and between the standards in mind, we prefer addressing those shortcomings in IAS 33 by amending or replacing the standard rather than supplementing the disclosure requirements of IAS 32.

## **Section 8 – Contractual terms**

### **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 observe that the concept of 'economic compulsion' is well-perceived in practice. Since the agenda decision of the IFRS IC (we refer to the IFRIC Update, November 2006: 'Classification of a financial instrument as liability or equity') all interested parties have come to terms with it, even though it offers further structuring opportunities.

The same is true for indirect obligations.

### **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 strongly disagree with the position taken on the relationship between contracts and law. Law, regulation or any other legal requirements issued by an authority in a particular jurisdiction might immediately affect the rights and obligations set out in a contract (or even make individual contractual provisions null and void) and therefore should be considered instead of being deemed not relevant for accounting purposes.

A non-consideration of law, regulation or any other legal requirements issued by an authority does not faithfully depict economic reality. Notably, we are concerned that the IASB appears to think that law, regulation or any other legal requirements does not play a role when applying IAS 32 and IFRS 9. In fact, there is some diversity in practice due to the lack of clear guidance on this issue in the current version of IAS 32.

We acknowledge that this consideration gives rise to additional challenges because a proper understanding of the applicable legal framework is necessary in addition to an understanding of the contractual terms and raises further

questions, e.g. when a contract is transferred between jurisdiction or when the law changes. Nevertheless, we believe the Board should spend more time on exploring this issue.

Thus, we think there should be a better distinction between legal rights and obligations that immediately affect a contract (i.e. a financial instrument) and are integral to its terms (e.g. a termination right). This contrasts with legal requirements that could only apply on a more abstract basis and do not immediately affect terms and conditions of specific instruments (such as a mandatory tender offer).

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

Ulrich Schneiß  
Vice Technical Director  
Accounting and Auditing

Kerstin Kliner  
Technical Manager  
International Accounting