la SOCIÉTÉ FRANÇAISE
des ANALYSTES FINANCIERS

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Discussion Paper "Financial Instruments with Characteristics of Equity"
Comments by the Financial Analysis and Accounting Committee of the French Society of Financial Analysts (SFAF)

Dear Sir,

The French Society of Financial Analysts, SFAF (Société Française des Analystes Financiers), is pleased to submit its contribution as part of the consultation undertaken by the IASB on the Discussion Paper " *Financial Instruments with Characteristics of Equity* ".

SFAF represents more than 1,500 members in France and is itself a member of the European Federation of Financial Analysts Societies (EFFAS), which comprises 26 member organizations representing more than 15,000 investments professionals. Its Accounting and Financial Analysis Committee intends to represent analysts and fund managers in the debate on accounting standards. Financial analysts are among the principal users of corporate financial statements and therefore wish to express their opinion on the implementation of new or revised accountings standards.

First, we would like to stress that the Discussion Paper is a very complex one. We also feel that there is a lack of clarity for some of the proposals. However, it is a key topic for financial reporting and therefore we did consider the DP as critical and performed a thorough analysis. Nevertheless, it took more time than expected to present our opinion in this comment letter and we hope that you will forgive our delay in answering.

Question 1 (page 27)

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?***

We consider that distinguishing between liabilities and equity is an important issue for users of financial statements. Therefore, establishing a clear and principles-based rationale for distinguishing between liabilities and equity makes sense, especially since complex instruments have been developed in the recent years.

We consider however that it may be challenging to establish a definitive distinction between debt and equity, as some instruments are complex and possess in equal terms features of each category. They sometimes sit on a very fine border line. Although they could be considered as belonging to a class of their own presented in between equity and liabilities, we acknowledge that the creation of a “mezzanine” category on the balance sheet would create other difficulties and we understand why the Board does not wish to pursue this avenue.

The views of issuers and investors for classification purpose may not be the same at a given point in time (and they may change over time depending on various factors such as market conditions). Furthermore, they may not need to be identical in the rationale developed for credit analysis and equity valuation which pursue different objectives. That is why we strongly support improving the disclosures required by the Standard to allow each type of user to conduct its own assessment when considering a peculiar instrument.

Establishing a clearer rationale for classification in the financial statements will be useful but will face some limits. This rationale, in spite or because of its limit, has to be complemented by adequate disclosure about all relevant characteristics of such instruments. Our experience currently is that disclosures that are provided by issuers do not often provide the relevant needed information.

As we believe that the classification rules in IAS 32 is not totally flawed and that users are accustomed to the current classification criteria, we consider this FICE project should take the form of an improvement to IAS 32 rather than leading to a totally new standard.

Finally, the IASB should be aware that SFAF has a better understanding of financial reporting by listed companies, whereas such project may have some impacts on private companies, such as situations of private-equity structured financing, which we are not able to assess with the same level of confidence.

Question 2 (page 41)

The Board's preferred approach to classification would classify a claim as a liability if it contains:

> ***(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or***
>
> ***(b) an unavoidable obligation for an amount independent of the entity's available economic resources.***

This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

We agree with the Board that, as equity is a residual, one should focus on defining characteristics that lead to classifying an instrument within liabilities. We consider that the proposed approach that combines two criteria is appropriate. This approach seems indeed to simply clarify and reinforce an existing concept whereas there was a need for clarification. We agree indeed that it is necessary to return to sound principles. As we are comfortable with the IAS 32 underlying (but not always clearly stated) principles, the objective should be to formulate more clearly the fundamental principles, that should apply to all newly developed and to future instruments, in order to help solve identified application problems; this should be completed by disclosures for complex or unusual cases.

Question 3 (page 49)

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?

We have the same response as for Question 2

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Question 4 (page 54)

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 are not disturbed by this exception, as a strict application of the criteria to certain types of entities may result in a counter-intuitive financial presentation i.e. all the equity instruments being classified as liabilities when there is indeed a permanent and loss-absorbing financing of the entity.

Question 5 (page 67)

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:***
  - ***a. 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***
  - ***b. 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?

Yes, we agree as paragraph (b) offers similar treatment as that for stock appreciation rights (as per IFRS 2).

Question 6 (page 89)

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 need further clarification to answer the question.

Question 7 (page 104)

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 roughly agree with the preliminary views stated in paragraphs 6.53–6.54, particularly the "OCI" presentation. However, we would appreciate further clarification on the scope of this separate presentation. Regarding the question related to embedded derivatives, we understand that the question is raised for embedded derivatives which are not separated from the liability AND that the whole liability is measured at fair value through profit and loss. Therefore, ie a drop in the share price could result in a gain which is counter-intuitive. We would suggest to further investigate the nature of embedded derivatives to assess the cost of application. Is it more costly than the separate presentation in OCI of the credit risk ?

Question 8 (page 117)

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 estimate as laudable the efforts made by the IASB to attribute earnings to the various classes of instruments. In a nutshell, who are the winners and the losers in the distribution of economic resources produced.

We consider however that one of the application issues is related to a potential mismatch that arises when reported income arises both from fair values changes and from items carried at historical costs. The amount of the Comprehensive income attributed to ordinary shares is not very meaningful to users[1], when it is calculated by substracting income attributed to other equity instruments on a fair value basis from total comprehensive income determined under a mixed-measurement basis.

Such an approach is very complex and may be too theoretical. The various examples proposed for attribution (page 112) illustrate how the attribution of comprehensive income may vary according to the methodology retained.

We consider that such an approach should be robust and that the issuer should be able to explain it to users in a clear, robust and understandable manner.

In addition, it should be applicable also to non-public entities. We consider indeed that such an approach may be difficult to apply in such cases.

As these methodologies rely extensively on the fair value of the various instruments at the end of the period or during the period, the outcome of such attribution will significantly depend on the reliability of the calculation of each instrument's fair value. As issuers, especially smaller one's, are not expected to be expert in such calculation, they may heavily depend on third party knowledge. This will not only prove costly to implement, but may also be the cause of some caution when explaining the outcome of such calculation.

As a first approach, we would favor an enhanced approach "d", as "a", "b" and "c" are too complex as explained above. Approach "d" should indeed be enhanced with disclosing data and sensitivity analysis on each material input to the measurement.

We consider also that it may be better to provide users of financial statements with sensitivity analysis, so that they make their own calculation.

Finally, we consider that if the Board decides to retain one of the contemplated methodology, the results should be presented in the notes rather than in the Primary Financial Statements because of the potentially counter-intuitive results.

[1] All SFAF comment letters, on accounting matters to the IASB, ESMA, EFRAG, and the European Commission are available at http://www.sfaf.com/base-documentaire/ in the category Accounting & Financial Analysis Commission. For comments specific to Comprehensive Income, the comment letter on ED *Presentation of Items of Other Comprehensive Income*, the views of users is available directly at www.sfaf.com/download/24/

Question 9 (page 124)

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?

We consider that

(a) providing at the end of each reporting period information about the priority of financial liabilities and equity instruments on liquidation may be very complex to present, as priorities may change depending on the circumstances (e.g. market situation). While such information could be interesting, we are not sure issuers would be able to present an order of priority. However, they should fully disclose each relevant factor;

(b) summary information about potential dilution of ordinary shares should be made available in the financial statements;

(c) Information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements. The main issue is about application of materiality, as we do not need to use all the legal details about such instruments. We need their main financial characteristics, so that we get true and fair view of the financial situation of an issuer. We would favor an easy access with an Internet link to the prospectuses or by cross-reference to other readily available published information.

Question 10 (page 131)

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 are not sure to understand the exact outcome of the paragraph 20 of IAS32. Providing typical examples would help in our analysis.

Nevertheless, we consider that in general, economic compulsion (i.e. the effect of significant economic incentives) should be considered when classifying a financial instrument. As an example, if the interest rate of an instrument is expected to significantly increase over time, absent the exercise of the issuer's call option, then there is a clear indicator that such an instrument would likely be reimbursed by the issuer under a good financial management behavior (stewardship). In spite of difficulties linked to application of economic compulsion, we are reluctant to disregard this principle. As a reminder, IFRSs are supposed to portray economic substance over form, i.e. to reflect a closely as possible the most likely outcome in a given set of circumstances. Refer for instance to IAS 37 constructive obligations and to the notion of "more likely than not". Relying only on the contractual ability to avoid repaying the instrument, whatever the cost to the issuer, may be a too legalistic approach.

Question 11 (page 134)

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?

Please see comments above.

We thank you for the opportunity given to us to provide our view on such important aspects of financial reporting for users. If you would like to further discuss the views expressed in this letter please do not hesitate to contact us.

Yours faithfully,

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