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May 13, 2019

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London, UK E14 4HD

RE: Financial Instruments with Characteristics of Equity

Dear Mr. Hoogervorst:

CFA Institute[1] appreciates the opportunity to comment on the International Accounting Standards Board ("IASB" or the "Board") discussion paper, *Financial Instruments with Characteristics of Equity* ("DP" or the "Discussion Paper").

CFA Institute is comprised of more than 166,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

OVERALL PERSPECTIVES

We welcome and support the DP's objectives of developing a strong conceptual basis for classification, presentation and disclosure of financial instruments. The issue has become important as more complex hybrid instruments have been issued since the financial crisis. These instruments are specifically designed to provide the best reporting outcome navigating between complex accounting rules, evolving regulatory regimes and local tax considerations. This results in difficulty for users in their ability to fully understand the economic implications of these complex instruments. That said, we believe the issue is not just confined to financial instruments but is more pervasive[2] than the narrow scope articulated in the DP.

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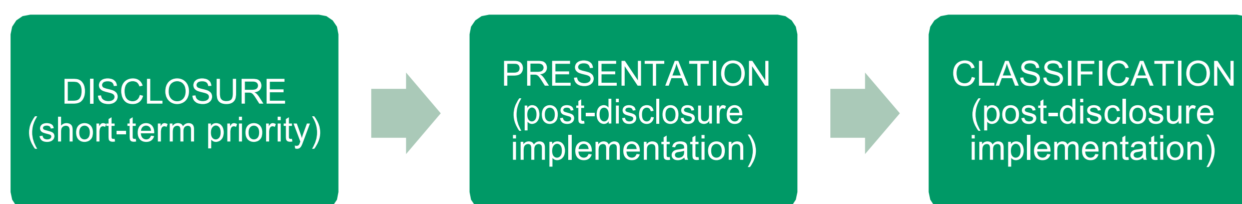
[1] With offices in Charlottesville, New York, Washington D.C., Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 166,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 163 markets, of whom more than 159,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 152 member societies in 74 markets. For more information, visit www.cfainstitute.org.

[2] A very good recent example of such an innovation is a sale and leaseback transaction with a joint venture involving third-party funding. The reporting entity retains control in the joint venture and consequently reverses the entire transaction in its consolidated financial statements. The joint venture legally acquires the asset from the parent company and funding from the third party for its minority stake. This asset is then leased back to the parent entity which agrees to pay fixed cash flows like an operating lease. A separate shareholder

An absence of a solid conceptual framework results in adverse behavioural consequences (e.g. structuring to meet accounting outcomes) which obscures the underlying economic reality. These consequences are exacerbated by the pace of innovation in instruments and various structured finance products. These innovations have led to new ways of shaping the distributions of risk and cash flows and new ways of circumventing existing accounting principles for claims. These innovations have not only challenged traditional liability and equity concepts but have led to increasing efforts to obscure the nature of the claims against company assets as well as the risk and reward distributions inherent in those claims.

Because of these factors, we think the IASB – as well as the FASB – should currently focus on improving disclosures of debt and equity instruments. With improved disclosures all stakeholders – preparers, auditors, investors and standard-setters will be better informed to address the classification of debt versus equity instruments issue. The classification and presentation of debt and equity instruments, along with implications for certain other standards, can then be addressed later based on a more complete view of the types of instruments needing to be assessed under a broader project. Further, the availability of the information will allow market participants to better assess and make their own conclusions regarding the debt versus equity treatment of the instruments. Our preferred path forward is highlighted in **Figure 1**.

FIGURE 1: PREFERRED PATH FORWARD



We believe improving disclosures and then addressing presentation and classification after having more information to truly improve the underlying conceptual principle will result in a far greater long-term benefit than the current approach of making limited changes to the current standards. We believe the current quick fix will not result in a lasting solution. Under the proposed approach in the DP, we believe the Board will be involved in a continuous process of tweaking the standards to keep up with an ever faster changing landscape of financial innovation.

We believe the best long-term solution is that the accounting boards devise a disclosure which has a broader scope – covering the entire liability and equity side of the balance sheet; based on a solid conceptual basis addressing information needs of its users; and having its own definition and

agreement between the joint venture shareholders ensures that all residual cash flows are distributed by the joint venture. Economically, this is a debt or debt-like obligation under IFRS 16, *Leases,* and should have been recognized as a lease obligation. Instead it results in being recognized as a minority interest on the consolidated balance sheet. The transaction could be debated, but the underlying root cause for such structuring opportunity is an absence of a sound conceptual basis to distinguish debt and equity concepts.

criteria for what is debt and equity, independently – irrespective of the fact that it could conflict or confirm the current accounting literature.

WHY STARTING WITH DISCLOSURE IS A BETTER IDEA

Our previous comment letter on the 2014 *Conceptual Framework Discussion Paper: Distinction Between Equity and Liabilities Instruments* sets forth our broad conceptual method for distinguishing between debt and equity. The classification and presentation of debt vs. equity has been an intractable problem for standard-setters (i.e. both the IASB and FASB) for a variety of reasons, not least of which is the desire for accountants to make a simple bifurcation of debt versus equity in a world when the spectrum and complexity of instruments does not lend itself to a bimodal solution to a multimodal problem. The pursuit of a solution is made more difficult by limited disclosure regarding the instruments being classified which leaves standard-setters attempting to classify instruments as debt vs. equity when they have little information regarding the precise nature of the instruments. Further, the pursuit of this debt vs. equity distinction seems to perpetuate a belief that investors don't look beyond this very simple analysis and distinction – possibly because there is a view by accountants that analysts and investors use ratios based upon debt and equity financial statement classification and presentation without adjustment. That is not the case. Sophisticated investors (i.e. price makers) in both debt and equity instruments seek to understand their priority in the waterfall of financing instruments and to perform sophisticated modelling to determine the risk and value of the instruments in which they invest or that proceed them in payment priority. In fact, many investors and credit rating agencies, make their own determinations and adjustments for debt and equity.

We believe it is exceptionally difficult in the short term to address classification, presentation and disclosure issues simultaneously due to various factors – competing information needs of fixed income versus equity analysts; investment philosophies ("point in time" versus "through the cycle"); multidimensional nature and complex terms included in underlying instruments; and the possibility of various outcomes arising from contractual, legal and economic circumstances. In addition, we believe there could be unintended consequences for wider capital markets considering the significance and nature of these instruments. Therefore, the first step should be initiation of a disclosure project which meets the needs of investors.

OUR RECOMMENDED DISCLOSURE: BASED UPON A NARROW DEFINITION OF EQUITY

Standards that are based on a solid conceptual basis provide clear and transparent guidance for preparers to comply with and comparable information for users to understand the underlying transactions. Unfortunately, a lack of clear and consistent guidance to differentiate debt and equity has resulted in diversity in practice – and with limited disclosures, investors are challenged to make their own presentation and classification adjustments. We believe the IASB should use a disclosure project as an opportunity to test a solid conceptual definition in an independent disclosure to resolve this lingering issue or where not solvable, let market forces decide. The first step should be to identify what is the key set of information that should be sufficient to meet the needs of a diverse user-group and then apply a solid conceptual basis to test it on instruments that are most problematic in practice.

In our opinion, the ideal disclosure should provide a waterfall table of claims arising from senior secured, senior unsecured, junior, subordinated claims and residual interest distributable to equity participants. Different countries could have a variation of claim categories based on local laws. However, a disclosure broadly covering these categories with simplified guidance would be operationally easier for preparers and exceptionally helpful for users. Our recommended disclosure differentiates “Claims” and “Equity Participants” based on the following definition:

> *Equity participants should be defined as the lowest ranking group that would be entitled to distribution collectively at the same point in time; and neither there is an obligation nor an option for an entity to transfer economic resource(s) to such a group. Any instrument, obligation, provision contingent liability or other claims not meeting this definition or up till a point in time it meets this definition, will be included as a Claim.*

Our definition complies and tightens the conceptual framework definition of equity:

> *Equity is the residual interest in the assets of the entity after deducting all its liabilities.*

Appendix 1 provides an assessment of our advocated definition of instruments impacted by this issue on our recommended disclosures. **Appendix 2** provides illustrative examples disclosing the impact of some of the financial instruments included in **Appendix 1.**

While we recognize the aforementioned definition conflicts with the concepts introduced in the DP and the current accounting standards – specifically IAS 32 and IFRS 2 guidance around equity-settled transactions – we have proposed it for purposes of building a disclosure that provides characteristics of instruments that are other than the most basic equity instruments.

We have discussed and developed our concept without any consideration as to how it could change the accounting outcome for certain instruments as our objective is better information based on a robust conceptual definition.

ILLUSTRATION OF RECOMMENDED DISCLOSURES

We have provided, in **Appendix 2**, an illustration of a proposed disclosure for both a limited liability company structure which represents a consolidated group perspective and includes amounts generally arising from individual financial instruments (separate legal contracts). The other example is based on a private equity structure which covers separate streams of claims and equity rights originating from a single legal contract – a limited partnership agreement between general and limited partners. We believe the disclosure should:

1. Be prepared on a going concern basis;
2. Provide visibility regarding whether the debt resides at the parent or subsidiary level and whether there are any restrictions on cash flows to the entity where the debt resides;
3. Provide priority claim rankings by group (instead of by specific ranking order for each claim which could be operationally very difficult) to map and keep track of changes in the underlying items and positioning in different legal entities within the corporate structure.
4. Assume minority interest is equity, based on a simplifying group assumption. Technically, a minority interest at a subsidiary level could rank higher over a secured lender at an intermediate holding level. We believe the simplified assumption should ease the operational burden for preparers but would still provide relevant information for users to understand the economic reality;
5. Include disclosures (alongside existing risk, fair value liquidity disclosures) such as estimates of contractual and expected cash flows, contractual maturity period(s) and contractual maturity yield(s);
6. Include qualitative and quantitative notes relating to settlement option owners (holder, issuer, both or contingent) and settlement options and potential dilution risk for equity participants. We support paragraph 7.22 and 7.23 which provides a list of disclosures and an illustrative quantitative table to cover the potential dilutive impact on equity participants; and
7. Provide a hyperlink reference to the original legal document or a summary page containing key terms and conditions.

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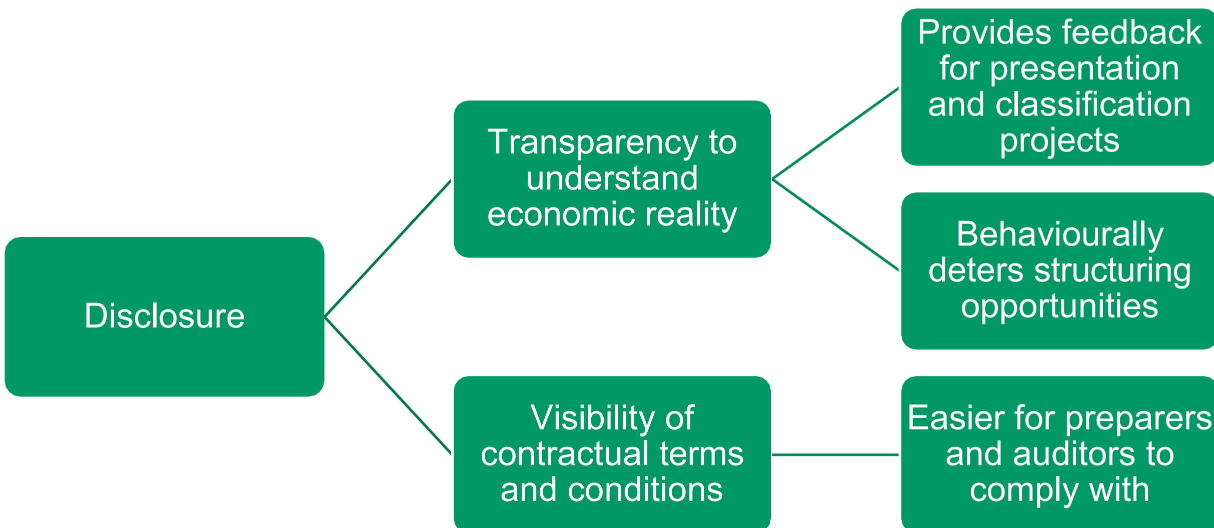
<u>**BENEFITS OF RECOMMENDED DISCLOSURES**</u>

FIGURE 2: BENEFITS OF IMPROVED DISCLOSURES



In addition to the important benefits included in **Figure 2**, we believe our recommended disclosure will provide:

1. Consistent and comparable ROE and leverage ratios irrespective of structure or mode of financing;
2. Sufficient granular information for users and regulators to make adjustments to their metrics or ratios based on their internal methodologies or regulatory directives;
3. Greater transparency for markets and policymakers providing an improved macro view including having information that would be consistent at a global level;
4. Less cumbersome compliance for preparers and auditors as information is principally sourced from contracts, local laws and regulations and is less prone to risk of errors;
5. Disincentives to aggressive accounting, structuring or window-dressing of transactions due to greater visibility regarding economic reality;
6. An analysis of the entire liability and equity side of the balance sheet than connects nicely with current disclosures on risk, liquidity and fair values;
7. A more holistic view of the business for both external users and internal users (responsible for corporate governance); and
8. Understandable and transparent information regarding capital structures.

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SPECIFIC QUESTION RESPONSES

The following part of the letter responds to specific questions mentioned in the Discussion Paper. We have responded to selected sections and questions which either clarify or explain our overall perspective.

Objective, Scope and Challenges

Question 1: Paragraph 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?***

We agree with the Board's description of the challenges and their causes. However, we believe the lack of conceptual basis to distinguish debt and equity instruments is a more pervasive issue that needs to be address not only for debt versus equity in IAS 32, but also within other standards. We support the ASAF members, suggestion in paragraph 1.13(c) for a fundamental review of the distinction between liabilities and equity based on sound concepts – this has the advantage of avoiding inconsistencies and exceptions arising in the future.

We agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity. However, the Board should split the entire project into short-term and long-term priorities. The short-term priority should be a disclosure note as mentioned above.

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 summarized 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 support a narrow definition of equity or basic ownership approach (as discussed in paragraph 2.43 of the DP). We disagree with the Boards preferred approach as we do not believe that it will improve transparency or comparability for users of the financial statements.

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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 suggestion 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 view on disclosures?

We agree and support the Boards' view that this information should be provided in the notes to the financial statements. The waterfall disclosure along with potential dilution effect will be very beneficial for both fixed-income and equity analysts. We believe our suggested disclosure, which has similar themes discussed in the discussion paper, will enhance transparency for the wider stakeholders. It also provides a greater visibility regarding capital structure and potential changes to it in the future. Please refer to **Appendixes 1 and 2** for more details.

We will again reiterate the importance of disclosure to users and request the Board to expedite its process to publish an exposure draft as soon as possible. The classification and presentation should be delayed until the completion of disclosure project.

Contractual Terms

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 scope of IAS 32? Do you agree? Why, or why not?

We disagree with the Board's approach of limiting its scope. We fully understand that there could be wider implications if the scope is broadened to include laws, regulations and constructive obligations. The limited scope could be operationally easier for preparers, but it will be very detrimental to the interest of users. Users include all claims in their analysis and therefore would strongly recommend a disclosure note that completely and comprehensively includes all types of claims. Please refer to **Appendixes 1 and 2** for more details.

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We are aware that there could be disruptions and unintended consequences if the Board decides to pursue all sections of the DP. Considering these implications, we believe the Board should postpone the classification and presentation part of the project and only proceed with disclosures. The effectiveness and feedback from the disclosure project would then provide vital strategic direction and evidence to identify shortcomings and make improvements to IAS 32, IAS 37, IFRS 2, IFRS 9 and IFRS 16.

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Thank you again for the opportunity to comment on the Discussion Paper. If you or your staff have questions or seek further elaboration of our views, please contact either Sandra J. Peters, CPA, CFA by phone at +1 2127548350 or by email at by email at sandra.peters@cfainstitute.org or Kazim Razvi, FCCA, by phone at +44 2073309549, or by email kazim.razvi@cfainstitute.org.

Sincerely,

/s/ Sandra J. Peters

Sandra J. Peters, CPA, CFA
Global Head, Financial Reporting Policy
Advocacy Division
CFA Institute

cc: Russell G. Golden
Chair, Financial Accounting Standards Board

APPENDIX 1

DISCLOSURE CLASSIFICATIONS

Appendix 1 provides an assessment of our advocated definition on instruments impacted by this issue on our recommended disclosures.

NO.	INSTRUMENT	WATERFALL CLASSIFICATION
1	**PUTTABLE FINANCIAL INSTRUMENTS**	**Claims.** Will always be included in Claims; except in a rare circumstance, when all holders of such instrument exercise their right at the same point in time. We believe this is the right outcome if one is considering liquidity or/and solvency risk. Regarding points mentioned in paragraph 3.31 of the DP, we recommend a full fair value balance sheet to address measurement issues.
2	**PREFERRED RETURN – PRIVATE EQUITY**	**Claims.** Will always be included in Claims, as this legally ranks before the final distribution between the general and limited partners.
3	**EQUITY-SETTLED REMUNERATION (RESTRICTED STOCKS OR STOCK OPTIONS)**	**Equity.** Will be included in Equity provided the only option to settle is by issuing shares. Therefore, an entity that has restricted itself to settlement by issuance of shares and cannot buy stocks from the market.
4	**CONVERTIBLE BOND**	**Equity.** Will be included in Equity when settlement by issuing shares is the only possible outcome. It must have same ranking and distribution rights as other equity participants.
5	**PREFERENCE SHARES**	**Equity.** Will be included in Equity if they are irredeemable and when settlement by issuing shares is the only possible outcome. It must have same ranking and distribution rights as other equity participants.
6	**MINORITY INTEREST**	**Equity.** Will be included in Equity as it meets the definition. However, any arrangement where economic resources could be transferred (like sale and leaseback via SPV with a minority investor) will require such arrangements to be included in Claims even if it is classified as a minority interest on balance sheet.
7	**NCI PUT (MINORITY SHAREHOLDERS)**	**Equity.** Will remain in Equity if settlement by issuance of shares is the only possible outcome. However, if there is an option to cash settle then it will be transferred to Claims until the option expires.
8	**MEMBERS' SHARE IN COOPERATIVE (IFRIC 2)**	**Equity.** Will generally fail the definition of equity and will be included in claims (similar to puttable financial instruments) except for the proportion of shares which are irredeemable, carries same ranking and distribution rights as other equity participants.
9	**A DERIVATIVE TO DELIVER A FIXED NUMBER OF ENTITY'S OWN SHARES FOR A FIXED AMOUNT OF CASH IN ANY CURRENCY**	**Equity.** Will always be included in Equity provided the shares issued have same ranking and distribution rights as the other equity participants. The amount in the disclosure table is recognized when the transaction happens. The note on dilution will provide more information about "timing" and "amount" of impact for such instruments.
10	**A DERIVATIVE ON OWN EQUITY INSTRUMENTS**	**Equity.** Will always be included in Equity provided it has similar ranking and distribution rights as other equity participants. And, there is no possibility of outflow of economic resources (or until a point in time this becomes certain).

DISCLOSURE ILLUSTRATIONS

Appendix 2 provides illustrative examples for limited liability and private equity structures disclosing impact of some of the financial instruments included in **Appendix 1.**

Illustrative Waterfall Disclosure - Limited Company							AC - Amortised Cost; CV - Current Value; and HC - Historical Cost
							G - Group (not concentrated in one place) ; P - Parent; S - Subsidiary; and O - Other
	------------------------------------- 2019 -------------------------------------						
			Contractual		**Settlement**		**Details**
	Act.	**Amount**	**Maturity**	**Annual**	**Option**	**Corp.**	
	Mthd	**$**	**Months**	**Yield**	**Owner**	**Struct.**	
Senior Secured Claims							
Lease obligation (sale and leaseback)	AC	20,000,000	60-120	4%-7%	None	S	
Minority interest (sale and leaseback)	AC	500,000	63	5%	None	S	
Secured bond	AC	80,000,000	72	3%	None	P	
Total senior secured claims		**100,500,000**					
Senior Unsecured Claims							
Trade creditors	AC	6,000,000	3-4		None	G	
Tax liabilities	AC	750,000	12-15		None	G	
Pension deficits	CV	1,000,000	0-1200		None	G	
Equity-settled remuneration	CV	300,000	3-48		Issuer	P	Settlement could be made by issuing ordinary 10,000 shares.
Total senior unsecured claims		**8,050,000**					
Junior Claims							
Bank overdraft	AC	100,000		10%	None	G	
Committed facility		-	36	5%	None	G	$2 million contractually agreed facillity with banks.
Convertible Bond	AC	5,000,000	52	0%-20%	Contingent	P	Settement could be made by issuing ordinary shares equal to $5 million.
Total junior claims		**5,100,000**					
Subordinated Claims							
Minority Interest (NCI Put)	CV	2,500,000	24-36		Holder	S	Settlement could be made by issuing ordinary shares equal to FV of minority interest.
Shareholder loans	AC	100,000	18	1%	None	P	
Redeemable preference shares	AC	500,000	120	2%	None	P	
Share buybacks (excluding remuneration)		-	0-48		None	P	$10 million approved mandate to do share buyback from the capital markets.
Total subordinated claims		**3,100,000**					
Total claims		**116,750,000**					
Equity							
Minority Interest (NCI Put)	HC	75,000			Holder	S	Settlement would be made by issuing ordinary shares equal to FV of minority interest.
Warrants	HC	-	37		Holder	P	Settlement would be made by issuing 10,000 shares at exercise price of $58 each.
Equity-Settled Remuneration	HC	-	3-48		None	P	Settlement would be made by issuing ordinary 10,000 shares.
Ordinary Shares (less buybacks)	HC	(17,834)			None	P	Shareholders hold 75,341 outstanding shares at par value of $10 each.
Total capital		**57,166**					
Additional disclosures by category - Issuer, holder and contingent settlement option (Qualitative); and dilution risk for equity participants (Paragraph 7.22-23).							
A hyperlink reference of documents in the table would be helpful for users.							

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Illustrative Waterfall Disclosure - Private Equity						AC - Amortised Cost; CV - Current Value; and HC - Historical Cost
	---------------------------- 2019 ----------------------------					
	Accounting Method	**Amount $'**	**Maturity 'Months'**	**Contractual Yield**	**Settlement Option Owner**	**Details**
Senior Secured Claims						
Lease obligation	AC	500,000	60-120	5%	None	
Secured bond	AC	1,500,000	72	2%	None	
Total senior secured claims		**2,000,000**				
Senior Unsecured Claims						
Trade creditors	AC	675,000	3-4		None	
Tax liabilities	AC	300,000	12-15		None	
Total senior unsecured claims		**975,000**				
Junior Claims						
Bank overdraft		1,000		9%	None	
Bond		500,000	52	3%	None	
Total junior claims		**501,000**				
Subordinated Claims						
Capital - limited partner	CV	80,000,000	24-40		None	Capital contribution from limited partners.
Preferred return - limited partner	CV	12,000,000	24-40	8%	None	Minimum 8% hurdle rate for limited partners.
Carried interest - general partner	CV	500,000	24-40		None	Payout for general partner for exceeding the hurdle rate.
Total subordinated claims		**92,500,000**				
Total claims		**95,976,000**				
Equity						
General Partner	HC	200	24-40		None	General partner entitled to 20% of the residual value.
Limited Partner	HC	800	24-40		None	Limited partner entitled to 80% of the residual value.
Total capital		**1,000**				
Additional disclosures by category - Issuer, holder and contingent settlement option (Qualitative); and dilution risk for equity participants (Paragraph 7.22-23).						