MNP LLP

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

Re: Discussion Paper ("DP") - Financial Instruments with Characteristics of Equity ("FICE")

Dear Sirs/Mesdames,

Thank you for the opportunity to comment on the above noted document.

MNP LLP is one of Canada's largest chartered professional accountancy and business advisory firms, with a significant focus on clients reporting under International Financial Reporting Standards. The nature of our client base is such that many of our assurance engagements involve the application of IAS 32 *Financial Instruments: Presentation* to determine whether the client's classification of its complex financial instruments, including derivatives over an entity's own equity instruments, is appropriate. We believe that we are well positioned to provide feedback on this important issue.

We have reviewed the DP and have provided our response to the specific questions in the DP below. Overall, we support the International Accounting Standards Board's (the "Board") project on the classification, presentation and disclosure of FICE. We agree that it is imperative to have clear classification principles with well-defined rationale to improve consistency in the classification of FICE. We also agree with the Board's objective to improve the information entities provide in their financial statements about features of FICE through a set of clear, thorough and well-balanced presentation and disclosure requirements.

However, we are concerned that the proposals in the DP will not eliminate the current challenges encountered in practice in regard to the application of IAS 32 to classify complex FICE. Further, should the Board continue with this project, consideration of the consequential impact of the proposed changes to IAS 32 on the revised Conceptual Framework and other standards, such as IFRS 2 *Share-based Payment* and IAS 33 *Earnings Per Share*, will need to be addressed.

Question 1: Paragraphs 1.23-1.37 describe the challenges identified and provide an explanation of their causes.

(a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

We agree with the described challenges and their causes as highlighted in the DP. Specifically, we agree that while the classification requirements in IAS 32 generally result in useful information for financial statement users, the principles underlying the requirements are not clearly articulated. Complex financing arrangements create challenges in applying the requirements of the standard and consequently lead to diverse accounting treatments. It is often difficult in practice to apply the related requirements to financial instruments with characteristics of both equity and liability, especially related to compound and hybrid financial instruments. Additionally, the revised Conceptual Framework does not explicitly address classification of such financial instruments, and as such we welcome the FICE project initiative to meet those challenges.

Further, we believe there is an additional challenge that was not identified in the DP related to whether the classification of financial instruments as liability vs. equity must be reassessed after initial recognition. We recognize that should the characteristics of an instrument be modified, this creates a new instrument and thus, an assessment of its appropriate classification is required. However, it is not clear whether a financial instrument's classification must be reassessed if, for example, one of its features expires prior to the instrument's extinguishment or maturity and, without this feature, the instrument would now be classified in equity. We encourage the Board to address this challenge in its next stage of the project.

(b) Do you agree that the challenges identified are important to users of the financial statements and are persuasive enough to require standard-setting activity? Why or why not?

The challenges identified are of sufficient importance to users of financial statements because they affect the important classifications that directly impact an entity's financial position, liquidity, and financial performance. With increasing complexity in financial instruments and the diversity in practice, it is difficult for users to assess how these financial instruments affect an entity's financial position and performance. Further, we anticipate the trend in the creation of complex funding models and financial instruments to continue. As such, the challenges are pervasive enough to justify standard-setting activity.

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?

Overall, we do not agree with the Board's preferred approach. We believe that the Board's preferred approach will result in continued difficulty in determining the appropriate classification of FICE and, thus, diversity in practice will persist. However, our concerns only involve criterion (b) of the Board's preferred approach, as described further below.

We agree with criterion (a) in the Board's preferred approach (i.e., the timing feature). We believe that this criterion will be well understood and easy to apply. However, we suggest clarifying the meaning of "liquidation". For instance, a limited partnership (LP) having a finite life, will have its equity redeemed only at the end of its term. Under existing IAS 32, such equity is classified as a liability unless it meets the puttable instruments exception in paragraphs 16A-16B or 16C-16D of IAS 32. Under the new DP, despite whether the puttable instruments exception applies, such equity of the LP will not be classified as a liability based on the timing feature, given that it is not redeemable prior to liquidation.

We do not agree with criterion (b) in the Board's preferred approach (i.e., the amount feature). We do not believe that this criterion is an improvement over the current fixed-for-fixed criteria as, in our view, this criterion will not be well understood or applied. If the Board decides to proceed with the preferred approach as presented in the DP, clarification is sought on the concept of "available economic resources". It is unclear whether such economic resources are contemplated from the perspective of an entity's carrying values of its available assets or whether the entity's market capitalization based on its share price could be considered a reasonable proxy of the entity's available economic resources.

Notwithstanding our disagreement with criterion (b), we support the Board's proposed efforts to incorporate additional information regarding an entity's claims through presentation and disclosure. Information regarding future potential dilution and the effects of other contractual terms and features will facilitate a financial statement user's understanding of the distribution of returns to ordinary shareholders, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future. However, similar to the scope of IAS 33, such presentation and disclosure should be limited to an entity that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation. In our view, the proposed additional presentation and disclosure requirements are not beneficial to the users of private entity financial statements because they are usually involved in the day-to-day operations of the entity. Therefore, these shareholders would already have, or could easily obtain, access to such information without the need to complicate the entity's financial statements.

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 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 liability.

Do you agree? Why, or why not?

If the Board decides to proceed with the preferred approach as presented in the DP, we agree with the Board's preliminary view that a non-derivative financial instrument will be classified as a liability based on the timing and/or amount feature. However, as noted in our response to Question 2, we suggest additional clarifications regarding certain terms in the criteria of the Board's preferred approach.

Additionally, while the overall objective of the DP's proposed classification requirements for a non-derivative financial instrument is similar to that of IAS 32, the proposed requirements may result in a change in the classification of certain instruments. It would be useful to have separate guidance and clarification on how the DP should be applied for such instruments, as well as how the Board's preferred approach will facilitate a better accounting treatment.

For instance, in the case of non-redeemable preferred shares with mandatory fixed dividends, the appropriate classification is determined by the other rights attached to them. Currently, the classification is based on an assessment of the contractual arrangement's substance and the definitions of a financial liability and an equity instrument per paragraph AG26 of IAS 32. While there is no obligation to redeem, the obligation to pay the dividends meets the definition of a financial liability, resulting in an overall classification of the preferred shares as a compound instrument, which may require each component to be accounted for separately. It would be a compound instrument if the coupon was initially set at a rate other than the prevailing market rate. In contrast, the DP's preferred approach would classify such cumulative preferred shares as financial liabilities because the entity has an obligation for an amount independent of the entity's available economic resources. This is because the fixed-rate dividends accumulate over time and changes in the entity's available economic resources will not result in changes in the amount of the obligation for the cumulative preferred shares, even though the entity is only required to transfer economic resources at liquidation.

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 the puttable exception should continue under the Board's preferred approach, along with the required disclosures of such instruments prescribed in paragraph 136A of IAS 1. The puttable instruments that meet the features described in IAS 32.16A meet the definition of an equity instrument, and should be classified as such, because they entitle the holder to a pro rata share of the residual interest of the entity upon liquidation. Thus, the puttable exception meets criterion (a) of the Board's preferred approach.

However, we believe that challenges exist relating to the practical application of this exception. Therefore, we recommend that the Board provide improvements to the guidance. For example, the Board should provide additional guidance on the classification of an entity's puttable instruments that are subordinate to all other classes of instruments when the entity also has perpetual instruments that are classified as equity. In such a case, there is a more subordinated equity class but in a scale that is much smaller and nominal in value (e.g. founder shares) than the class of puttable instruments issued.

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, and that 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 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?

If the Board decides to proceed with the preferred approach as presented in the DP, we agree with the Board's preliminary views for the classification of derivatives on own equity. While the overall objective of the DP's proposed classification requirements of such instruments is similar to that of IAS 32, the proposed requirements may result in a change in classification for some derivatives on own equity due to the 'amount' feature, as discussed further below.

Foreign currency derivatives

Foreign currency derivatives that currently meet the exception criteria in paragraph 16 of IAS 32 and, hence, are classified as equity will be classified as financial assets or financial liabilities under the DP's preferred approach. This is due to the net amount being affected by an independent variable (i.e., the foreign exchange rate). The IAS 32 requirement for classification as equity is that "rights, options or warrants to acquire a fixed number of the entity's own equity instruments for any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments." This requirement reflects the fact that classifying these instruments as derivative liabilities is not consistent with the substance of the transaction and that such pro rata issues are transactions with an entity's owners in their capacity as owners. On the other hand, there is counter argument that such foreign currency rights issues should be liabilities, as they do not result in the entity receiving a fixed amount of cash. We welcome the Board's decision to eliminate the IAS 32 exception to maintain consistency in the presentation of foreign currency derivatives.

Anti-dilution protection

Another example is a debt/equity instrument that contains anti-dilution protection clauses. Such clauses may provide protection to the holder of the instrument by ensuring their relative rights remain the same before and after the event (i.e., the instrument holder's equity interest is not diluted or augmented). It may also attempt to put the holder in the same economic position relative to the ordinary shareholders. However, in some situations it provides preferential treatment to the instrument holder.

Any such clauses are currently assessed to determine whether they breach the fixed-for-fixed criteria under paragraph 16(b) of IAS 32, and cause the derivatives on own equity to be classified as a liability. Analyzing the amount feature of the DP's preferred approach, an entity must assess whether the anti-dilution clause introduces another variable that is independent of the entity's available economic resources. If it does not, the anti-dilution clause in and of itself is not an independent variable and, therefore, the anti-dilutive adjustment would not prevent equity classification. Should the Board proceed with its preferred approach as presented in the DP, we agree with this classification method for anti-dilution clauses.

Cashless exercise

The DP's preferred approach considers whether there is a contractual obligation to transfer economic resources at a specified time other than at liquidation and as a result, gross physically settled instruments and 'net-share settled' instruments are classified consistently given that neither require the transfer of economic resources. Therefore, if both types of instruments are unaffected by a variable independent of the entity's available economic resources, the DP's preferred approach would classify both as equity instruments whereas IAS 32 classifies only 'gross-settled' derivatives as equity instruments.

For example, in the case of a cashless exercise, suppose an entity has a contract to issue 100 shares at $2 per share. If the share price increases to $10, the contract may allow the holder the option, instead of having to pay $200 to obtain 100 shares, to pay nothing and receive just 20 shares. Current accounting practice often raises concerns as to why the instrument is recognized as a liability given that the entity will never have to pay cash to the holder under any scenario. The proposed changes in the DP place more weight on that fact and that the settlement mechanism depends only on the entity's own share price, thereby permitting an equity classification for such instruments.

We support this change which also aligns the Canadian financial instruments requirements more closely to the US GAAP requirements.

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?

Overall, we agree with the Board's preliminary views for the classification of standalone derivatives to extinguish an equity instrument, and separate classification of the financial liability and equity components of compound instruments or redemption obligation arrangements. We also agree with the Board's assessment that a compound instrument and a redemption obligation arrangement are economically similar from the perspective of the entity and should result in similar accounting outcomes.

However, we suggest additional guidance and clarification on the accounting of written put options on non-controlling interests (NCI), specifically relating to the derecognition of the NCI at fair value in a scenario when the NCI was not recognized at fair value but based on the proportionate share in net assets under the measurement policy choice available under IFRS 3 *Business Combinations*.

We believe the Board has adequately presented its position relating to financial instruments with alternative settlement outcomes that give the entity an unconditional right to choose the settlement outcome. Where there are alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability, and such settlement outcomes are practically and economically feasible (see our response to Question 10), that instrument should be classified as equity. Additional information about the entity's settlement options can and should be provided through presentation and disclosure.

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?

Overall, we agree with the Board's preliminary views regarding separate presentation of the three categories of financial instruments stated in paragraphs 6.53-6.54 of the DP, in both the statement of financial position and the statement of financial performance.

The DP seeks to separately identify income or expenses relating to instruments, which have something 'extra' about them, based on the criteria-based approach. For example, warrants classified as derivative financial liabilities are measured at fair value through profit or loss. Currently, there is no prescribed format for identifying such items in the statement of financial position or statement of financial performance, and it can therefore be difficult to track their impact on the financial statements. Also, the measurement requirement often exacerbates issues as the accounting outcomes of such instruments is counter-intuitive. For example, a warrant liability denominated in a foreign currency will increase in value, when there is an increase in the entity's share price, thereby resulting in a loss.

The DP's new presentation requirements of including changes in fair value of the above-noted instruments as part of other comprehensive income rather than profit or loss will enhance the relevance of the basic profit/loss measure. We also see this presentation requirement being consistent with the presentation of the gains and losses arising from changes in own credit risk of financial liabilities designated as measured at fair value through profit or loss under IFRS 9. However, we recommend that the Board provide additional guidance and clarification on the accounting treatment of transaction costs incurred at the time of initial recognition of each of the three categories of financial instruments stated in paragraphs 6.53-6.54 of the DP.

We also agree with Alternative A in paragraph 6.38 of the DP. In our opinion, the Board should not require entities to apply the separate presentation requirements to an embedded derivative that is not separated from its host contract. In our experience, entities often designate hybrid contracts as measured at fair value through profit or loss in order to reduce the costs and complexities associated with measuring the derivative separately and accounting for the host instrument. The fair value of the entire hybrid instrument is determined to eliminate the need for separately determining the fair value of the embedded derivative. Applying the separate presentation requirements to embedded derivatives regardless of whether they have been separated would effectively negate the associated benefits of this election.

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 full fair value approach;**
- **The average-of-period approach;**
- **The end-of-period approach; and**
- **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?

Overall, we agree with the Board's preliminary view that it would be useful to the users of financial statements to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Expanding the attribution of comprehensive income to other equity instruments would enhance the information provided about the effects that different features of equity instruments have on the distribution of returns between equity instrument holders.

However, we share the Board's concern that any approach applied for attribution to derivative equity instruments are too complex and costly because they require determining the fair value of the derivative equity instruments even if they are not observable.

Non-derivative equity instruments

We agree with the Board's preliminary view that attribution of earnings to non-derivative equity instruments should be based on the existing requirements of IAS 33. In our view, the existing requirements of IAS 33 are well understood and consistently applied.

In our experience, certain equity instruments can provide rights to the entity's net assets on liquidation that differ from ordinary shares. For example, preferred shares with discretionary dividends may have preferential rights on liquidation. We recommend that the Board incorporate guidance regarding the attribution of income to such instruments and whether it should differ from the attribution of income to ordinary shares based on their legal rights.

Derivative equity instruments
We do not believe that income and expenses should be attributed to derivative equity instruments. The leveraged feature of such instruments would make income attribution difficult. An attribution approach, especially one which incorporates the fair value of the entity's own equity instruments as an input to the calculation, will not enhance an ordinary shareholder's understanding of the entity's income that is attributable to their shares.

Further, we do not agree with the Board's proposal to extend the fair value disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* to derivative equity instruments. Determining the fair value of an instrument settled in an entity's own equity instruments is especially challenging for entities that do not have a publicly listed share price. While the scope of IAS 33 is limited to entities whose securities trade on an active market, the scope of IFRS 7 is not similarly restricted. Incorporating additional disclosure requirements regarding the fair value of derivative equity instruments would result in additional costs and complexities for entities whose securities are not actively traded. As such, we feel that such disclosure requirements should not be incorporated in IFRS 7 or, alternatively, they should be limited in scope to those entities that apply IAS 33.

In our view, information about the effect of derivative equity instruments should continue to be provided through disclosure of the instruments' terms and conditions, and through diluted earnings per share. Additional information about the potential dilution of ordinary shares should also be provided (see our response to Question 9).

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 liability and equity instruments on liquidation (see paragraphs 7.7-7.8). Entities could choose to present financial liability 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 you think the Board should consider when developing its preliminary views on disclosures?

We agree with the Board's preliminary views that information should be provided regarding the priority of financial liabilities and equity instruments, the potential dilution of ordinary shares, and the terms and conditions of financial liabilities and equity instruments. In our view, the additional information, especially the information regarding the potential dilution of ordinary shares, would meet the needs of financial statement users and would render unnecessary the attribution of income and expenses to derivative equity instruments as noted in our response to Question 8.

The Board identified a number of challenges associated with disclosure regarding priority of financial instruments. In our opinion:

- Where the priority of a particular financial instrument is not evident, entities should be permitted to group similar priorities of claims together, subject to other IFRS guidance. This would also assist in ensuring that an entity is not required to make and publicly disclose a judgment that could impair its relationship with a creditor or restrict its ability to negotiate the settlement of a claim.
- Priority should be based on the stated terms and conditions of the instrument. Where priority may be impacted by a related party relationship or contingent event(s), this should be disclosed, but should not directly impact the priority ranking.
- Sufficient information is available from other disclosures to enable users to reconcile an instrument's carrying amount with its fair value. Accordingly, disclosures should directly reconcile to an instrument's carrying amount on the statement of financial position.

We believe that arranging claims by priority on liquidation would help users of financial statements assess in more detail how any potential shortfall or surplus in economic resources is allocated among claims.

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 equity; and

(b) that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

We agree with the Board's preliminary view that the classification of an instrument as a financial liability or equity instrument should be based on the entity's contractual obligations, or lack thereof. Economic incentives that might influence the issuer's decision to exercise its rights should not impact the classification of an instrument as the issuing entity is not privy to all factors that the financial instrument holder may consider in deciding whether to exercise. For example, an investor may have a tax-related or other business reason to proceed with a settlement option contrary to an economic incentive. Information about these incentives can be incorporated into the measurement of the claim and/or its eventual settlement.

We also agree that the requirements in paragraph 20 of IAS 32 should be retained and updated to ensure consistency with the classification features discussed in the Board's preferred approach.

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?

If the Board decides to proceed with the preferred approach as presented in the DP, we agree with the Board's preliminary view that the preferred approach should be applied to the contractual terms of a financial instrument, consistent with the existing scope of IAS 32. We do not believe that the amendments to IAS 32 should incorporate the treatment of rights and obligations that arise from law in the determination of the appropriate classification of an instrument as these may differ in each jurisdiction where IFRS is applied. Therefore, issuing guidance in this area would be extremely challenging. Further, we do not feel that such guidance must be incorporated into IAS 32 as the assessment of the impact of an entity's relevant laws and regulations is already driven by the requirement to comply with ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*.

We are pleased to offer our assistance to the Board in further exploring issues raised in our response or in finding alternative solutions to meet financial statement users' needs.

Yours truly,

MNP LLP

Michelle Balmer

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