14th January 2019

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Via email: commentletters@ifrs.org

Dear members of the IASB

Discussion Paper: Financial Instruments with Characteristics of Equity

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* Issued by the International Accounting Standards Board (IASB) in June 2018.

As an introduction, in September 2008 CRUF wrote in response to an earlier DP on FICE that we would characterise as equity any instrument in issue, or contractually obliged to be issued on sale of a business, as equity where the instrument participated without upward limit on the sale of the business. We argued that after initial recognition at fair value there was no need to remeasure specific instruments as long as participations at a wide range of total equity value were sufficiently well disclosed. We further argued that any fair value movements flowing through comprehensive income, which implicitly required a perpetuity valuation of the reporting entity at each period end, was inherently misleading about performance and value creation.

Our specific responses to the questions in the December 2018 presentation to CRUF on the discussion paper are set out below. (The questions are reproduced in italics).

1. *Do you think attributing total comprehensive income would provide useful information?*

Our position outlined above has not changed but we recognise that there are significant vested interests (corporations and regulators) which makes any fundamental change to equity classification a significant issue. If this is not to be addressed then, in answer to your question, yes, it is important to split out profits for each claim so that we can readjust performance to align more closely with our own understanding of repeatable performance. Equity investors are interested in isolating the profits and OCI attributable to equity in aggregate and attributing this to all instruments which meet their definition.

2. *If so, do you have any preference on how the attribution of total comprehensive income should be presented/disclosed?*
   a. *Presentation on the face of the statement of changes in equity (using one of the methods in the appendix such as changes in the fair value of derivative equity instruments during the reporting period); or*
   b. *Disclosure in the notes to the financial statements of the fair value of derivative equity instruments at the reporting date*

CRUF would prefer, *in general*, that attribution of total comprehensive income be presented on the face of the statement of changes in equity. However, we remain of the view, explained in our introductory second paragraph above, that the example in the question - changes in the fair value of derivative equity instruments during the reporting period – is a *particular* example of what we had in mind: an unnecessary remeasurement that is inherently misleading about performance and value creation and, therefore, should not be reflected in comprehensive income.

3. *Do you think the proposals in the DP would result in useful information for you? If you were to rank them in the order of priority/usefulness, how would you rank them?*

Information is useful if it is material to the assessment of the enterprise value under various scenarios and/or the attribution by claim.

a. Maximum dilution of ordinary shares

CRUF agrees that disclosing the maximum number of shares is useful in modelling different valuation scenarios provided it is accompanied by sufficient disclosure to understand criteria for vesting so that a full analysis of participation can be undertaken.

b. Priority of claims on liquidation

CRUF reiterates that it issued a letter in September 2008 highlighting that considering liquidation is not the most important for an equity investor. Financial statements assume a going concern basis and equity investors value equity assuming a perpetuity basis. Linked to this, and consistent with presentation as a going concern, we also noted above that the fair value movements of derivatives is largely irrelevant as there is no value transfer between an option holder and an equity holder during the period as this only takes place at the time of issuance and therefore there was no benefit to seeing fair value movements.

Nevertheless CRUF does believe that credit investors would require clear disclosure about priority on liquidation as they are looking at downside scenarios that are taken into account when considering the hierarchy of financing of a going concern. It is worth noting in these scenarios gains on issued options would be reported and be clearly meaningless. We certainly believe that more information about claims should be linked clearly to reference readily available on-line sites where users can access a fuller description of all instruments issued by the corporation, ideally in tabular form showing issuing entity, cross-collateralisation, guarantees, maturity, acceleration clauses etc.

c. Terms and conditions that affect the timing and the amount of cash flows

CRUF does believe that the proposed disclosures would be helpful and closer to what investors need. Again it is worth noting that year on year movements on participation curves are relevant to investors as equity investors are interested in how much of the enterprise value is attributable to equity holders under different valuation scenarios.

Whilst directionally this is right, CRUF believes that the IASB's approach on disclosures does not come close to the granularity of information required by fund managers managing fixed income portfolios.

- Fund managers read the terms and conditions in the prospectus for the financial instruments. Better availability of these prospectuses on-line should be required instead of attempting to include all terms and conditions in the financial statements. Key terms of material instruments in the capital structure should be highlighted in the financial statements with clear links to the location of full information in prospectuses or otherwise.
- CRUF agrees that holders of financial instruments do not expect all the useful information in the annual report, especially when it is better kept comprehensive and up to date on-line.
- CRUF also would like to emphasise that the IASB should avoid the creation of further accounting taxonomies and hierarchies for the capital structure, as preparers and users already have to manage complex regulatory overlays to contractual terms, especially in financial sector issuers.
- More important from a fixed income perspective are the proposed disclosures which would help evaluate refinancing risk (also called "rollover risk"). Terms of conditions for material tranches of debt are needed to assess this risk.
- CRUF also would like to highlight that investors were interested in temporal subordination in addition to liquidation hierarchy.

- Finally, the broad principle for detailed on-line disclosure should be the availability of all material information on material capital structures.

We also agree that further complexity arises in consolidated accounts for capital structure analysis as it is the solus position which should actually be considered. In this connection, it will be arrangements such as cross guarantees and inter-creditor agreements that are more significant than accounting rules for consolidation.

Whilst the above discussion appears rather theoretical, it reflects the real world of (i) one ISIN or a small number of ISINs for common equity in any one large issuing group compared to (ii) a much larger number of ISINs for other traded instruments including bonds and loans as well as (iii) no ISINs at all for most non-traded debt.

Inadequate information on just one such non-equity example will illustrate the point. CRUF members have highlighted an example of insufficient disclosure as a UK company had US private placement debt with an early redemption penalty which was not disclosed in the accounts. The original prospectus was also not publicly available. When the company redeemed these tranches early the penalty was material to the value of common shareholders. Clearly rules around materiality should have required this disclosure for the accounts to be "true and fair" but disclosure requirements in the standards do need to highlight the need for it as well.

4. *Do you think separately presenting income and expenses from financial liabilities with returns that behave like the return on an equity instrument would provide more useful information?*

CRUF does agree because users may want to reclassify some of the income and expenses relating to financial liabilities as operational. For example, when preference dividends are a function of profits the investor may want to reclassify them as an operational expense - unless those participating preference shares would convert into equity on a sale of the business in which case they would be removed from operations and treated as an equity instrument in an analysis of dilution. When companies share risk in business combinations the accounting is often opaque. Turnover of the business combination may be clear, but the split of profits by claim is often difficult to work out. There are often numerous claims (e.g. common equity, preference shares, contingent consideration) as well as options to consider. The information in the accounts should be sufficient to enable an investor to work out the value of the business combination attributable to common shareholders under different scenarios.

5. *Should these income and expenses be presented in other comprehensive income (as proposed) or a separate line item in profit or loss?*

CRUF believes that unless we have an aligned view on the definition of equity then our general aim is to have maximum disclosure to allow us to restate performance in whichever way the user deems to be appropriate. The actual location of the changes is therefore less significant as they would need to be adjusted wherever they are placed in the accounts.

6. *Under the current proposals, gains or losses on this type of liabilities would not affect profit or loss even when such gains or losses are realised (i.e. when the liabilities are settled). If other comprehensive income is used, would you prefer to have such gains or losses affect profit or loss when they are realised?*

CRUF is not an advocate of recycling these items through the profit and loss account as our valuation analysis is performed based on instruments in issue and therefore after they are settled any gain or loss relating to the settlement becomes irrelevant. Performance in the period will not be clearer with recycling and we would therefore need to reverse any items of this nature as a "one off" movement.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

(Signatures)

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