International Accounting Standards Board
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March 21, 2024

Exposure draft - Proposed amendments to IAS 32 and IFRS 7

Dear IASB Board Members,

We welcome these proposals to improve the consistency of application of IAS 32 and to provide investors with better information about complex capital structures. We have chosen to respond to only three questions in the ED, where we either disagree or have suggestions for modifications or clarification. In all other respects we support the proposals.

Question 3: Obligations to purchase an entity's own equity instruments

We disagree with the proposals because we disagree with the conclusion in paragraph BC78 that there is no double-counting. While we agree that NCI shareholders who have a put option obtain an additional right enabling them to receive cash, upon exercising this right they must give up their right to an equity return. Either NCI shareholders keep their equity interest, and the rights and flows that arise therefrom, and do not receive cash by selling to the parent company, or they give up their equity interest and elect to receive that cash – they cannot have both. NCI shareholders have only one interest in the entity but with two potential outcomes. Recognising both outcomes as a claim in the balance sheet – one as NCI equity and the other as a liability – is, in our view, double counting.

The fact that both rights exist for a period until a put option expires does not mean that both should be reflected in the balance sheet; For example, NCI shareholders may receive dividends while they remain shareholders prior to exercising an NCI put. These dividends are in addition to the cash receipt from selling their shares. This is not a reason to recognise both the NCI equity interest and a liability, instead the expected dividends should be considered when measuring the present value of the liability (assuming a gross-up is applied).

The consequence of the double counting can be observed by considering the impact on price to book and price earnings ratios, both of which are widely used by investors. The double counting is easiest to appreciate in the case of price to book ratios with NCI puts exercisable at fair value.

Price to book represents the share price compared with book value per share of the parent shareholders' interest in a group. The price to book ratio is particularly useful in equity analysis where corporate value largely arises from assets recognised in the balance sheet and where the book value of these assets is not significantly different from their fair value. There are several sectors where this applies, but it is particularly the case for investment companies. For an investment fund with underlying assets measured at fair value, one would expect a price to book ratio close to 1.0x. Whether, and by how much, an investment fund trades above or below the fair value of the underlying investments, is a key indicator for investors.

If an investment fund has an NCI put accounted for in accordance with the ED, total equity is the fair value of the underlying investment assets less the grossed-up NCI put liability. Equity attributable to the parent shareholders is total equity less NCI. If the put is exercisable at fair value, then the fair value of the underlying investments attributable to the NCI ownership interest is deducted twice in arriving at the parent shareholders' equity. Shareholders' equity is understated and the price to book ratio is overstated.

There is similar double counting in respect of earnings per share and a consequent likely overstatement of a price earnings ratio. In the case of the investment fund and NCI put at fair value, the double counting is exact. The finance expense for the grossed-up liability is the NCI share of the fair value change of the underlying assets and precisely the same amount is also deducted as an attribution. In other situations, the double counting may not be the same amount but, under the ED the approach, two economic effects are recognised when there should be just one.

We are happy to share our analysis of the price to book and price earnings multiple effect of the proposals in the ED and alternative methods of accounting for NCI puts and forwards.

Our comments about investment funds are simply to illustrate the double counting, we do not think the problem is limited to these companies (or even that NCI puts are common in this sector). The double counting problem applies to any company and to both forwards and puts with fixed, fair value and other formula-based exercise prices.

If the IASB maintains the gross up approach currently required by IAS 32, we think its application needs to be revised to avoid double counting. However, we think that any application of grossing-up is inherently problematic and we would advise that other approaches should be investigated, including that put forward by Mr Uhl in his alternative view.

It appears that the rationale for a gross-up approach is to provide information about liquidity and to ensure that if equity capital may have to be repaid (and this is outside the control of the entity), it is not reported as equity. While we agree that equity subject to put or forward sale may be temporary, we believe there are methods other than grossing-up that could be used to effectively convey this message to shareholders.

Question 7(d): Potential dilution of ordinary shares

We agree with the disclosure objective, and it seems to us that all the proposed individual disclosures help in achieving that objective. Our concern with the disclosure about dilution is not the disclosure of the maximum dilution itself, but that there are insufficient additional supporting disclosures required to enable investors to understand the implications.

Having data for maximum dilution is not useful, and could potentially be misleading, unless investors are also aware of the probability that this maximum will occur and understand the other financial effects of the additional shares being issued, such as the issue proceeds.

In paragraph 30G(d) of the proposed revision to IFRS 7, there is a requirement to disclose the "terms and conditions relevant to the understanding of the likelihood of the maximum dilution". We agree that this is necessary; however, we are not convinced that the level of detail provided in the illustrative example (IG14H) is sufficient to fulfil that objective. For example, there is nothing in the illustrative disclosures to say whether the convertibles are in or out of the money and by how much. This is perhaps the most important factor in determining the likelihood of conversion taking place. We recognise that the illustrative example is not intended to be comprehensive, but we think it needs to set a higher benchmark to ensure that, in practice, these disclosures fulfil the stated objective.

One simple way to provide information about the likelihood of dilution, and the financial implications of that dilution, is to require disclosure of the fair value of derivatives and derivative components classified as equity. Fair value disclosure for non-common share equity, particularly derivatives classified as equity, would be enormously useful for investors and not just in the context of dilution.

Furthermore, we think that the Board should investigate whether the disclosure of maximum dilution could be integrated with the existing disclosure about diluted shares used for earnings per share. While these are different, the two amounts are also linked. Having one disclosure that explains that linkage would help investors understand the nature of both disclosures.

Question 8: Presentation of amounts attributable to ordinary shareholders

We welcome the proposal to present amounts attributable to ordinary shareholders on the face of the balance sheet and income statement. We suggest that a similar split is applied to non-controlling interests, where the amount of NCI attributable to 3rd party holdings of ordinary shares in subsidiaries is shown separately from the NCI attributable to other 3rd party equity holdings in those subsidiaries. We also suggest that it be made clear that further disaggregation may be necessary if non-ordinary share equity includes instruments with very different characteristics, such as perpetual bonds and written call options.

We find it difficult to give detailed comments on this proposal considering that the ED does not specify how the amounts attributable to equity instruments that are not ordinary shares should be measured. We presume for perpetual bonds, preference shares, and other similar equity securities, the attributable profit would be the same as that specified in IAS 33. However, it is unclear what the board intends in respect of equity derivatives. The ED mentions attribution proposals that were previously included in the FICE discussion paper, but we presume this is not what is intended.

We suggest that the Board clarifies exactly how it intends the attribution should work in respect of equity derivatives and, if necessary, seek further feedback. In our view, an attribution to equity derivatives based on the relative fair value of those instruments (one of the approaches suggested in the FICE DP) would be highly useful for investors. However, it would need to be considered in conjunction with potential changes to IAS 33, which we presume puts it outside the scope of this project.

However, we strongly support the attribution proposal and, even if it is scaled back to exclude equity derivatives and only consider perpetual bonds, preference shares and similar securities using the existing measurement approach in IAS 33, we think it would be very helpful for investors.

Yours,

Steve Cooper and Dennis Jullens

The Footnotes Analyst is a blog for investors and analysts on financial reporting and equity analysis that is written by Steve Cooper and Dennis Jullens. Steve Cooper is a former IASB Board Member. Dennis Jullens is an academic and a member of the EFRAG Technical Expert Group. Both Steve and Dennis previously worked in investment banking, including as colleagues at UBS investment research.