FICE – JOINT OUTREACH

SUMMARY REPORT

FRANKFURT 20 NOVEMBER 2018

European Financial Reporting Advisory Group

Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

Photo by Christian Salow

This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by the speakers at the event.

EFRAG and the Accounting Standards Committee of Germany ('ASCG') organised a joint outreach on the Financial Instruments with Characteristics of Equity ('FICE') Discussion Paper ('DP') in Frankfurt on 20 November 2018. This report has been prepared for the convenience of European constituents to summarise the event.

Participants and presenters were welcomed by Sven Morich, Executive Director of ASCG. The proposals in the DP was explained by Thomas Schmotz, Technical Director of the ASCG, for each individual chapter. This was followed by the tentative EFRAG position presented by Fredré Ferreira, assisted by Saskia Slomp of EFRAG. Thomas then explained the tentative position of the ASCG. The presentation can be found here.

The following feedback was received:

Section 1: Objective, scope and challenges

Participants thought that the IASB should take more time and spend more effort on the conceptual basis for the classification of claims. Although many participants agreed that IAS 32 *Financial Instruments: Presentation* does not create conceptual and application problems for most instruments, they considered the current ideas of the IASB as conceptually inadequate as IAS 32. The participants were not convinced that the proposals in the DP would solve the existing issues with IAS 32 and believed the DP would bring further uncertainties. Some participants argued that classification for regulatory purposes should also be considered, and that it would be of concern if the results differed significantly.

Participants also raised concerns that the IASB had left out certain relevant issues, such as reclassification, and the question who the "entity" actually is. They found the scope of the DP not clear when considering IAS 33 *Earnings per Share* and IFRS 2 *Share-based Payment*. Furthermore, a two-step approach may be better for the project: firstly, urgent amendments and quick fixes to IAS 32 including the enhancement of disclosures, clarifications on the accounting for shares puttable at fair value should be made in short term in a narrow-scope manner and in the longer term, if needed, a more conceptual approach.

Sections 2 and 3: The IASB's preferred approach and classification of non-derivative instruments

Many participants were critical of the preferred approach due to its complexity. This was in the light of the extensive efforts to implement the current requirements of IAS 32 at its inception in 2001 or in 2005 with the adopt of IFRS in Europe. Participants also observed that classification is driven by individual assessments of what is debt and what is equity. This would lead to regulators, analysts, and even reporting companies to define equity inconsistently. One possible (even if theoretical) consequence would be to do without classification as any classification would always be a compromise and moreover every user has his/her own picture of equity.

The compromise achieved by the preferred approach was unanimously deemed not to be better than IAS 32. Some participants also thought that the preferred approach would not limit structuring opportunities. Participants also expressed concerns about the going concern assumption given aspects of the approach. Furthermore, the implementation efforts expected as all claims outstanding would have to be reassessed, was not deemed appropriate.

Some participants pointed to the practical impacts of a change to the preferred approach: certain claims, also known as hybrid instruments[1], currently classified as equity under IAS 32 would be classified as liabilities under the DP. Based on participant analysis, at a minimum, €120bn of such hybrids currently classified as equity (issued in Europe and Asia) would have to be classified as liabilities under the preferred approach. This change in accounting would have considerable consequences on the market's behaviour, as many issuers may exercise the embedded accounting or regulatory changes calls. In countries with less well-developed capital markets, access to these types of financing may be severely hampered, which would also have a significant economic impact. Furthermore, such a change could impact ratings of entities given the worsening of leverage due to the change. The same would be true for non-rated companies as in these cases the financial statements are of greater interest to investors.

The ASCG's tentative view that the amount feature of the new approach would accord with the proprietary perspective, rather than the entity perspective, was not supported by all participants. Many expressed the opinion that the amount feature would weigh the purely legal view over the economic view, instead. For example, the amount feature will result in callable perpetual bonds where the coupon could be deferred indefinitely (i.e. equity under IAS 32) to be classified as liabilities, although the amount is irrelevant in economic terms on a going concern basis. Some participants suspected that implicit aim of the amount feature was to limit the challenges arising from economic compulsion, since those bonds are deemed (and priced) as liabilities in the markets although being accounted for as equity under IAS 32 (ignoring economic incentives). In general, they did not consider the amount feature as more appropriate than the fixed-for-fixed-concept in IAS 32. Participants wanted to be reassured that IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* would continue to apply so that cooperatives would remain to have equity.

With regard to claims defined in paragraphs 16A to 16D of IAS 32 participants supported that these continue to be classified as equity. However, the need for an exception to achieve equity treatment under the new approach was seen as a significant weakness.

Section 4: Classification of derivative financial instruments

The application of the preferred approach to the classification of derivatives on own equity was unanimously deemed as too complex. In particular, participants thought the implementation efforts would not be appropriate. In contrast, EFRAG's alternative suggestion to classify derivates on own equity as either assets or liabilities (but not as equity) was supported. Such a treatment would limit structuring opportunities as equity classification is excluded from the outset. However, participants noted that such a requirement would be inconsistent with IFRS 2. A number of participants supported to continue classifying foreign currency rights issues as defined in para 16(b)(ii) of IAS 32 as equity.

[1] In general, there is no present obligation on the issuer to pay coupon or outstanding amount, however, these generally would trigger the amount feature under the preferred approach and be classified as liabilities.

Section 5: Compound instruments and redemption obligation arrangements

The accounting treatment of compound instruments and redemption obligation arrangements resulted in split views. Some participants supported the IASB suggestions and agreed to define the package of rights and obligations arising from a put option on own shares as follows: First, there is a non-derivative liability to the amount of the payment to be made by the issuer (the entity) when the holder exercises the option. Second, the remaining rights and obligations are economically considered as an obligation of the entity to issue shares (although legally issued, these are not deemed issued from a balance sheet perspective) in exchange for settling the non-derivative liability. Other participants disagreed with this approach as impracticable. However, the clarifications made in the DP regarding the booking entries to be made in equity for such obligations were supported. There was support for recognition of fair value changes of written puts on non-controlling interest in other comprehensive income as is done by some currently and which would be allowed in some cases under the presentation proposals. The IASB was criticised for not addressing claims with alternative settlement outcomes where events are outside the control of both the issuer and the holder, e.g. contingently convertible bonds.

Section 6: Presentation

The presentation requirements were discussed subsequently, with mixed views on the separate presentation requirements for liabilities with value changes dependent on the resources of the entity (such as changes in the value of ordinary shares). Some participants saw an advantage in reporting those value changes in OCI as this would isolate all or most of the profit or loss effect that is deemed counter-intuitive. Others thought that reflecting this in in profit or loss (e.g. measurement changes of puttable shares that are not captured by the exception) was not counter-intuitive at all.

The tenor of the debate was that the information in general was deemed relevant; however, participants disagreed with showing that on the face of the balance sheet and profit or loss but supported the idea of disclosing it in the notes.

Similar reservations were raised with regard to the presentation of equity instruments other than ordinary shares as suggested in the DP. Although participants agreed with the IASB’s observation that the information provided about equity instruments was inadequate under current IFRSs; they disagreed with providing information on the face of the balance sheet but clearly preferred the notes. Remeasuring equity claims would represent a radical breach of established and accepted accounting conventions. Participants suggested amendments to IAS 33, e.g. with regard to anti-dilutive equity instruments but understood that this would be addressed in the Primary Financial Statements project.

Section 7: Disclosure

Mixed views were expressed on the IASBs ideas on the enhancement of the notes as well: Although information about the claims' contractual terms and conditions were considered useful, there was a concern around practicability given the large number of various claims an entity may issue. The views were also split with respect to the disclosures on the order of the claims' priority on liquidation of the entity. Proponents considered such information to be useful to users (for instance the waterfall for senior subordinated loans were mentioned to be important), but others considered such a disclosure requirement inappropriate for consolidated financial statements, as a group of legal entities cannot be liquidated, only individual legal entities.

Section 8: Contractual terms

Lastly, the participants discussed if and how obligations of a claim against an entity, which are set by the law, are considered in classification of such claim. Participants noted that the assessment should not only consider contractual features exclusively, as the relevant characteristics are often determined by additional legal and regulatory requirements, e.g. in case of shares puttable at fair value at German partnerships. Furthermore, it was noted that the discrepancy between IFRIC 2 and IAS 32 in respect of consideration of the legal and/or regulatory requirements will still not be clarified in IFRS.

Sven Morich thanked participants and presenters for the valuable discussion and encouraged participants to respond to the EFRAG draft comment letter available for comment or to the IASB on the DP. The event was then closed.