

JOINT OUTREACH EVENT FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

MILAN

7 NOVEMBER 2018

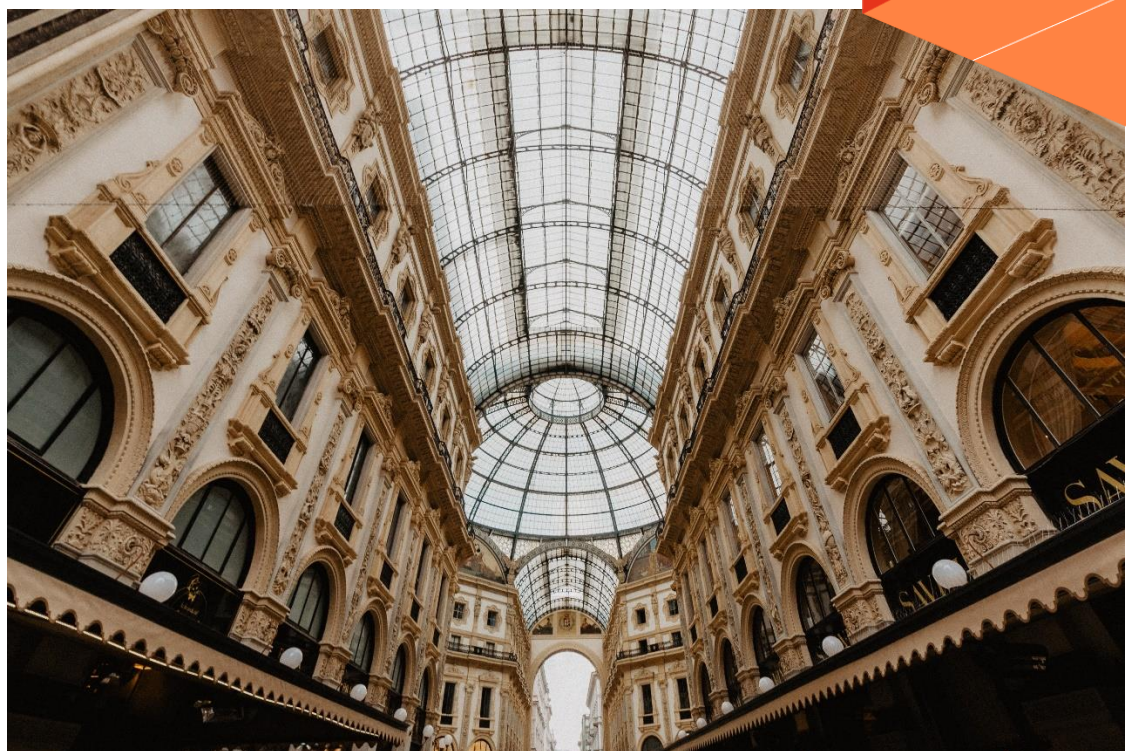


Photo by [Fernando Meloni](#)

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 IASB staff and has been jointly approved for publication by representatives of EFRAG and the OIC who attended the outreach event.

Introduction

EFRAG together with the OIC and IASB organised an event covering the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity* (the DP). This report has been prepared for the convenience of European constituents to summarise the outreach event held in Milan on 7 November 2018.

Paolo Gnes (President OIC Supervisory Board) opened the outreach event and welcomed EFRAG, the IASB and the participants.

At the conference, Sue Lloyd (IASB Vice-chair, IFRS Interpretations Committee Chair) introduced the DP.

Subsequently, it was followed by a round-table discussion consisting of the following panellists:

- Angelo Casò, OIC Executive Board Chair, EFRAG Board member (Moderator)
- Tommaso Fabi, OIC Technical Director, EFRAG TEG Member
- Fabio Goia, Head of Group Accounting and Regulatory Rules Intesa Sanpaolo
- Sue Lloyd, IASB Vice-chair, IFRS Interpretations Committee Chair
- Patricia McBride, EFRAG Technical Director
- Ambrogio Virgilio, EY SpA – IFRS Desk, EFRAG TEG Member, EFRAG Insurance Accounting Working Group Chair

Paolo Gnes thanked panellists and attendees for their participation and closed the event.

Summary of observations

Participants at the event expressed the following views:

- They welcomed the IASB's proposals to address the issue of distinguishing between debt and equity but indicated that existing problems should be solved rather than creating a new set of principles resulting in changes to classification outcomes.
- The proposals in the discussion paper introduce new terminology which may create new concerns about the distinction between debt and equity.
- They supported the proposal to continue current practice where rights and obligations should only arise from contractual agreements and economic compulsion should be ignored.
- They agreed that the puttables exception should be retained.
- They raised concerns about the proposal that information on the priority of claims on liquidation should be provided. They considered that such information is important but noted practical difficulties such as liquidation in many jurisdictions applies at the legal entity level.
- The proposed attribution approach could be too complex for the information that it provided.
- They supported the proposed enhancements to presentation and disclosure.

Discussion

Debt and equity: Is change needed? What is broken today?

Known problems should be addressed rather than developing a new set of principles.

Panellists noted that:

- The distinction between debt and equity plays a key role in understanding the financing of entities.
- Banks are concerned about the impact of the proposals in the DP for regulatory purposes as Common Equity Tier 1 (CET 1) capital must be classified equity for accounting purposes.
- Although banks appreciate the approach in the DP, they consider the terminology used to be complex. The project should not fundamentally change the existing classification outcomes of IAS 32 *Financial Instruments: Presentation* because current rules are widely used and well understood. Hence, it may be better if the IASB were to address the known problems with IAS 32 rather than developing a new set of principles especially where these result in significant changes.
- It is important that practical application challenges should be addressed.
- The price to tangible book value ratio could be impacted by the proposals in the DP as the tangible book value is calculated by deducting intangible assets from accounting equity.
- It is still early in the process of revising IAS 32 and banks do not expect a lot to change with the introduction of the DP, but corporates may be significantly impacted by the proposals.
- The IASB is in discussion with the Basel Committee as well as with equity investors about the DP.
- The proposed removal of the fixed-for-fixed condition could introduce structuring opportunities

With new principles on equity debt distinction, do we still need exceptions?

The puttables exception should be retained

Panellists acknowledged that the puttables exception is still retained even though the new principles should reduce the need for extensive exceptions.

Panellist asked whether the puttable exception:

- is common and/or difficult to apply in practice; and
- should it be available for holders of these instruments as well as for issuers?

Others indicated that as open-ended funds do not apply IFRS, the exception for puttable instruments is not widely used, but they thought that the exception is still necessary because the problems giving rise to the puttables exception will not be resolved by the proposals in the DP.

Panellists reiterated that from the asset side these instruments were not seen as equity therefore fair value through other comprehensive income classification under IFRS 9 *Financial Instruments* is not permissible.

Should derivatives ever be equity or should they be classified at FVPL under IFRS 9? Should, unlike IAS 32, the same logic be used for classification of derivatives and non-derivatives?

A range of views were expressed on how derivatives should be classified.

Panellists questioned what equity is and whether it relates to current and/or future shareholders.

Panellist expressed a range of views including:

Measurement of derivatives

- Measuring all derivatives at fair value through profit or loss under IFRS 9 would be too great a change.

Classification of derivatives

- The concept of dependence should be clarified in order to simplify classification for derivatives over own shares.

- Application of IAS 32 is sufficiently robust and that proceeding with the notion of dependent on and independent of the entity's available economic resources required further analysis in the context of derivatives.
- Agreed that a derivative should be classified as an asset or liability if the net amount is affected by a variable that is independent of the entity's available economic resources, even if classification of derivatives at FVPL is consistent with IFRS 9. To a certain extent the application of the amount feature principle is consistent with IAS 32, for example: features that are linked to interest rates, foreign exchange rates or gold/commodity prices.
- Supported the classification of derivatives as assets or liabilities if they are cash settled.
- One should consider whether the amount of the derivative is only impacted by the performance of the entity, if so then it should be classified as equity.

Should information on the priority on liquidation be provided? If yes, where should it be shown: on the face of the balance sheet or in the notes?

Information on the priority on liquidation should be provided and only in the notes

Panellists:

- Agreed that information on the priority on liquidation should be provided but highlighted that liquidation is usually applied at the legal entity level. They considered that the proposal for disclosure at consolidation level needs further consideration.
- Questioned whether testing for liquidation will provide the information that users are seeking.
- Noted that some information about resolution is already required for banks.
- Noted that the order of priority is not a concern for all investors and that the impact on disclosure overload should be considered.
- Agreed that the information should be provided in the notes as opposed to the face of the balance sheet.

Should the law or economic compulsion affect accounting for financial instruments? What are the practical challenges of introduction of economic compulsion in classification decisions?

Rights and obligations should only arise from a contractual agreement and economic incentives should not be considered.

Panellists indicated that:

- OIC stakeholders are likely to support the proposal not to consider law or economic compulsion in the classification of financial instruments.
- Economic compulsion should be ignored as it may lead to continuous reclassification which could have implications for investors and preparers.
- In many jurisdictions many of the terms of contracts are implied from statute, so a simple distinction between what is contractual and what is statutory may be difficult to apply.

Should information on potential dilution be improved?

IAS 33 information should be improved and the approach to attribute total comprehensive income is too complex.

The panellists made a range of comments including:

- The approach to attribute total comprehensive income is too complex.
- Information on potential dilution should be improved but questioned what that information should be.
- Significant guidance on disclosures about terms and conditions would be needed to avoid disclosure overload.
- The costs and benefits of the proposals should be analysed; and
- Disclosures in addition to these proposed in the DP should be considered (such as information on the sensitivity in the fair value of derivatives over own shares).

Way forward: Fine-tuning or pushing a reset button? Should presentation and disclosure proposals be pursued in conjunction with classification proposals or in isolation?

Fine-tuning focused useful information for users but presentation and disclosure should not be ignored.

Panellists noted that presentation and disclosure requirements were at least as important as the classification proposals.

Comments made by panel members included:

- It is better to have fine-tuning that focuses on information that is useful to users.
- Careful consideration is needed as to whether the benefits arising from the DP will exceed the costs.
- The proposals under the DP could change aspects of the current well-understood accounting treatment and may create confusion.