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FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Early-Stage Impact Assessment

FINAL REPORT

Contents

Executive Summary

ES1 This report provides an early-stage assessment of the impact of the IASB's Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity* (IASB DP). This report will also help inform EFRAG's final comment letter in response to the IASB DP.

ES2 As outlined in Chapter 1, this early-stage impact assessment is based on quantitative and qualitative data gathered from several sources including preparer and user surveys, aggregated data in commercial databases, EFRAG's review of the financial statements of the largest EU financial institutions and from obtaining stakeholder views on impact from outreaches and responses to EFRAG's draft comment letter on the IASB DP.

ES3 European Public Good - Economic consequences (see Chapter 4): To assess economic consequences, we considered the potential impact on competition for capital and behavioural impacts including on the issuance of instruments and on covenants and compensation contracts. However, as there was no indication of concern from stakeholders, this report does not have an assessment on if there are any impacts on EU entities investment choices with an implication for EU economic development. It is also hard to assess and quantify potential second order effects including investment choices on an *ex-ante* basis and particularly in respect of impact of proposals that are only at DP stage.

Highlights of our findings include the following:

a) At this stage, we have no evidence of negative effects on competition for capital by EU IFRS reporting entities but we have not undertaken a detailed review of the competition dynamics and the extent and implications of GAAP differences across major economic jurisdictions. At the same time, although most preparer and user survey respondents did not expect a significant impact on the cost of capital, we recognise that at this stage of the due process, it remains difficult to accurately anticipate the transitional and long-run effect of potential updates to IFRS requirements on cost of capital.

b) There could be potential for significant short-term market disruption to existing and prospective issuance of perpetual hybrid bonds as these instruments could potentially be reclassified from equity to debt under the IASB DP proposals. This disruption may arise from the call feature[1] within the covenants of perpetual hybrid bonds. The call feature can trigger early redemption of these instruments at a redemption price that is typically at 101% of par value and these may encourage the early call of current issues or deter new issuances. Early calls may impose costs[2] to both existing issuers and investors. Furthermore, based on the prevailing coupon rates, preparers may perceive that hybrid bond issuances that they considered as "cheap equity" have transformed to "expensive debt".

c) At this stage, we have only obtained indicative estimates of the market size of outstanding issued perpetual hybrids by EU non-financial entities and some indicative estimates of impact at individual entity level but we do not have any

[1] Accounting call feature necessitates redemption by the issuer at a strike price of 101% of par value should perpetual bonds that are classified as equity under IFRS change their classification to debt.

[2] Costs to issuers could arise if issued bonds carrying value is less than the redemption amount, while costs to investors could arise if they hold perpetual bonds that are trading at above the redemption price.

evidence of the possible second order effects[3] of such disruption at an aggregate level or whether it has any ramifications for entities investment choices and financial stability. We also consider that there could be measures (e.g. transitional arrangements) taken to mitigate the mentioned potential market disruption.

d) The IASB DP[4] (Paragraph IN19C) notes that the provisions in IFRIC 2 *Members' Shares in Cooperative Entities* will be retained. However, a number of co-operative banks expressed uncertainty about the implications of the IASB DP and expressed concerns about the impact of a potential reclassification of their member shares from equity to liabilities.

ES4 European Public Good - In addition to economic consequences, we considered impact on financial stability and sustainability as part of the assessment of European public good (Chapter 5).

a) To assess the impact on financial stability, we considered the potential interaction between the IASB DP proposals and prudential regulatory requirements for banking and insurance entities. From a banking regulatory capital perspective, there could be the following mechanisms of impact:

i) Reclassification between equity and liabilities for accounting purposes could impact regulatory capital if the accounting reclassification changes the regulatory classification of the instruments. However, as we understand, the regulatory capital classification (CET1 and AT1) categories will not be affected[5] by the IASB DP proposals.

ii) Reclassification of financial instruments from equity to liability could increase volatility in profit or loss due to the remeasurements of these instruments. Profit or loss for the period could change due to carrying value/notional amount remeasurements and due to changes in the amount of interest expense recognised (i.e. effective interest charge). In turn, subject to tax, the profit or loss effects could impact retained earnings.

Remeasurements of instruments that could be reclassified from equity to financial liabilities under the IASB DP proposals could potentially impact on retained earnings and CET1 volatility. However, such volatility is unlikely to occur in practice in an EU context for some instruments that may be reclassified from equity to debt but remain classified as AT1 for regulatory capital. For example, remeasurements of these instruments would likely only occur[6] and impact retained earnings if there was a temporary write-down gain that is taxable.

[3] As observed by a sell-side analyst commenting on the IASB DP proposal, an example of a second order effect could be an incremental spread/compensation for the loss of the cumulative features should cumulative perpetual bonds be replaced by non-cumulative bonds. But at this stage, we are not aware of any evidence that substantiates this expectation nor are we aware of any evidence that shows reduced issuance of bonds with cumulative features would adversely impact economic development or financial stability.

[4] Paragraph IN 19 C states that the conclusions of IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments would be carried forward. They should be part of particular requirements of IAS 32 that should be carried forward largely unaltered.

[5] An accounting classification change from equity to debt could impact classification under CET1 but not under AT1. However, we are not aware of any instruments that are part of CET1 that will be affected by the IASB DP proposals. Co-operative entities have raised concerns about the reclassification of their member shares from equity to liability and a potential consequential impact on CET1 but as noted the IASB DP has a provision for the retention of IFRIC 2.

[6] These instruments are normally recognised on an amortised cost basis. Profit or loss volatility could arise from the temporary write down of these instruments.

From a prudential perspective, regulatory capital volatility would also increase should the reported comprehensive income that updates CET1 not be subject to prudential filters that strip out volatility arising from accounting remeasurement.

iii) The proposed attribution[7] of comprehensive income could reduce retained earnings included in the highest quality of capital, CET1. This is because portions of amounts that are currently attributed to ordinary shareholders would be attributed to secondary equity claims if the IASB attribution approaches that result in an update of the statement of equity and carrying value on statement of financial position were adopted. Hence, subject to there being prudential filters for amounts included in retained earnings, there could be an impact of attribution on CET1.

b) With regards to insurance solvency requirements: As own funds (both basic and ancillary own funds) refer to the absorption of losses, the reclassification of financial instruments for accounting purposes will not directly impact the basic and ancillary own funds because the ability to absorb losses arises from the economic substance of an instrument rather than its classification for financial reporting purposes.

c) Overall, any effect on regulatory capital will ultimately depend on the extent to which prudential authorities decide to adapt or not adapt prudential filters to align with or deviate from the accounting.

d) We are not aware of any evidence or stakeholder concerns that suggests that the accounting classification of liabilities and equity could impact on the sustainability of EU business entities.

ES5 An assessment of whether the IASB DP will lead to an improvement in financial reporting (see Chapter 6) is set out below. When considering the expected effects on entities' financial statements it is however important to keep in mind that the IASB DP is a preliminary consultation document and does not cover all the matters or the level of detail that would be expected in a final IFRS Standard.

a) The new terminology related to classification has been identified by many stakeholders (both preparers and users) as unclear and challenging, which raises the possibility that the IASB DP proposals on classification could lead to new interpretative challenges and concurrent challenges in the analysis of financial statements.

b) Specifically, concerns have been raised that because users analyse financial statements with an assumption that reporting entities are going concerns, they are unclear about the use of liquidation in the IASB DP's proposed definition of financial liabilities. Furthermore, the meaning and application of "*independent of an entity's available economic resources*" in the definition of financial liabilities was considered unclear.

c) In relation to the classification concerns summarised above, there is recognition in the IASB DP that no matter what criteria are applied for a binary classification of financial liabilities versus equity, the ever- widening range of complex financial instruments that have characteristics of both debt and equity will limit the information that can be conveyed to users of financial statements

[7] The total retained earnings corresponds to a CET1 items, as per article 26 of the CRR. According to EBA, this prudential rule is not planned to be changed with the proposed attribution.

through classification. The IASB DP argues that enhanced presentation and disclosure requirements have a role in meeting the information needs of users.

d) However, there are mixed views on the usefulness of the IASB DP presentation proposals. There was some support for the IASB DP proposals for presentation of financial liabilities with more support for the proposals related to the statement of financial position than for the statement of financial performance. For the presentation of equity instruments, there was a particular concern on the complexity and relevance of attribution of comprehensive income to equity instruments other that ordinary shares. There was more support for only disclosures and improvements to the earnings per share calculation than the approaches that would result in an update of the carrying value of equity instruments other than ordinary shares in the statement of financial position and statement of changes in equity.

e) User feedback indicates that the proposed IASB DP disclosures are useful but could be refined to be as relevant as intended (e.g. priority on liquidation and terms and conditions).

ES6 Anticipated costs and benefits of the proposals in the DP (see Chapter 7): The findings show that:

a) A majority of preparer respondents expect the costs of implementing the IASB DP proposals to be minor.

b) There are contrasting views between users and preparers on the costs versus benefits with preparers viewing that costs outweigh benefits and users taking the opposite view. It is notable that a majority of preparer respondents expect costs to outweigh benefits while at the same time expecting only minimal or zero implementation costs. This could mean that preparers could be considering other costs beyond the direct implementation costs and/or they perceive no benefits from the proposals.

ES7 The impacts on the financial statements (see Chapter 8): Key findings are as follows

a) Reclassification of perpetual hybrid bonds will likely affect a number of financial and non-financial entities. There is some evidence that the impact on key ratios can be quite significant at an individual reporting entity level.

b) A number of financial institutions highlighted a potential significant impact on their financial statements due to the potential reclassification from equity to debt of some instruments that are classified as AT1 under regulatory capital classification.

c) From the preparer survey respondents, there is no evidence of a significant impact on financial statements due to the potential reclassification of irredeemable, fixed rate cumulative preference shares, net share-settled derivatives and foreign currency rights issue.

ES8 Reporting and use of non-GAAP information (see Chapter 9). The findings show that the majority of both user and preparer survey respondents expect there to be either no impact of the IASB DP proposals on the reporting and use of non-GAAP measures or they found it difficult to assess. This result could be indicative that either these respondents

a) Do not expect the need for a change in adjustments to financial liabilities and equity instruments related line items in the statement of financial position and statement of financial performance; or

b) Are unsure about whether the classification principles of the IASB DP will better reflect economic leverage than is the case under IAS 32.

CHAPTER 1: INTRODUCTION

Objective

1.1 This early-stage impact assessment is conducted in the spirit of putting into practice EFRAG's call for an evidence-based approach through all phases of standard setting activity.

1.2 The assessment relates to the proposals of the June 2018 *IASB Financial Instruments with Characteristics of Equity Discussion Paper (IASB DP)*.The IASB DP set out the preliminary proposals to amend existing requirements for the distinction between financial liabilities and equity in financial statements as well as an update of current presentation and disclosures requirements.

1.3 The impact assessment focuses on the anticipated effects of the IASB DP proposals including the likely impact on financial statements and possible economic consequences. At a high-level, it also considers the consistency of these proposals with the "European public good" criterion.

1.4 An impact assessment on the IASB DP proposals is appropriate given the pervasiveness and continued growth of innovative financial instruments that have liability and/or equity characteristics, the practical challenges arising from existing requirements, and the potential significant impact of these proposals for both financial and non-financial entities.

Approach

1.5 The impact assessment is based on both quantitative and qualitative data, as well as anecdotal stakeholder feedback related to both financial and non-financial institutions. The data informing the analysis is from the following complementary sources:

a) *Preparers and users surveys*: EFRAG conducted a preparer survey focusing on anticipated changes in classification and anticipated level of costs associated with the IASB DP proposals. The preparer survey had 51 completed responses and some partial responses[8]. And 11 of the non-financial preparer respondents account for approximately 49% of the universe of the issued European Economic Area (EEA) perpetual hybrid bonds. EFRAG also conducted a user survey focusing on the perceived usefulness of current reporting; users' assessment of potential changes in presentation and disclosure requirements and the anticipated cost versus benefits of the proposals. The user survey had 37 completed responses and some partial responses[9] (see Appendix 2 for profile of survey respondents).

b) *Stakeholder outreach feedback*: Outreach activities were conducted with the following stakeholders:

(i) EFRAG and Organismo Italiano Contabilità (OIC) joint outreach event in Milan on 7 November 2018 (users and preparers);

[8] For some of the questions in the preparer survey there were more than 51 responses

[9] For some of the questions in the user survey there were more than 37 responses.

(ii) EFRAG, the Dutch Accounting Standards Board (DASB) and Eumedion joint outreach event in Amsterdam on 20 November 2018 (users and preparers);

(iii) EFRAG and Accounting Standards Committee of Germany (ASCG) joint outreach event in Frankfurt on 20 November 2018 (users and preparers);

(iv) EFRAG, FSR-Danish Auditors (FSR) and Confederation of Danish Industry joint outreach event in Copenhagen on 23 November 2018 (users and preparers);

(v) EFRAG, European Federation of Financial Analysts Societies (EFFAS), Belgian Association of Financial Analysts (ABAF-BVFA) and the IASB joint user outreach event in Brussels on 26 November 2018 (users); and

(vi) EFRAG and UK Financial Reporting Council (UK FRC) joint outreach event in London on 4 December 2018 (users and preparers).

c) *Aggregate data related to instruments with expected changes in classification*: The EFRAG Secretariat analysed data sourced from third party databases and available public information included in a sell-side report with details of the universe of global, non-financial institutions' hybrid issuances that are currently accounted for as equity and would potentially be expected to be classified as liabilities under the IASB DP proposals. We used this data to assess the potential magnitude of EU hybrid securities that could have a classification change due to the DP proposals.

d) *EFRAG review of financial statements*: This review highlighted key findings from the review of financial statements of 16 financial institutions and data available from third-party databases.

e) *High-level review of related academic evidence*: Considered a high-level review of relevant academic literature[10]. This review cites studies with evidence on the analytical benefits of enhanced disclosures, economic consequences and on how accounting classification requirements impacts preparer issuance of financial instruments.

Limitations

1.6 *Limitations of survey data*: Similar to other evidence gathering methodologies, the exercise of gathering data on potential impacts through surveys, is subject to particular limitations[11]. These limitations includes: (a) the possibility that the aggregated results may only partly represent the population of IFRS reporting entities; and (b) partly represent the views of users.

1.7 *Status of proposals*: The IASB DP is a preliminary consultation document that sets out the IASB's current preferred views and their rationale but does not cover

[10] Fargher,N.,Sidhu,B.,Tarca,A., and Van Zyl, W. 2016. Accounting for financial instruments with characteristics of debt and equity: Finding a way forward, Working Paper-Australian National university, UNSW Australian Business School, University of Western Australia- This paper provides a comprehensive overview of available FICE related academic studies

[11] One limitation of survey data is the possibility of self-selection bias of respondents- whereby for example, the responses are dominated by individuals who have a particular influencing agenda or concerns- consequently, they are likely to be more incentivised to respond than the typical target respondent.

all the matters or the level of detail that would be expected in a final IFRS Standard. The ultimate impact of any resulting changes impact would depend on the specific final requirements and supporting guidance, including maters not addressed in the IASB such as transitional provisions. Moreover, preparers and other constituents may be unwilling to invest in an extensive review of the expected effects of implementing potential changes at this relatively early stage which leads to limitations in the volume and reliability of relevant data (e.g. costs) at the DP stage. Notwithstanding these limitations, the surveys and other feedback provide useful insights into the potential the impact of the IASB DP proposals.

1.8 *Limited aggregate data on specific instruments*: In the search for relevant aggregate data for purposes of the impact assessment, the EFRAG Secretariat reached out to the three European Supervisory Authorities (ESAs) and the European Central Bank (ECB) to ascertain whether they are aware of and could provide access to aggregate data related to instruments where classification changes are expected. They advised that such data is currently not readily available.

1.9 *Limitations of presented and disclosed financial statements information*: Information in databases does not include a detailed disaggregation of the equity components within total equity. In addition, the level of disaggregation[12] of equity within the statement of financial position varies, particularly when dealing with derivatives on own equity and hybrids.

1.10 *Limited recent IFRS/EU academic evidence*: There is not much IFRS/EU academic literature focused on FICE as most of the available academic evidence is focused on US data. There is particularly little direct evidence on the economic consequences of the various IAS 32 classification related amendments made in the last 10+ years (e.g. foreign currency rights issues and the puttable shares exceptions).

1.11 *Difficult to identify and quantify all potential second-order effects*: It is inherently difficult to anticipate all the unintended consequences and second-order effects including any impact on reporting entities' investment and future structuring choices by preparers or any changes in the level of issuance of different instruments that may arise from the IASB DP proposals. For example, there could be aspects of the IASB DP proposals that create incentives for increased issuance of instruments that are currently not prevalent (e.g. foreign currency rights issues). Hence, the impacts described in this report are not necessarily exhaustive.

[12] The EFRAG Secretariat considers that the varied presentation is partly due to the fact that IAS 1 *Presentation of Financial Statements* has limited requirements on the presentation of line items on equity components on the face of the statement of financial position (i.e. 'issued capital and reserves attributable to owners of the parent' and 'non-controlling interest') and statement of changes in equity (i.e. amounts attributable to owners of the parent and to non-controlling interests).

CHAPTER 2: IS THERE A NEED FOR ACTION?

2.1 The IASB DP and EFRAG's draft comment letter response outline challenges associated with current IAS 32 *Financial Instruments: Presentation* requirements that form the background to the proposals put forward by the IASB DP. These include:

a) *Conceptual issues*: currently IAS 32 sets out various requirements to distinguish liabilities from equity, including some rule-based requirements that lack a clear underlying rationale. IAS 32 also includes complex exceptions that override the definition of a liability in the Conceptual Framework, which make it inconsistent internally and create difficulties for the IFRS IC in interpreting IAS 32.

b) *Application issues*: the lack of clarity in the existing guidance and the absence of guidance on some issues leads to divergence in practice. For example,

(i) The application of the fixed-for-fixed condition to derivatives on own equity (e.g. written call option to deliver a fixed number of own shares in exchange for a fixed amount of cash when the number of shares changes as a result of an anti-dilution provision);

(ii) Accounting for written put options on non-controlling interests (NCI) – issues with the grossing up requirements and accounting within equity; and

(iii) Accounting for instruments for which the form and/or amount of the settlement depends on events beyond the control of the entity and the counterparty (some types of contingent convertible bonds such as bail-in instruments).

2.2 The IASB DP and EFRAG also acknowledge that the much information that users of financial statements can glean from any bifurcation of claims into liabilities or equity is limited. In addition to classification proposals aimed at resolving some of the classification challenges that arise under IAS 32, the IASB DP includes presentation and disclosure proposals aimed at enhancing the overall information provided to users.

2.3 Challenges with existing disclosures are highlighted by the EFRAG review of disclosures of 16 largest EU financial institutions. The report highlights the lack of adequate granularity related to issued equity instruments. The case for improved disclosures in this area is also supported by the 2018 European Securities Market Authority's (ESMA) enforcement report[13].

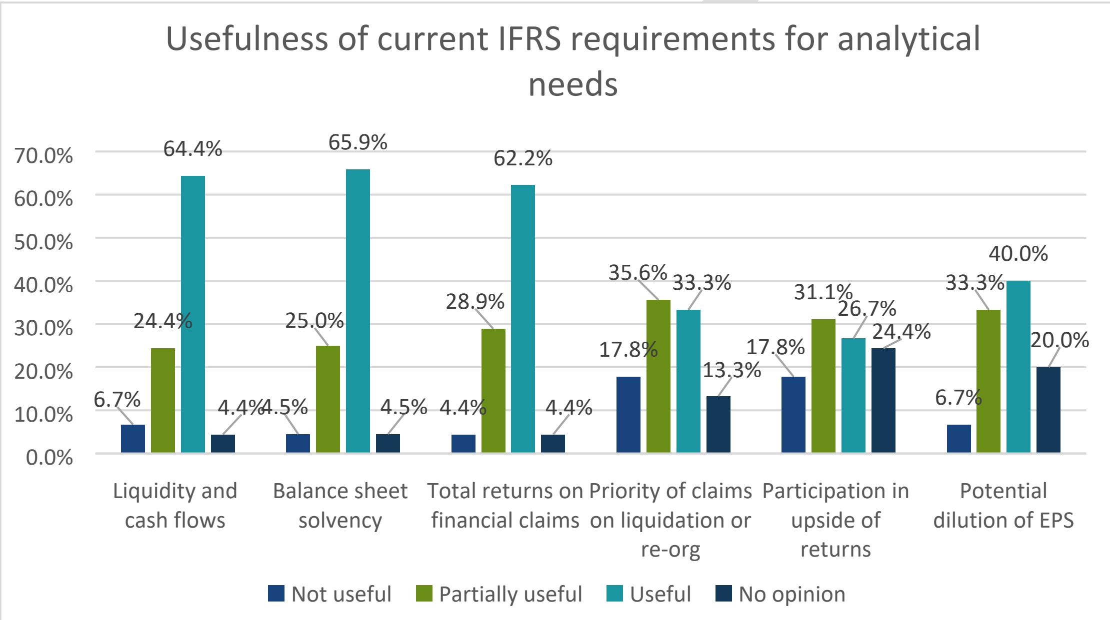
[13] ESMA Report, 2018. Enforcement and Regulatory Activities of Accounting Enforcers in 2017. The report notes that the analysis for 44 issuers carried out in the report revealed that where significant analysis was required in the classification of financial instruments either as a financial liability or as equity instrument, approximately 40% of issuers did not disclose the accounting policy and the analysis made in their classification. In addition, key characteristics of financial instruments were not always provided. https://www.iaasa.ie/getmedia/dfb49c86-600b-48a0-ad70-5b92718261f1/esma32-63-424_report_on_enforcement_activities_2017.pdf

Case for change - Evidence from Survey Feedback

2.4 The EFRAG user survey feedback (see Figure 1) provides support for enhancing the disclosures as a majority (>60%) of user respondents find current information to be useful for assessing liquidity, balance sheet solvency and total returns on financial claims (financial liabilities and equity).

2.5 However, the survey results also show that less than 40% of respondents find current IFRS requirements to be fully useful for the analysis of priority of financial claims (financial liabilities and equity), participation in upside of returns and potential dilution of earnings per share (EPS). Hence, there is scope to enhance existing information so as to better meet investors analytical needs.

Figure 1: Usefulness of current IFRS requirements for analytical needs



Conclusion

2.6 The analysis outlines in paragraphs 2.1 to 2.4 above, including the feedback from users, indicates that there is a case for enhancing the existing IFRS requirements on financial instruments with characteristics of equity. At a minimum, based on the user survey feedback, there seems to be a need to enhance current disclosures.

CHAPTER 3: IASB DP PROPOSALS RELATIVE TO CURRENT REQUIREMENTS

3.1 This section provides a comparison of the IASB DP proposals and IAS 32 (see summary of IAS 32 requirements in Appendix).

IASB DP Classification proposals

3.2 The IASB DP articulates new classification principles by describing two features for defining a financial liability. A claim is a financial liability if either (or both) of the following apply:

a) the timing feature, similar to IAS 32 which defines a financial liability as a contractual obligation to transfer a financial asset (e.g. cash).

b) the amount feature, where the contractual settlement amounts are independent of an entity's available economic resources.

3.3 Equity is a residual category (i.e. a claim is equity if it is not defined as a liability based on amount and timing features).

Potential changes in classification identified by IASB DP

3.4 The IASB expects that most of the existing classification outcomes of IAS 32 will not change under the IASB DP proposals. However, there would be:

a) Changes from equity to liability for the following instruments due to the application of the amount feature:

(i) certain types of perpetual bonds (e.g. those with a cumulative deferral feature);

(ii) non-redeemable fixed-rate cumulative preference shares; and

(iii) foreign currency rights issues.

b) Changes from liability to equity for net-share settled derivatives on own equity that are meet the amount feature test (Appendix 1 contains a description of the "fixed-for-fixed" condition under IAS 32).

Potential changes in classification not identified by the IASB DP

3.5 The four types of financial instruments (undated or perpetual bonds with a payment deferral cumulative feature; non-redeemable fixed rate cumulative preference shares; foreign currency rights issues; and net share settled derivatives on own equity) identified in the IASB DP are not the only cases where a change in classification would occur if the IASB DP proposals were adopted.

3.6 To assess whether a change in classification would occur to any other financial instruments requires an assessment of how the IASB DP classification principles, coupled with the accompanying additional guidance, would be applied depending on the terms and conditions of the financial instruments. For example, the IASB DP provides guidance on when a net amount of a derivative is affected by a variable that is independent of the entity's available economic resources. The clarifying guidance covers several variables[14] where there is current diversity in practice and therefore could result in changes in accounting classification for some entities.

IASB DP presentation and disclosure proposals

3.7 The IASB DP proposes that financial instruments that will be classified as financial liabilities but have equity-like returns (i.e. the amount of the liability depends on the entity's performance or value of its own shares) should have their changes in value presented in other comprehensive income (OCI) and that reclassification (recycling) from OCI to profit and loss is not allowed. For example, shares redeemable at fair value (other than instruments classified as equity in accordance with the so-called "puttables exemption") would be classified as liabilities and with changes in their fair value presented in OCI without recycling to profit or loss.

3.8 The IASB DP proposes that total equity and changes in equity should be disaggregated between ordinary shares and equity instruments other than ordinary shares.

3.9 The IASB DP includes the idea of allocation of profit or loss and OCI to different classes of equity instruments in order to depict the wealth transfers across these instruments (i.e. attribution).

3.10 The IASB DP explores possible improvements to disclosure requirements for priority of claims on liquidation, potential dilution of ordinary shares; and terms and conditions of financial instruments.

[14] Variables that the IASB DP provides guidance on include: currency- other than the entity's functional currency - and fixed units of financial assets; variables that depend on an entity's resources before deducting all other claims against the entity (e.g. total assets, EBIT); time value of money; anti-dilution provisions; distributions to holders of equity instruments; non-controlling interests; and contingencies.

CHAPTER 4: EUROPEAN PUBLIC GOOD - ECONOMIC CONSEQUENCES

4.1 Assessing the potential economic consequences of changes to financial reporting requirements on an *ex ante* basis is a complex and challenging exercise. For instance, for the IASB DP proposals, it is challenging to disentangle transitional economic consequences such as the impact of reclassification of current issuances from the long run economic consequences such as the impact of a potential *de facto* change in the threshold for equity classification under IFRS reporting.

4.2 One of key potential economic consequences - with potential implications for entities' value creation and contribution to economic development - could be changes to entities' operational and investment choices as a result of the IASB DP proposals. However, during the consultations on the IASB DP, EFRAG has not heard any explicit concerns about any impact on entities' operational and investment choices. Furthermore, according to financial economic theory, in a frictionless world where there would be no taxes, transaction and bankruptcy costs- entities' operational and investment decisions ought to be decoupled from their capital structure and financial engineering choices.

4.3 Nonetheless, in the practical world, entities tend to have an optimal or desirable target capital structure (i.e. aggregate amount and type of financial liabilities). EFRAG observes that certain forms of funding, including hybrid bonds, are a popular choice for entities that have particular strategic and operational investment needs. For instance, Scope rating agency report[15] attributes the recent surge in issuance of EU corporate hybrids to the growth in merger and acquisition transactions.

4.4 Hence, any factor that impacts on the issuance of instruments used for financial engineering purposes could possibly also have either disruptive short term or long term economic consequences including a potential effect on investment and operational choices. But these consequences are difficult to assess and quantify on an *ex-ante* basis and are not covered by EFRAG's assessment.

4.5 Instead, EFRAG's assessment has limited its scope and considered whether the various findings from the surveys and other sources provide *prima facie* evidence of a significant risk of negative unintended consequences for the European economy in the following areas:

a) Competition for capital;

b) Issuance of instruments of interest; and

c) Covenants and compensation contracts.

[15] Scope rating. July 19 2018. Europe's hybrid bond market rebound gathers pace: Issuance set to exceed EUR 20bn in 2018

Competition for capital

Comparison with other national GAAP reporting requirements

4.6 Accounting classification of financial instruments does not affect their economic fundamentals and, to some extent, some investors and credit rating agencies will make adjustments based on their own analysis of the economics. Nonetheless, equity classification reduces the reported liabilities and evident solvency of the issuer and may be perceived to have a positive effect on reporting entities' creditworthiness and ease of raising capital.

4.7 We have very little evidence on the competition effects of GAAP differences. However, entities may be concerned that they face a disadvantage in raising capital if the accounting requirements they apply lead to a substantially higher level of reported liabilities than for non-IFRS reporters with which they compete for capital. Hence an analysis of potential competition effects should consider the relevant IFRS requirements would give rise to this situation. A comprehensive analysis would require sub-analyses of the competition landscape for capital, the applicable GAAP differences and the mechanisms of effect by which those differences could affect the availability and/or cost of capital for European entities.

4.8 Besides the classification effects of the IASB DP, there is likely to be interest in the overall presentation and disclosure requirements by users of financial statement (*see analysis of user feedback in Chapter 6: Improvements to Financial Reporting*). Users' information needs beyond the debt or equity classification include information that can be provided by disclosures (e.g. priority of claims on liquidation or re-organisation, potential dilution of earnings, potential for participation in the upside of returns).

4.9 Assessing the proposals in the IASB DP on classification, presentation and disclosure of instruments against equivalent national and international GAAPs is beyond the scope of this report. Similarly, it is beyond the scope of this report to consider market practices and regulatory regimes where IFRS Standards are not applied.

4.10 Any future comparison of IFRS requirements with international GAAPs would in future need to consider in particular the requirements of US GAAP, which are themselves under review. In September 2017 the Financial Accounting Standards Board (FASB) included a project on financial instruments with characteristics with debt and equity (including convertible debt) on to its Technical Agenda. This topic has been one of longstanding focus by the FASB dating back to 1986 with various updates and via the 2008 FASB-IASB joint Discussion Paper whereby both standard setters were considering a fundamental overhaul to their respective requirements for distinguishing financial liabilities from equity. Any future research would need to include both developments.

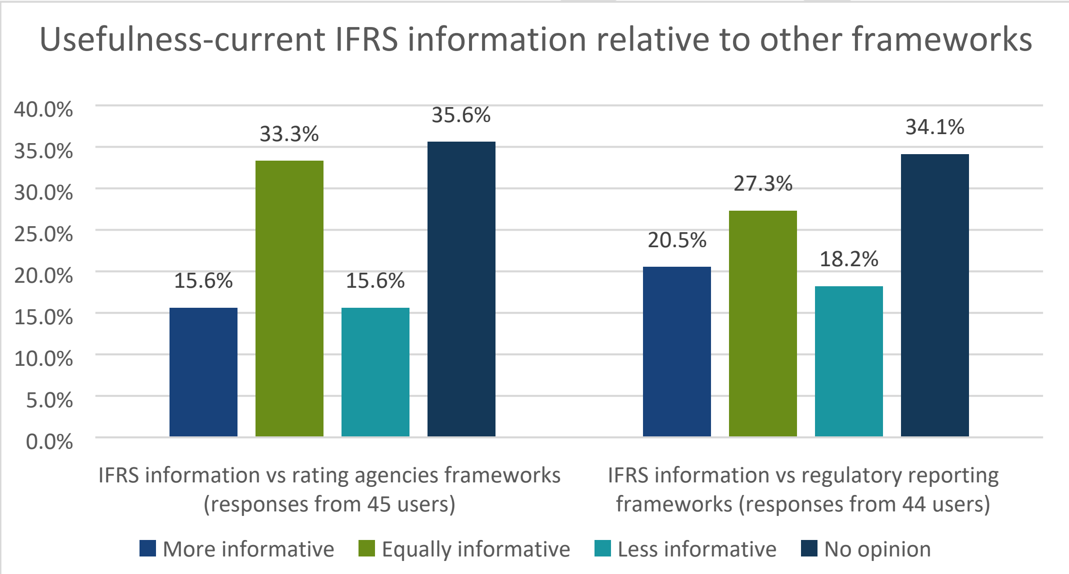
Role of IFRS information versus rating agencies criteria in capital allocation

4.11 The role that IFRS information fulfils in the capital raising and allocation process is an important consideration whilst considering the impact of the IASB DP proposals on competition for capital. Could the DP proposals result in IFRS information having either a greater or diminished role in capital allocation? A related question is whether, for issuer entities and investors that are raising and allocating capital, the IASB DP proposals will impact on the usefulness of IFRS information relative to credit rating agencies' assessment of issued instruments?

4.12 Credit ratings play a key role in both the issuance and investor demand for financial instruments with characteristics of debt and equity. There is academic evidence[16] showing that for a sample of EU issuer entities, credit rating matters more than accounting classification in influencing their hybrid bond issuance. According to a sell-side report[17], 78.8% of issued hybrids are rated.

4.13 Furthermore, as can be seen from EFRAG's survey results (Figure 2), investors and analysts rely on debt versus equity information from accounting, rating agency[18] and regulatory reporting[19] frameworks and have differing views on the information value of the debt-equity distinction made across these different frameworks. As can be seen from the survey results, there are some users who consider rating agencies' assessment to be more informative than IFRS information.

Figure 2: Usefulness – Current IFRS information relative to other frameworks



4.14 A key difference is that, for the purpose of their analysis, rating agencies are able to apply a continuum approach by classifying instruments as partly debt and partly equity. For example, EFRAG has seen rating agencies typically apply such an approach to hybrid instruments. Rating agencies consider the expected maturity rather than contractual maturity and their criteria[20] for assigning equity

[16] Bierey. M, Muhn. M, and Martin Schmidt.M. 2016. Competing debt-equity classification regimes: Do firms care more about accounting standards or rating agencies? Working paper- ESCP Europe and Universität zu Berlin

[17] Deutsche Bank Corporate and Investment Bank: Cumulative and non-cumulative FICE – November 2018

[18] The rating agencies assignment of equity credit to hybrid instruments is mainly considered by investors who are focused on the creditworthiness of an entity and on investing in the debt and hybrid instruments rather than those who are only focused on the valuation of a reporting entity's equity. Hence, the EFRAG survey results that includes views of the full spectrum of users may differ from those of a survey that would have only got views from debt and hybrid instrument investors.

[19] Regulatory reporting distinction of debt versus equity would mainly be considered by investors and analysts who cover banks and insurance entities. Hence, the EFRAG survey results that includes views of the full spectrum of users may differ from those of a survey that would have only got views from investors and analysts who at least cover banks and insurance entities.

[20] Bierey. M, Muhn. M, and Martin Schmidt.M. 2016. Competing debt-equity classification regimes: Do firms care more about accounting standards or rating agencies? Working paper- ESCP Europe and Universität zu Berlin- According to the working paper, the criteria across the three main rating agencies (S&P, Moodys and Fitch) is fairly consistent though S&P

credit differs from both the IAS 32 and IASB DP proposals criteria for distinguishing debt from equity.

4.15 A couple of observations relating to whether there will be increased reliance on rating agencies assessment relative to IFRS information by financial capital providers:

a) As we understand, the three main rating agencies' criteria for assigning equity credit to hybrid instruments is unlikely to change. Hence, the main variable that ought to affect capital providers reliance on rating agencies assessment ought to be the extent to which there are perceived enhancements or otherwise to IFRS information.

b) From the outreach to users, EFRAG has not heard from users that the IASB DP classification proposals would provide less relevant information than current IAS 32 classification requirements.

c) The IASB DP proposals include additional disclosures. The EFRAG user survey results shows that most user respondents (>70%) find all the proposed disclosures to be useful (see Chapter 6). There is academic evidence[21] showing that for experienced investors, disclosures are probably more important than the debt versus equity classification distinction. This evidence would support the view that investors are unlikely to lessen their reliance on IFRS information due to the IASB DP proposals.

4.16 Overall, it seems unlikely that investors would lessen their reliance on IFRS information relative to rating agencies assessment. And it is possible that they might increase their reliance on IFRS information- should potential updates to classification, presentation and disclosure requirements result in enhanced information relative to current reporting.

4.17 It is harder to clearly anticipate whether entities issuance of hybrid securities will be affected by rating agencies assessment to a greater extent than they are currently. A couple of observations

a) As noted in paragraph 4.14, rating agencies consider expected maturity to assign equity credit and this criteria is not expected to change. At the same time, due to the amount feature under the IASB DP proposals, some hybrid

tends to have the strictest criteria. The paper points to one difference between rating agency and IFRS equity classification-while perpetual bonds are classified as equity under IAS 32 and those with a cumulative feature will be classified as debt under the IASB DP proposals- rating agencies do not focus on contractual maturity but determine and take into account the expected maturity (e.g. S&P defines expected maturity date as the date on which the cumulative step-up reaches at least 100 basis points).

[21] Clor-Proell, S., Koonce, L. & White, B. 2016. How do experienced users evaluate hybrid financial instruments? Journal of Accounting Research, - The paper experimentally tests whether the features of hybrid instruments affect the credit-related judgments of experienced finance professionals, even when the hybrid instruments are already classified as liabilities or equity. The results suggest that getting the classification right is not of primary importance for these experienced users, as they largely rely on the underlying features of the instrument to make their judgments. A second experiment shows that experienced users' reliance on features generalizes to several features that often characterize hybrid instruments. However, the paper find that experienced users vary in their beliefs about which individual features are most important in distinguishing between liabilities and equity. Together, the results highlight the importance of effective disclosure of hybrid instruments' features.

instruments may get reclassified from equity to debt. Hence, at face value and consistent with the academic evidence cited in paragraph 4.12, it would seem that if the IASB DP proposals are adopted, entities issuance of hybrid instruments would more likely be influenced by credit rating agencies assessment than by the accounting classification. During one of EFRAG's outreach meetings, a representative from a large cap utility entity emphasised the continued importance of rating agencies assessment in determining their hybrid issuance.

b) On the other hand, if the gap between the portrayal of reporting entities financial liabilities based on rating agencies' criteria versus IFRS information were to widen, and if in parallel, the potential updated IFRS requirements conveys to investors additional information that incrementally affects the pricing of hybrid bonds- then rating agencies' assessment could become less influential than they are today. In other words, entities that issue instruments are likely to consider and be responsive to capital markets pricing factors including whether investors increase their reliance on IFRS information relative to rating agencies assessment.

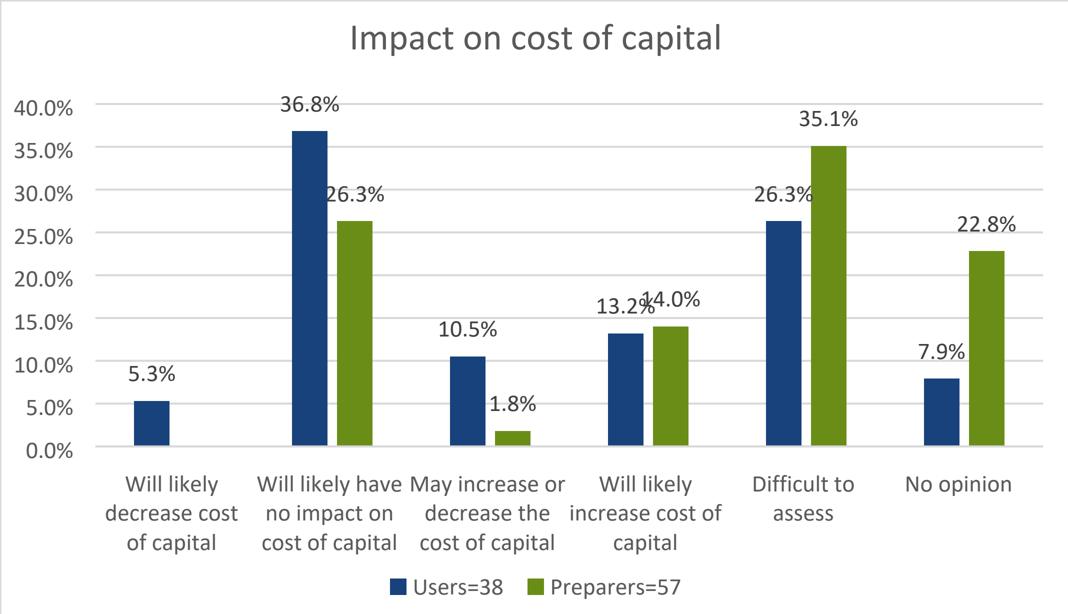
Impact on cost of capital

4.18 The EFRAG surveys sought information on the expectations of preparers and user as to changes in the cost of capital if the IASB DP proposals were adopted. The responses in Figure 3 show that there are various views but most of those that had a view expected no impact on cost of capital. There are also a significant proportion of respondents with either no opinion or found it difficult to assess the impact on cost of capital, reflecting a general difficulty in anticipating the overall marginal effect of any new accounting standard on the cost of capital.

4.19 It is not surprising that there is no unanimity or clear cut view from the user and preparer survey respondents on the aggregate directional impact on cost of capital. It is difficult to predict the likely impact as there are different factors that could either increase or decrease the cost of capital. For example, any perceived increases in transparency of debt versus equity may reduce cost of capital. At the same time, if entities are perceived to be riskier due to an aggregate increase in items that are reclassified from equity to debt, there could be an increase in cost of capital.

4.20 Besides the directional effect, the impact on cost of capital may not be static (i.e. transitional impacts may differ from steady state impacts). At this early stage of potential standard setting, it is hard to meaningfully predict how the cost of capital may change during the transitional period and in the long run.

Figure 3: Impact on cost of capital



Summary on competition for capital

4.21 At this stage, we have no evidence of negative effects on competition for capital by EU IFRS reporting entities but we have not undertaken a detailed review of the competition dynamics and the extent and implications of GAAP differences across major economic jurisdictions.

4.22 Whilst they may rely on rating agencies assessment, there is no reason to expect a reduced dependence by investors on IFRS information. Finally, although many preparer and user respondents expect no impact on cost of capital due to the IASB DP proposals- at this stage of the due process it is difficult to accurately anticipate the transitional and long-run impact on cost of capital.

Impact on issuance of instruments of interest

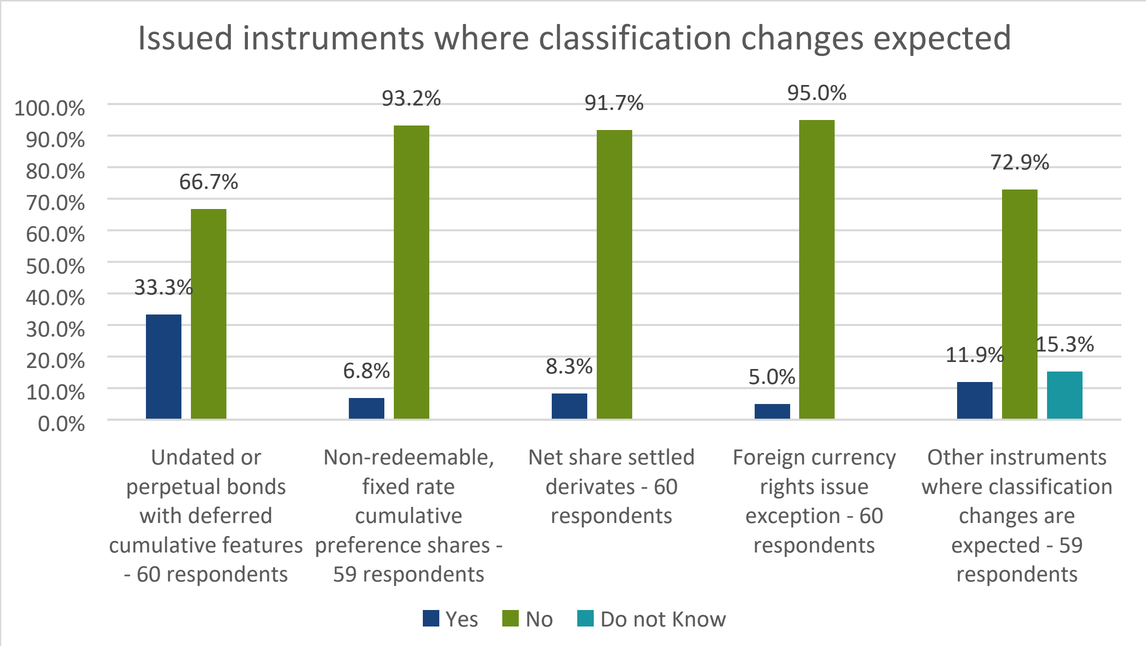
Overview of issued instruments of interest

4.23 The IASB DP proposals address various areas where there are inconsistencies in the accounting for financial instruments with characteristics of debt and equity. This impact assessment report has prioritised particular areas and does not address all aspects covered by the IASB DP (e.g. does not address written put options on non-controlling interests).

4.24 Stakeholder feedback indicates that most concerns are generally about any changes in accounting classification from equity to debt. This includes three of the four instruments identified by the IASB DP where changes in classification would occur (undated or perpetual bonds with a payment deferral cumulative feature; non-redeemable fixed rate cumulative preference shares; and foreign currency rights issues).

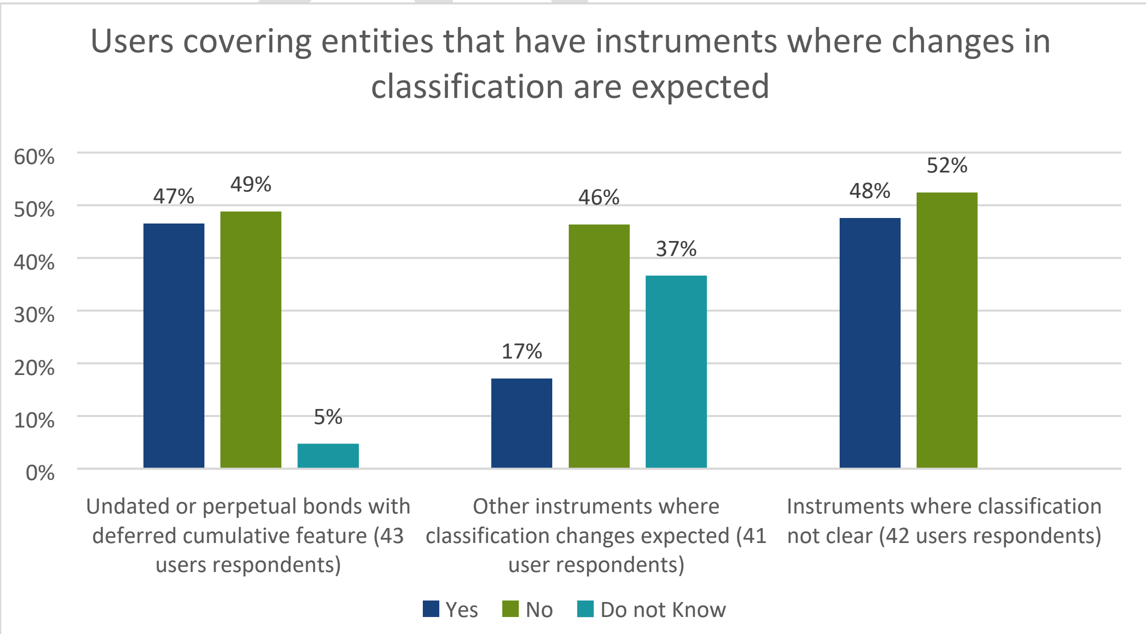
4.25 The survey results (see Figure 4 below) show that for the preparer respondents - undated or perpetual bonds with payment deferral cumulative features- were the most commonly issued among the four instruments identified by the IASB DP where changes in classification would occur. The accounting of hybrid bonds was also of particular interest to investors during several of the outreach meetings.

Figure 4: Issued instruments where classification changes are expected



4.26 To further assess the pervasiveness of instruments where changes in classification are expected, the EFRAG user survey sought views on whether users were covering entities with exposure to these instruments. The results (see Figure 5) show undated perpetual hybrid bonds as being the instruments where changes in classification are expected.

Figure 5: User coverage on instruments that are likely to change in classification



4.27 Besides the four instruments identified[22] in the IASB DP, there are other instruments where changes in classification could occur depending on the

[22] Undated or perpetual bonds with a payment deferral cumulative feature; non-redeemable fixed rate cumulative preference shares; net settled derivatives on own equity; and foreign currency rights issues

application of the IASB DP proposals to individual instruments' terms and conditions. Stakeholder and survey feedback also identified instruments where there are concerns about the impact of potential changes in classification including:

a) Some AT1 instruments such as perpetual bonds with discretionary dividends; and undated non-cumulative preference shares with conversion features; and

b) Co-operative shares due to the application of amount feature (although the IASB DP notes that the provisions in IFRIC 2 *Members' Shares in Cooperative Entities* will be retained).

4.28 On the basis of the EFRAG preparer and user surveys feedback and stakeholder outreach feedback, the sections below further analyse the potential economic consequences of the potential classification change on perpetual bonds, some AT1 securities and co-operative shares. Finally, due to the proposed elimination of the foreign currency rights issue exception in the IASB DP, there is also a brief review of impact on rights issues in the below section.

Perpetual hybrid bonds

4.29 Hybrid bonds - with features of debt and equity - are an attractive form of funding for entities because of:

a) their tax deductibility in some jurisdictions;

b) the deferability of coupon and/or principal payments of some hybrid instruments[23];

c) their eligibility for equity classification under accounting requirements and for classification as intermediate equity by rating agencies- bolstering issuing entities' rating agencies key ratios and perceived creditworthiness;

d) they can lower the weighted average cost of capital because interest paid is lower than shareholder return requirements (i.e. cheap equity); and

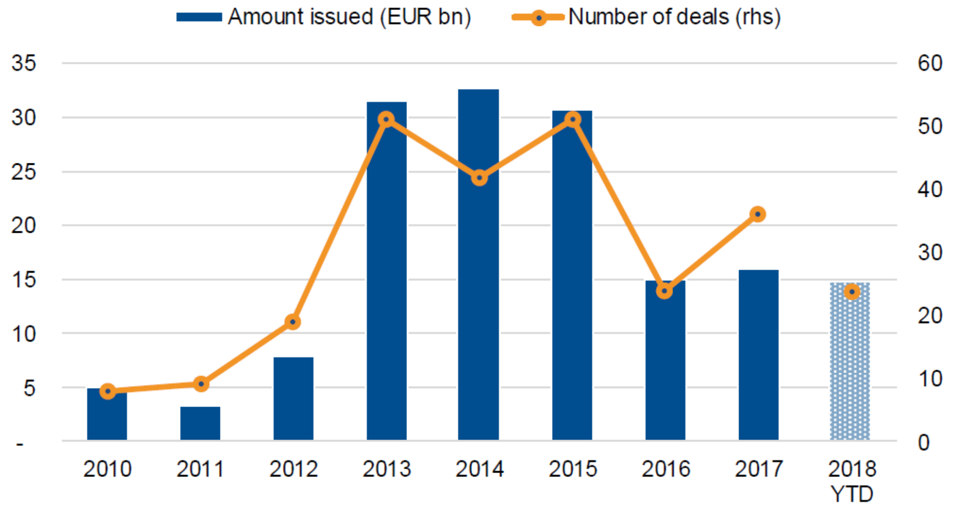
e) hedge accounting treatment eligibility when classified as liabilities. Liability classification makes it possible to hedge interest and foreign currency risks.

4.30 At the same time, hybrid bonds are an attractive asset class for investors because of their relative high coupons.

4.31 As shown in Figure 6, the volume of issuance of hybrid bonds over the last few years has been significant and fluctuated depending on the economic environment (e.g. level of interest rates) and different factors that influence the supply and demand for these bonds (e.g. investor sentiment, entities merger and acquisition financing needs).

[23] Not allowed for pure AT1 instruments

Figure 6: Volume of issuance of hybrid bonds



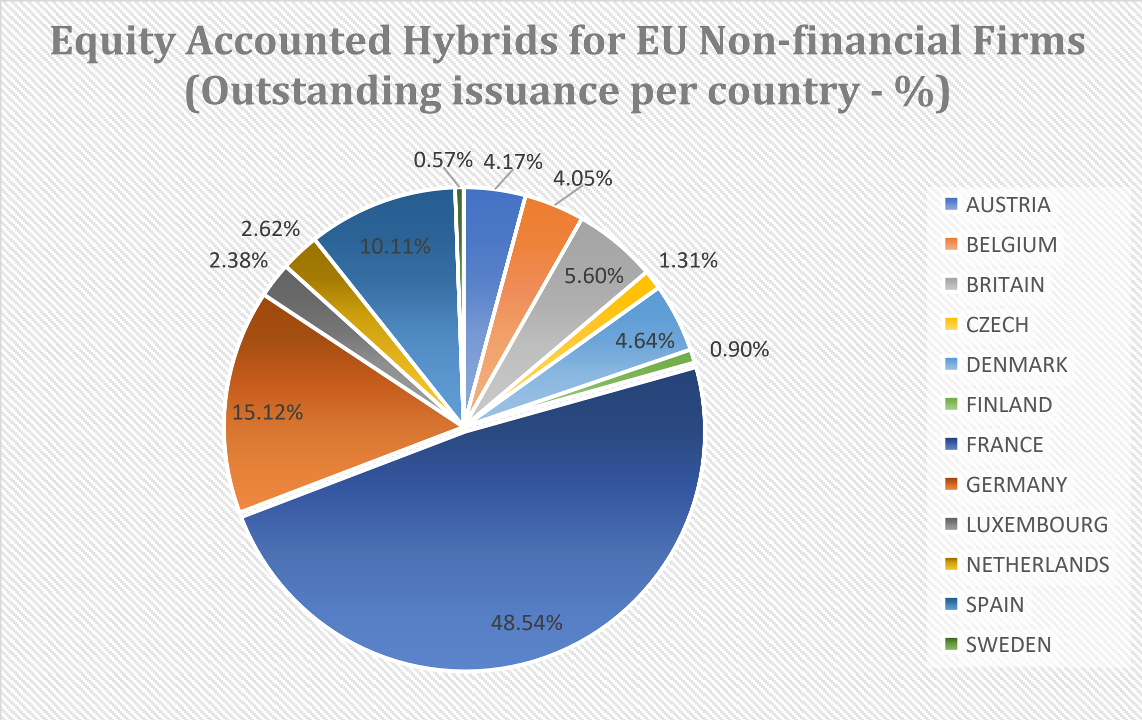
Source: Bloomberg, Scope

4.32 Only some of these hybrid bond instruments including perpetual bonds with deferred cumulative features are currently classified as equity under IAS 32. According to a recent analysis by one of the sell-side research firms[24], about 69% of EU hybrid bonds are currently booked as equity under IAS 32 and the cumulative feature is a standard feature of all rated corporate hybrid

4.33 Using data of outstanding global issuance of hybrid bonds that was sourced from Bloomberg and included in a Deutsche Bank sell-side research report, data for EU entities suggests that there are 83 billion euros worth of outstanding hybrids bonds for EU non-financial entities- representing a significant albeit relatively modest proportion of the aggregate financial liabilities of EU non-financial entities (43 trillion euros). Figure 7 provides a breakdown by country based on the Deutsche Bank data:

[24] Credit Agricole, September 2018. IASB Discussion Paper on corporate-hybrid market: manageable uncertainty

Figure 7: Equity Accounted Hybrids Outstanding for EU Non-financial firms



Potential effect of classification change on issuance of perpetual bonds with deferral cumulative feature

4.34 There is academic evidence related to US GAAP[25] and IAS 32 [26] showing that after a change in accounting standards that required financial instruments (e.g. preference shares, mandatorily redeemable bonds) to be reclassified from equity to debt, the issuance volume of the related instruments declined dramatically. The same effect may occur were the IFRS classification of perpetual bonds with deferred cumulative payment feature to change from equity to debt as proposed by the IASB DP.

4.35 Another anticipation of economic consequences is highlighted in a sell-side research report[27] and echoed during an EFRAG user outreach meeting pointing to the risk of market disruption due to the IASB DP proposals. The potential disruption could arise due to the callability of perpetual bonds whereby there

[25] Levi and Segal (2015)- The impact of debt-equity reporting classifications on the firm's decision to issue hybrid securities. *European Accounting Review* 24 (4):801- 822.- The paper found that when the US GAAP classification rules changed such that mandatorily redeemable preference shares were reclassified from equity to debt, there was a decline in the issuance of these instruments.

[26] De Jong, A., Rosellon, M. & Verwimejeren, P. 2006. The Economic Consequences of IFRS: The Impact of IAS 32 on Preference Shares in the Netherlands. Accounting in Europe, 3, 169-185. - This paper demonstrates one of the economic implications of accounting standards- focusing on the impact of the International Financial Reporting Standards (IFRS) regulation on preference shares in the Netherlands. IAS 32 causes most preference shares to lose their classification as equity and these shares will hence be classified as liabilities. The paper documents that for Dutch firms with preferred stock outstanding, the reclassification will on average increase the reported debt ratio by 35%. The paper finds that 71% of the firms that are affected by IAS 32 buy back their preference shares or alter the specifications of the preference shares in such a way that the classification as equity can be maintained. The main determinant of the decision whether to give these consequences to IAS 32 is the magnitude of the impact of IAS 32 on a firm's debt ratio. The paper concludes that IFRS does not only lead to a decrease in the use of financial instruments that otherwise would have added to the capital structure diversity, but also changes firms' real capital structure.

[27] Credit Agricole, September 2018. IASB Discussion Paper on corporate-hybrid market: manageable uncertainty

could be an early redemption call of these instruments at a strike price (typically at 101 or 101% of par value) in the event that issuers are no longer able to classify these instruments as equity. The redemption arises from the accounting call feature that are typically included within the covenants of these hybrid instruments.

4.36 Due to the early redemption, there could be a cost to issuers whose bonds are trading or have a carrying value below the redemption price. There could also be a cost (foregone returns) to investors that are holding any of these bonds while they have a market value that is above the redemption price.

4.37 In response to the EFRAG draft comment letter, Danish Power and Utility company, Orsted raised similar concerns indicating that it would no longer be able to classify 1.8 billion euros of its hybrid capital as equity due to the accounting call feature.

4.38 Notwithstanding the potential impact of the IASB DP proposals, there is also evidence[28] showing that credit rating matters more than accounting classification in influencing hybrid bond issuance. The evidence is based on a study that analyses 115 hybrid bonds issued by 74 European firms between 2005 and 2016 and shows that issuance is more influenced by negative development in firms' credit ratings than by their GAAP leverage ratios (e.g. equity ratio, interest coverage). The study shows that the effect of accounting classification on hybrid bond issuance is more pronounced in unrated than rated instruments. One could infer from this study that the impact of change in accounting classification ought to be more pronounced for unrated than for rated instruments.

4.39 In similar fashion, the sell-side research report, which highlighted the possibility of market disruption[29] due to issuer recall of perpetual bonds, were these to be reclassified to debt based on the IASB DP proposals, notes that this impact could be most pronounced for non-rated hybrids. It could also occur for an unquantified subset of rated hybrids where issuers are interested in attaining equity classification more than they are in obtaining rating agency equity credit. A Deutsche Bank report[30] estimates the split between rated (78.8%) and non-rated (21.2%) hybrid instruments.

4.40 We do not have any evidence of the possible knock-on second order effects of such disruption (e.g. impact on pricing and volume of issuance) and whether it has any economic consequences and implications for financial stability. Furthermore, it is possible to mitigate the disruption. For example, some stakeholders have suggested that transitional arrangements such as the IASB allowing grandfathering of existing instruments could be applied to mitigate against such a potential market disruption.

4.41 As observed by a sell-side analyst commenting on the IASB DP proposal, an example of a second order effect could be an incremental spread/compensation for the loss of the cumulative features should cumulative perpetual bonds be replaced by non-cumulative bonds. But at this stage, we are not aware of any evidence that substantiates this expectation nor are we aware of any evidence

[28] Bierey. M, Muhn. M, and Martin Schmidt.M. 2016. Competing debt-equity classification regimes: Do firms care more about accounting standards or rating agencies? Working paper- ESCP Europe and Universität zu Berlin

[29] Disruption due to callability of bonds due to accounting event clause in covenants

[30] Deutsche Bank Corporate and Investment Bank: Cumulative and non-cumulative FICE – November 2018

showing that reduced issuance of bonds with cumulative features would adversely impact economic development or financial stability.

Estimating potential impact of reclassification of perpetual bonds with deferral cumulative feature.

4.42 The EFRAG preparer survey data provided some indication of impact at individual firm level revealing a wide range of impacts for affected entities ranging from 8% to 40% of total equity attributable to ordinary shareholders. One entity indicated that its financial leverage ratio net debt to EBITDA would increase from 2.4 to 3.1. However, these highlighted potential impacts for some reporting entities may not be representative of the impact of the potential reclassification of perpetual bonds across all EU entities.

4.43 It is noteworthy that a recent Deutsche Bank sell-side report[31] indicated that there is approximately 120 to 130 billion Euros of issued perpetual bonds related only to global non-financial entities outside of the US. Of these issuances, 83 billion Euros are attributable to EU non-financial entities.

4.44 In the absence of access to detailed terms and conditions it is hard to determine the amount of these bonds that might be reclassified. Though estimates of the amount to be reclassified have been made[32], it will remain challenging to reliably estimate the aggregate impact on EU entities without knowing the contract terms and features across of specific perpetual bonds.

Contingent convertible bonds and other Additional Tier 1 (AT1) instruments

4.45 Contingent convertible bonds (CoCos) are a subset of hybrid bonds prevalent amongst some[33] financial institutions (mostly large EU banks) and intended for strengthening the capital base. CoCos, classified as Additional Tier 1 (AT1) bonds under regulatory capital classification, force losses on investors when a bank's capital falls below a certain trigger level through conversion into equity or a write-down.

4.46 These instruments have been a key pillar in the regulatory regime drawn up to strengthen banks' capital levels through the Capital Requirements Regulation, the Bank Recovery and related Delegated Acts.

4.47 Figure 8 from a Deutsche Bank report[34] shows that Europe leads the issuance of AT1 instruments and that there has been significant albeit varied year to year demand for AT1 instruments over the last five years.

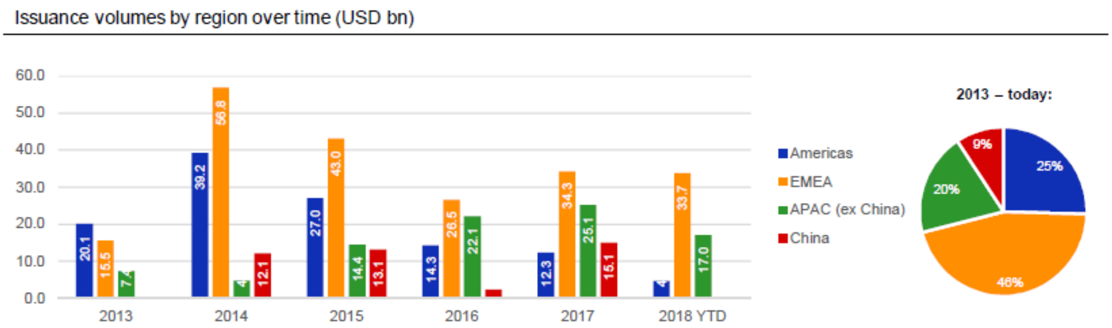
[31] Deutsche Bank Corporate and Investment Bank: IFRS Equity accounted hybrids – November 2018. Has data sourced from Bloomberg and available public information

[32] A sell-side research report suggested 70% of issued perpetual bonds with a value of more than 80 billion euros would be reclassified.

[33] https://www.economist.com/news/finance-and-economics/21740744-new-type-asset-supposed-help-return-struggling-banks-health-has-not- April 2018 Economist article highlights around USD 155 bn of Contingent convertibles issued in 2017 -mainly issued by 50 banks (mainly EU banks and not US banks that are barred by regulatory and tax considerations).

[34] Deutsche Bank Corporate and Investment Bank: Cumulative and non-cumulative FICE – November 2018

Figure 8: Issuance of AT1 instruments



4.48 The EFRAG preparer survey feedback showed that five financial institutions had concerns about the impact of potential reclassification of different types of AT1 instruments including undated non-cumulative preference shares with conversion, which deliver a variable amount of shares upon an event outside the control of entity. One of the preparer respondents indicated that these instruments are fairly widespread in Spain.

4.49 Similar to perpetual bonds with deferral cumulative feature, in the absence of detailed data, it is challenging to estimate the aggregate amount of potential reclassification from equity to debt for all affected AT1 instruments.

4.50 Related to the concern raised by stakeholders on the potential impact of the IASB DP proposals on the classification of bail-in instruments, EFRAG's comment letter response to the IASB DP has suggested the need for the IASB to provide clarifying guidance related to bail-in instruments. Hence, it is difficult to conclusively state at this stage as to whether there will be an actual classification impact and a corresponding impact on issuance of AT1 instruments were the IASB DP proposals to be adopted.

Co-operative shares

4.51 A number of respondents to the EFRAG preparer survey highlight that the amount feature could result in certain members' shares in co-operative entities being classified as liabilities. The IASB's preliminary view is that the provisions in IFRIC 2 would be carried forward, so the classification of these members' shares are not affected by the proposals in the IASB DP.

4.52 This is a significant issue as equity in co-operative banks across Europe amounted to 479 billion euros at the end of 2017 based on a European Association of Co-operative Banks (EACB) report[35]. A potential change in classification could have a major impact on the capital structure of co-operative banks with them potentially portraying no equity capital. But as noted in Paragraph ES3d), the IASB DP has indicated that IFRIC 2 will be retained.

Foreign currency rights issue

4.53 The evidence obtained indicates that these instruments are not pervasive for EU entities. Only two out of 50 respondents to the EFRAG preparer survey indicated that they had current or past issuances of instruments that meet the foreign currency rights issue exception. Furthermore, based on feedback from users, these instruments were not widely held by the entities they cover (see Figure 5 and paragraph 4.26 above).

[35] Refer to the following link: Report from the European Association of Co-operative Banks

4.54 Based on the evident lack of pervasiveness for EU entities, it may be expected that the potential change in classification from equity to debt will have minimal impact on issuance of instruments that meet the foreign currency rights issue exception. However, the potential change in classification may deter future issuance even when it is desirable to issue these instruments in response to the economic environment.

Summary on issuance of instruments of interest

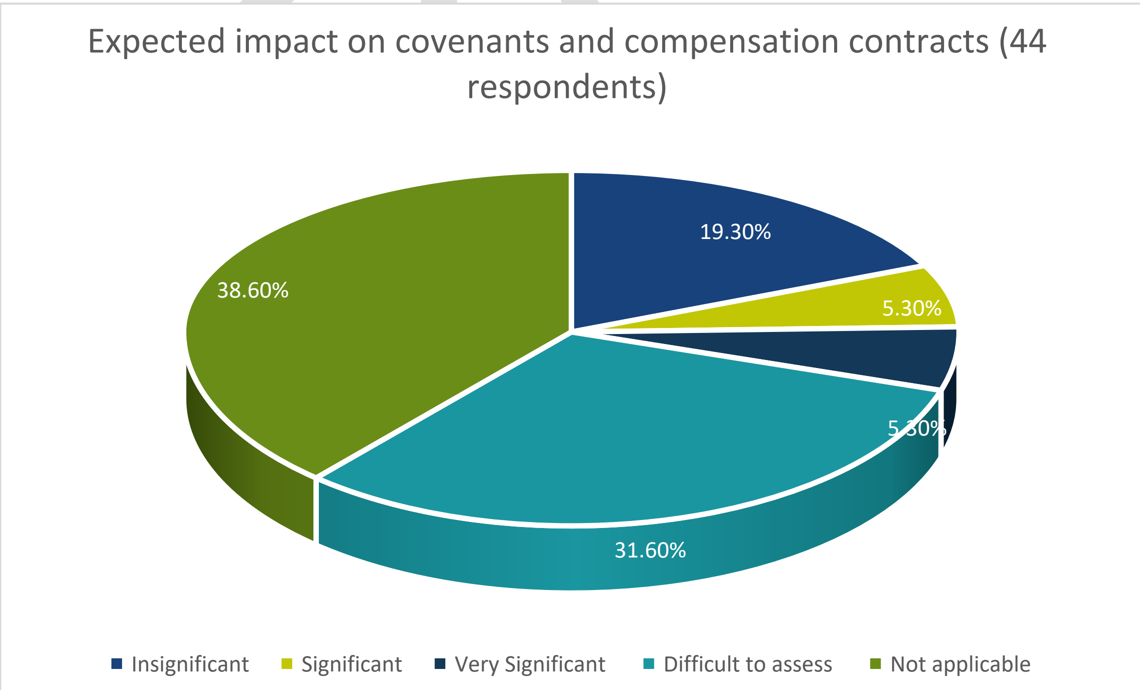
4.55 The above analysis highlights that the largest potential impacts could be with undated or perpetual bonds with deferred cumulative payment where there could be potential disruption due to the callability of these bonds alongside an impact on the key metrics of entities that have significant amounts of these financial instruments. The impact on key metrics could also be significant for some instruments that are classified as AT1 for regulatory capital purposes.

4.56 Though it seems that there is minimal immediate impact for instruments that meet the foreign currency rights issue exception as these appear not to be widely held by EU entities, the impact of the change in classification could arise at a future date whereby the economic environment would make it desirable to issue these instruments. As noted earlier, it is difficult to identify all possible second order effects.

Impact on covenants and compensation arrangements

4.57 The EFRAG preparer survey shows that only a small minority of preparer respondents expect a significant impact of the IASB DP proposals on covenants and contracts.

Figure 9: Expected impact on covenants and compensation contracts



CHAPTER 5: EUROPEAN PUBLIC GOOD – FINANCIAL STABILITY AND SUSTAINABILITY

5.1 To assess the impact on the European Public Good, consideration is made of the impact on financial stability and on sustainability.

Impact on Financial Stability

5.2 To assess the impact of the IASB DP proposals on financial stability, there is need to consider whether there is an impact on bank prudential capital and insurance solvency requirements.

5.3 There could also be a question of whether the IASB DP proposals could lead to a substantial reduction in the ability of banks to extend credit. However, as noted, in the earlier discussion on economic consequences (paragraph 4.4) and on the limitations of this impact assessment (paragraph 1.11), it is difficult to meaningfully assess and quantify potential second order effects on reporting entities including their lending, investment and asset allocation choices. Hence, this report does not address any potential impact on lending activities by credit institutions and the bearing that any such impact, if it would arise, on financial stability. Instead, the focus is mainly on the interaction of IASB DP proposals and prudential requirements.

Interaction with bank prudential requirements

5.4 Banks have various tiers of regulatory capital including:

a) Common Tier 1 (CET1): This is the highest quality of capital and consists mainly of common shares, retained earnings and other reserves.

b) Additional Tier 1 (AT1): Consists of instruments not having a fixed maturity (e.g. contingent convertible bonds, instruments including a loss absorption mechanism in the form of a conversion or write down upon the occurrence of a trigger event, with full discretion for the bank at all times to cancel distributions for an unlimited period and on a non-cumulative basis) and they must contain no incentive for the issuer to redeem them. CET1 plus AT1 form the so-called Tier 1 capital.

c) Tier 2: Is considered to be 'gone concern capital' (e.g. subordinated debt) that allows a credit institution to repay depositors and senior creditors if a bank became insolvent.

5.5 CRR have minimum capital requirements for both CET1, AT1 and Tier 2 capital.

5.6 Hypothetically, a potential adverse impact on capital adequacy could arise due to:

a) Reclassification of any CET1 instrument from equity to debt under the IASB DP proposals, when such instruments are currently part of CET1 based on existing prudential requirements. However, as we understand, the regulatory capital classification (CET1 and AT1) categories should not be affected by the IASB DP proposals.

An accounting classification change from equity to debt could impact classification under CET1 but not under AT1. However, we are not aware of any instruments that are part of CET1 that will be affected by the IASB DP proposals. As highlighted by the EBA comment letter response[36] to the IASB and based on feedback to the EFRAG survey and outreaches, co-operative entities have raised concerns about the reclassification of their member shares and consequential impact on CET1 but as noted the IASB DP has a provision for the retention of IFRIC 2.

b) Reclassification of financial instruments from equity to liability could increase volatility in profit or loss due to the remeasurements of these instruments.

Profit or loss for the period could change due to carrying value/notional amount remeasurements and due to changes in the amount of interest expense recognised (i.e. effective interest charge). In turn, subject to tax, the profit or loss effects could impact retained earnings.

Remeasurements of instruments that could be reclassified from equity to financial liabilities under the IASB DP proposals could potentially impact on retained earnings and CET1 volatility. However, such volatility is unlikely to occur in practice in an EU context for some instruments that may be reclassified from equity to debt but remain classified as AT1 for regulatory capital. For example, remeasurements of these instruments would likely only occur[37] and impact retained earnings if there was a temporary write-down gain that is taxable.

From a prudential perspective regulatory capital volatility could also increase should the reported comprehensive income that updates CET1 not be subject to prudential filters that strip out volatility arising from accounting remeasurement.

c) The proposed attribution[38] of comprehensive income could reduce retained earnings included in the highest quality of capital, CET1. This is because portions of amounts that are currently attributed to ordinary shareholders would be attributed to secondary equity claims if the IASB attribution approaches that result in an update of the statement of equity and carrying value on statement of financial position were adopted. Hence, subject to there being prudential filters for amounts included in retained earnings, there could be an impact of attribution on CET1.

5.7 Members of the EFRAG Financial Instruments Working Group (FIWG) expressed the view that the IASB DP proposals would have no impact on prudential regulatory capital requirements implying that the potential adverse impact on capital adequacy described in the preceding paragraph would be unlikely.

5.8 The European Banking Authority (EBA) has confirmed that the instruments identified by the IASB DP as those where classification from equity to debt would occur (perpetual bonds with deferral cumulative feature, non-redeemable fixed-rate cumulative preference shares) - are not part of a credit institution own funds.

5.9 However, stakeholder feedback through both the preparer and user surveys are indicating certain AT1 instruments where a potential change in classification is

[36] To post link once on IASB website

[37] These instruments are normally recognised on an amortised cost basis. Profit or loss volatility could arise from the temporary write down of these instruments.

[38] The total retained earnings corresponds to a CET1 items, as per article 26 of the CRR. According to EBA, this prudential rule is not planned to be changed with the proposed attribution.

expected including for example perpetual bonds with discretionary dividends (AT1).

Interaction with insurance solvency requirements

5.10 In accordance with Solvency II, own funds of insurance entities consist of basic and ancillary own funds:

a) basic own funds comprise the excess of assets over liabilities valued at fair value[39] and subordinated liabilities. Basic own funds instruments will qualify as:

(i) Tier 1 when they are fully and permanently available to absorb losses; and

(ii) Tier 2 when they are subordinated to all other obligations, including the obligations to (re-)insurance policy holders;

b) ancillary own funds comprise:

(i) unpaid share capital or initial fund that has not been called up;

(ii) letters of credit and guarantees; and

(iii) any other legally binding commitments received by insurance and reinsurance undertakings.

5.11 As these requirements refer to the absorption of losses, the reclassification of financial instruments for accounting purposes will not impact the basic and ancillary own funds because the ability to absorb losses arises from the economic substance of an instrument rather than its classification for financial reporting purposes.

Impact on Sustainability

5.12 The European Commission Action Plan *Financing Sustainable Growth* (EC Action Plan)[40] that focuses on promoting sustainable finance and a sustainable EU economy has outlined various areas for consideration in stimulating sustainable finance. The accounting classification of liabilities versus equity has not been identified as one of the factors that could disincentivise long-term investment or adversely affect the sustainability of business entities.

[39] Article 75 Valuation of assets and liabilities

Member States shall ensure that, unless otherwise stated, insurance and reinsurance undertakings value assets and liabilities as follows:

(a) assets shall be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction;

(b) liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction.

When valuing liabilities under point (b), no adjustment to take account of the own credit standing of the insurance or reinsurance undertaking shall be made.

[40] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

CHAPTER 6: IMPROVEMENT TO FINANCIAL REPORTING

6.1 The question of whether the IASB DP proposals will be an improvement to financial reporting is considered by evaluating:

a) Preparer and user feedback on the IASB DP classification principles

b) User feedback on the IASB DP presentation and disclosure proposals.

c) EFRAG's own analysis articulated in the comment letter.

Preparer and user feedback on classification

6.2 Preparer and other stakeholder feedback on the IASB DP classification principles was mainly obtained from outreaches and responses to the EFRAG draft comment letter. This feedback includes.

a) *Impact of new terminology*: Concerns were often raised by stakeholders about the complexity and lack of clarity on the new terminology, particularly around the amount feature, that may result in preparers having to review all their contracts against the new terminology, even if classification is not expected to change. In response to this concern, there has been an indication that the IASB could make any changes to IAS 32 prospective and not require a review of existing instruments.

b) *Lack of clarity on guidance related to member co-operative shares*: The IASB DP notes that the provisions in IFRIC 2 *Members' Shares in Cooperative Entities* will be retained. However, a number of co-operative banks have expressed uncertainty about the implications of the IASB DP proposals for classification particularly the amount feature when considering the face value of an instrument.

c) *Potential challenges of users interpreting information based on IASB DP proposals for classification:* User feedback during some of the outreach meetings indicated that they consider the IASB DP's proposed criteria for classification confusing and complex and there was a particular struggle with the amount feature and the notion of "independent of an entities available economic resources'.

In its response to the EFRAG draft comment letter, the European Federation of Financial Analysts Association (EFFAS), while broadly supporting the IASB DP preferred approach for distinguishing financial liabilities and equity, has also indicated that because users analyse financial statements with an assumption that reporting entities are going concerns, they struggle with the consideration of liquidation in the IASB DP's proposed definition of financial liabilities. EFFAS also proposed the need for clarification of the idea of "independence of an entity's available economic resources" in the definition of financial liabilities.

At the same time, there is a recognition in the IASB DP that no matter what criteria are applied for a binary classification of financial liabilities versus equity, the ever widening range of complex financial instruments that have characteristics of both debt and equity- will limit the information that can be conveyed to users of financial statements by a two-category accounting classification. Hence, enhanced presentation and disclosure requirements have a role in meeting the information needs of users and can offset any perceived shortcoming that arises from any chosen classification criteria.

Due to the complexity of the terminology, there is a risk that the complexity could exacerbate existing challenges that users face in analysing complex financial instruments under IAS 32. Several user respondents to the EFRAG user survey pointed to different instruments where the classification is unclear leading to diversity in practice. Instruments highlighted include:

(i) Contingent convertible bonds;

(ii) Convertible preference shares with multiple features that are debt-like and equity-like;

(iii) Callable perpetual preference shares with a fixed dividend;

(iv) Participating shares with puttable features (the same instruments were identified by preparers);

(v) Subordinated loans;

(vi) Preference share where the only distinction from common shares is the differences in rights to vote and profit distribution preferences;

(vii) Perpetual bonds.

User feedback on presentation and disclosure

6.3 User feedback on presentation and disclosure was obtained through a combination of survey feedback and outreach meetings and events. On balance, there were mixed views on the usefulness of different elements of the presentation proposals and subject to their refinement, there is strong support for and perceived benefits of the proposed disclosures.

Presentation of financial liabilities and equity instruments

Financial liabilities presentation

6.4 The EFRAG user survey sought to assess the perceived usefulness of the IASB DP proposals related to the following:

a) *Statement of financial performance* - The IASB DP proposes that financial instruments that will be classified as financial liabilities but have equity-like returns (i.e. the amount of the liability depends on the entity's performance or value of its own shares) should have their changes in value presented in other comprehensive income (OCI) and that reclassification (recycling) from OCI to profit or loss would not be allowed.

b) *Statement of financial position* - The IASB DP proposes requirements for separate presentation of both derivative and non-derivative financial liabilities that have equity-like returns in the statement of financial position. The IASB DP also proposes that financial liabilities be presented by order of priority in liquidation on the face of statement of financial position. Some entities present assets in order of liquidity.

6.5 The EFRAG user survey results (Figure 10) shows that user respondents assigned a higher level of usefulness to the presentation proposals for the statement of financial position than they did to the presentation proposals for the statement of financial performance (i.e. use of OCI). The specific results are as follows:

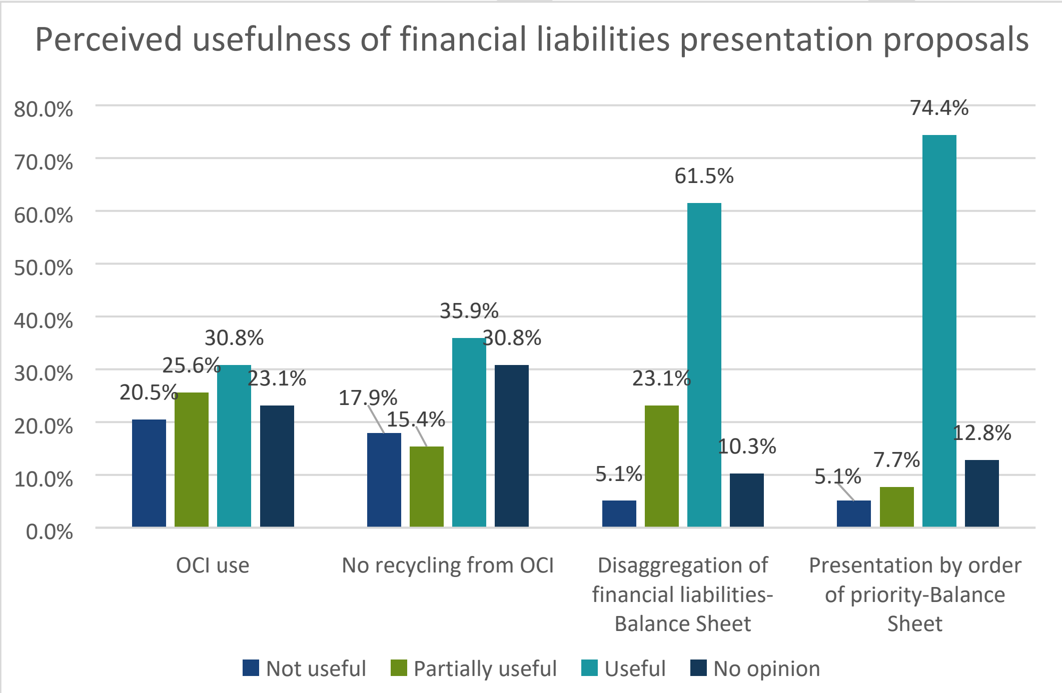
a) Use of OCI for remeasurement of financial liabilities with equity-like returns (statement of financial performance): A majority of respondents find this proposal either partially useful or useful.

b) *No recycling of OCI (statement of financial performance)*: A majority of respondents find this proposal either partially useful or useful.

c) Disaggregation of financial liabilities (statement of financial position): Most respondents find this proposal useful.

d) Presentation of financial liabilities by order of priority (statement of financial position): Most respondents find this proposal useful.

Figure 10: Perceived usefulness of financial liabilities presentation proposals



6.6 The user feedback from outreach events provided a little more context on their views around the proposed presentation in OCI:

a) There was limited feedback focused on the proposals for separate presentation of financial liabilities with equity like returns using OCI. Some users aired what are often expressed concerns about the increased use of OCI.

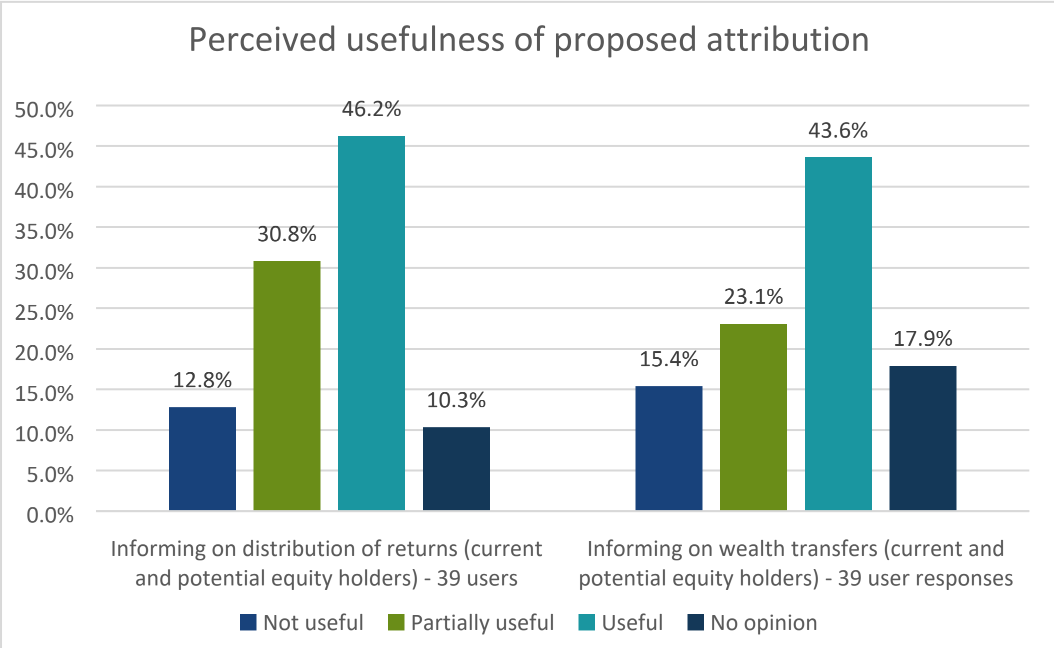
b) A sell-side equity analyst who participated in the EFRAG/EFFAS/IASB/ABAF-BVFA user event held in Brussels indicated that what gets presented in OCI usually gets ignored by the analyst community. He indicated that he was not concerned about re-measurements of liabilities through profit or loss as long as there is adequate disaggregation that can allow analytical adjustments if required (i.e. users can adjust for themselves any counter-intuitive returns).

Equity instruments presentation

6.7 The IASB DP proposes the allocation of profit or loss and OCI to different classes of equity instruments in order to depict the wealth transfers across these instruments (i.e. attribution).

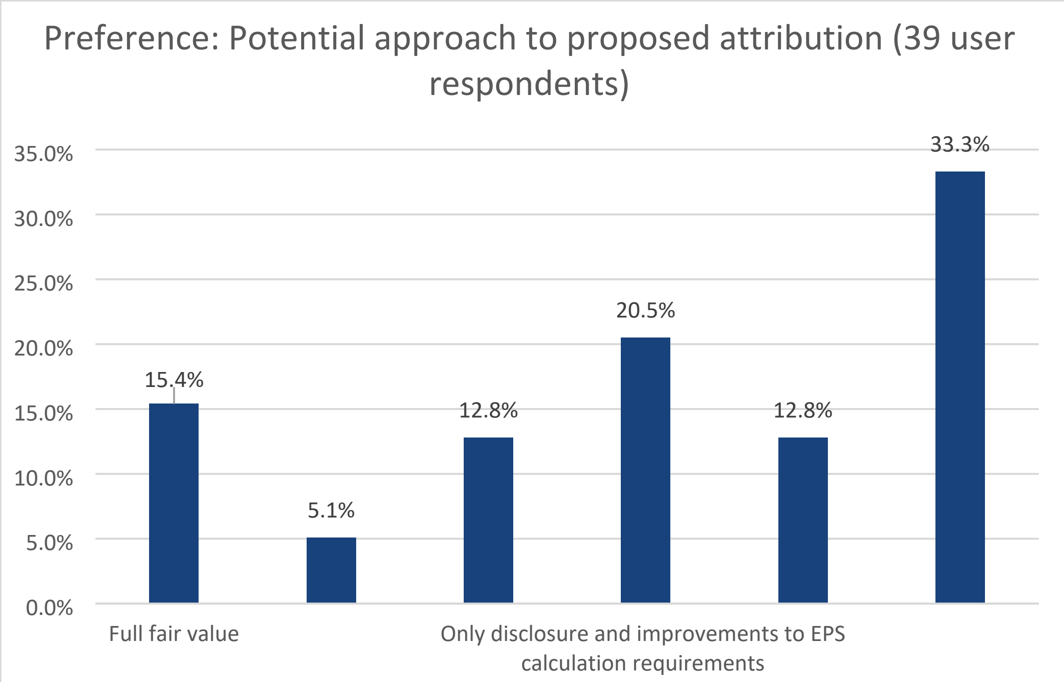
6.8 The EFRAG user survey results (see Figure 11 below) show that a majority of respondents considered the proposed attribution information to be either partially useful or useful for the intended analytical purposes (i.e. informing on distribution of returns and wealth transfers).

Figure 11: Perceived usefulness of proposed attribution requirements



6.9 The IASB DP proposes four possible approaches to providing attribution related information. An analysis of the EFRAG user survey results (see figure 12 below) shows mixed views with more support for only disclosure and improvements to the EPS calculation than the approaches that would result in an update of the carrying value of equity instruments other than ordinary shares in the statement of financial position and statement of changes in equity.

Figure 12: Preference: Potential approach to proposed attribution



6.10 Taken together, the survey results related to the proposed attribution of comprehensive income to equity instruments (Figure 11 and Figure 12) indicate that respondents find some benefit from the attribution proposals if it was provided through only disclosure and improvements to EPS calculation.

6.11 User feedback obtained through outreaches and in the comments to the survey provided further context to user views on the potential attribution approaches and indicated the following:

a) While supporting the intent of attribution, there were concerns about the complexity and relevance of the information that would be conveyed through the attribution approach. Below are a selection of comments from the EFRAG user survey respondents that had reservations about the proposed attribution that would require an update of statement of financial position and statement of changes in equity

(i) User Respondent 1 - "*The main information I need is the future dilution (i.e. how number of shares will be affected and when the new shares will become eligible for dividends, rights issues with bonus elements etc.). There is no point in fair valuing derivatives on own equity and putting that onto the balance sheet, because any equity instrument reflects future expected profits/losses, whereas the balance sheet only looks backward. So mixing profits for the period applicable to current equity holders with the fair value of derivatives on equity that represent future profits attributable to future shareholders is an apples to oranges comparison.*"

(ii) User Respondent 2 - "*I think we are mixing up things: the outcome of "accounting" (debits and credits the result being a certain "profit") and "valuation" of certain financial instruments that is not part of the framework. The IASB calls this "wealth transfers across subclasses of equity" ... an approach that I do not understand. What is important* *is the dilution effect of course. On that I would recommend more informative disclosures*."

(iii) User Respondent 3 - "Given the complexity of the issue, for investors and analysts, only disclosure and improvements to EPS calculation requirements will matter."

b) But one user respondent seemed supportive of the full fair value attribution approach:

(i) User Respondent 4 - "*Derivatives on own equity (such as warrants) are dilutive to existing shareholders, only if they get exercised. However, if disclosure was available to strip what is attributed to such derivatives I believe it would be useful to deliver a more meaningful valuation. The fair value of those derivatives, calculated using the Black Scholes model, includes also the risk-adjusted probability of being exercised (i.e. the N(d2) in the formula). While this may include a lot of assumptions, it is a fairer view of what belongs (and will belong) to existing shareholders since company valuation is forward looking. If a shareholder is in risk or losing 10%, for example, of his/hers ownership of the company's profit, this should be factored in the valuation, and I think this is the easiest way to do so. Also, I think that the year-end fair value weighting provides the latest information of what is the probability to have those derivatives exercised (on reporting date) and as such more informative*."

c) Under the attribution approaches being considered by the IASB, reporting entities would be required to apply the fair value of their issued equity derivative instruments as an input in the allocation of total comprehensive income. Some users expressed concern that the application of the proposed attribution approach based on fair value information would be challenging in certain jurisdictions that have limited[41] active markets for purposes of determining the fair value information.

Disclosures

6.12 The EFRAG user survey results show strong support for the following disclosures proposed by the IASB DP with most (≥70% of respondents) indicating that they would find the following proposed disclosures to be useful (see Figure 13 below):

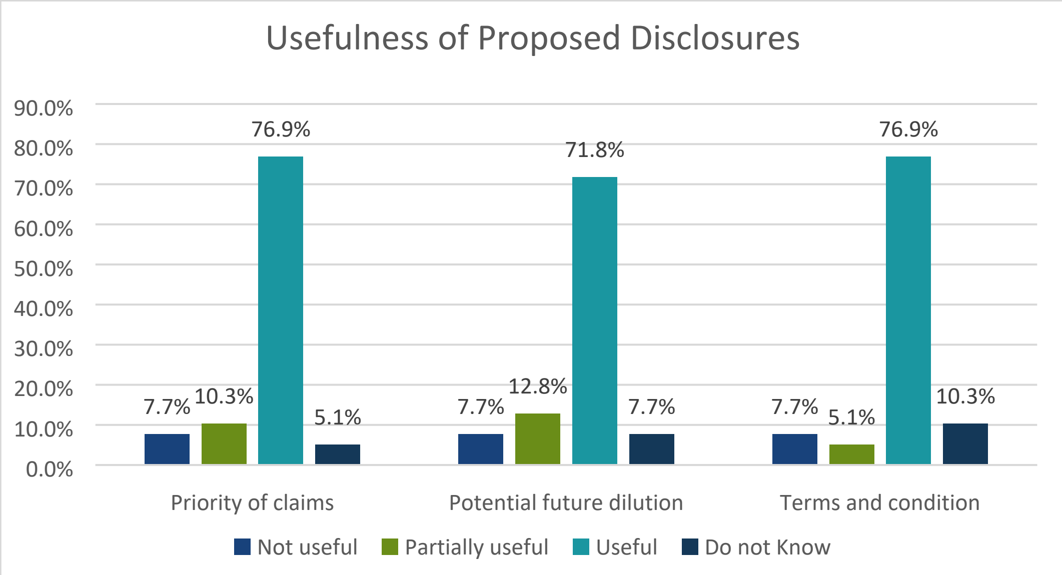
a) priority of claims;

b) potential future dilution; and

c) terms and conditions.

[41] Whenever an entity makes use of a fair value they are required to measure and disclose such information under IFRS 13 *Fair Value Measurements*.

Figure 13: Usefulness of the proposed disclosures in the DP



6.13 User feedback from the outreaches provides support for the IASB DP proposals for disclosures. User comments were often oriented towards supporting specific IASB DP disclosure proposals (e.g. the potential future dilution) or refining the proposed disclosures (priority of claims on liquidation, and terms and conditions). For example:

a) There is need to consider whether priority of claims in liquidation is meaningful at the level of the consolidated entity as opposed to legal entity.

b) There is challenge of disclosing terms and conditions in a useful manner that does not impose an information overload in the financial statements.

6.14 The user feedback is indicative of the expected benefits of the IASB DP proposals for disclosures. As noted, there is academic evidence[42] showing that for experienced investors, disclosures are probably more important than the debt versus equity classification distinction.

[42] Clor-Proell, S., Koonce, L. & White, B. 2016. How do experienced users evaluate hybrid financial instruments? *Journal of Accounting Research*, - The paper experimentally tests whether the features of hybrid instruments affect the credit-related judgments of experienced finance professionals, even when the hybrid instruments are already classified as liabilities or equity. The results suggest that getting the classification right is not of primary importance for these experienced users, as they largely rely on the underlying features of the instrument to make their judgments. A second experiment shows that experienced users' reliance on features generalizes to several features that often characterize hybrid instruments. However, the paper find that experienced users vary in their beliefs about which individual features are most important in distinguishing between liabilities and equity. Together, the results highlight the importance of effective disclosure of hybrid instruments' features.

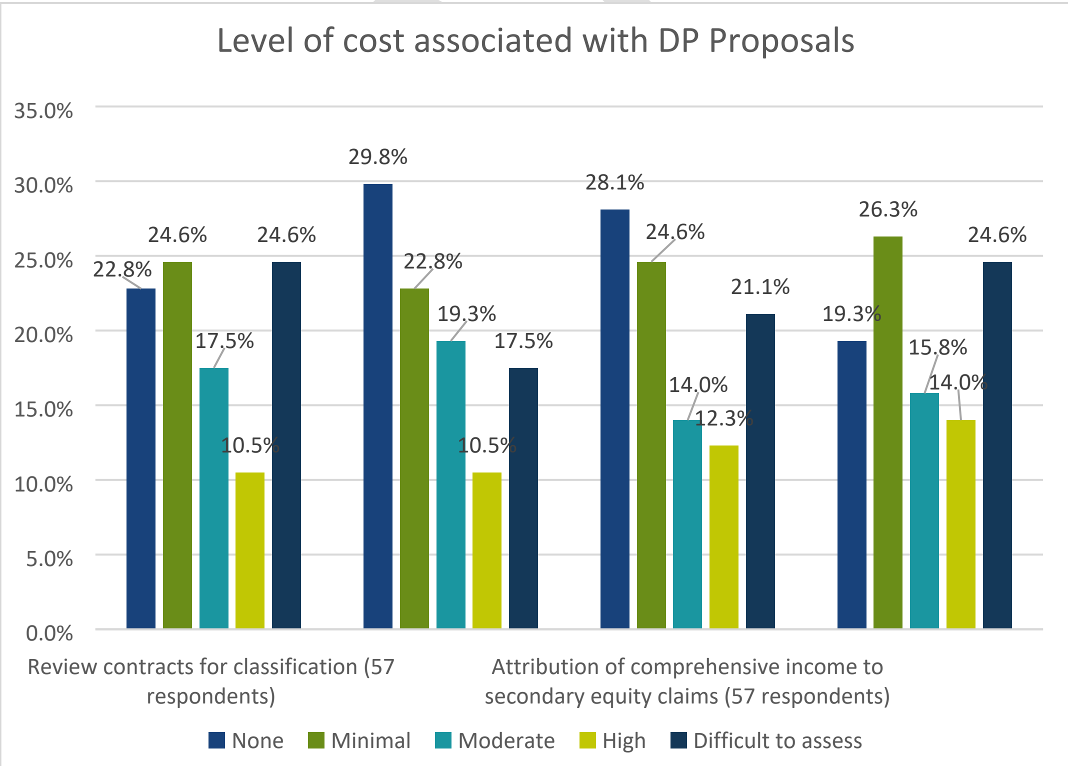
CHAPTER 7: ANTICIPATED COSTS AND BENEFITS

7.1 The EFRAG preparer survey sought to establish the level of costs that would be expected if the IASB DP proposals were adopted. The survey questions aimed at eliciting cost components making a distinction between the costs of reviewing contracts for purposes of classification and costs associated with the presentation and disclosure proposals. The survey results (see Figure 14 below) show the following

a) A sizeable proportion (>40% of respondents) indicated that they expect none or minimal costs across the four components of potential costs. This finding tallies up with the finding that a majority of respondents expected no change in classification for any of their issued instruments (*see section on impacts on financial statements*).

b) Another sizeable proportion (17.5% to 24.6%) of respondents indicate that it is difficult to assess the expected cost levels across the four cost components. Such uncertainty can perhaps be explained by the proposals only being at DP stage and preparers may be waiting to see whether and how the IASB will proceed with the DP proposals.

Figure 14: Level of costs associated with IASB DP Proposals



7.2 The EFRAG user and preparer surveys also sought to get user and preparers views on the overall cost-benefit of the IASB DP proposals. The results (Figure 15) show contrasting views between users and preparers on the costs versus benefits with preparers viewing that costs outweigh benefits and users taking the opposite view.

7.3 It is notable that a majority of preparer respondents expect costs to outweigh benefits while at the same time expecting no to minimal implementation costs.

This could mean that these preparers could be considering costs beyond direct implementation costs and/or that they perceive no benefits of the proposals.

7.4 Figure 16 shows that a majority of user respondents (64%) expect significant to very significant benefits and of those who did not find it difficult to assess a majority expect the analytical costs to be insignificant.

Figure 15: Preparer versus user views - anticipated costs versus benefits

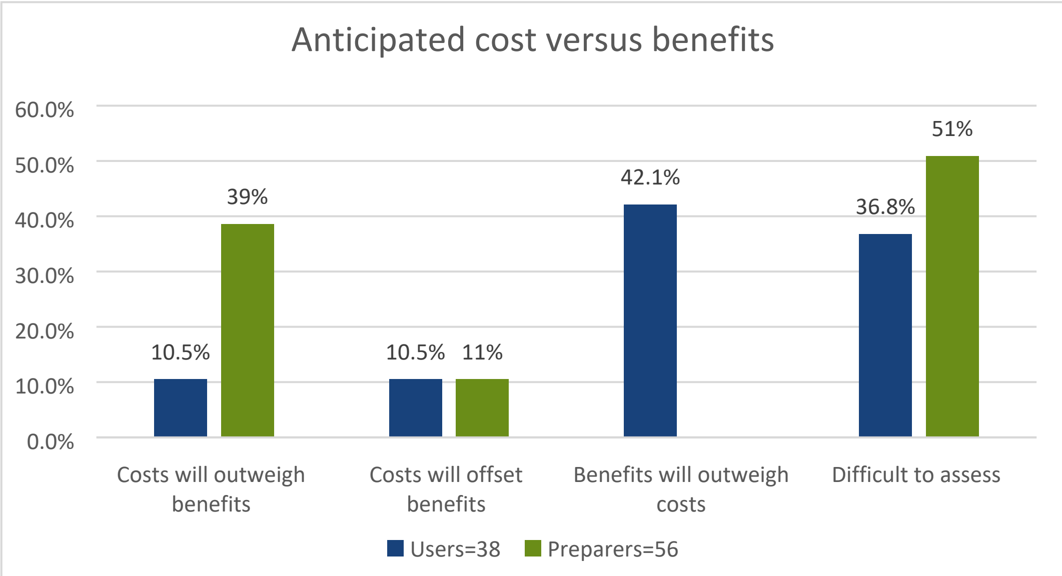
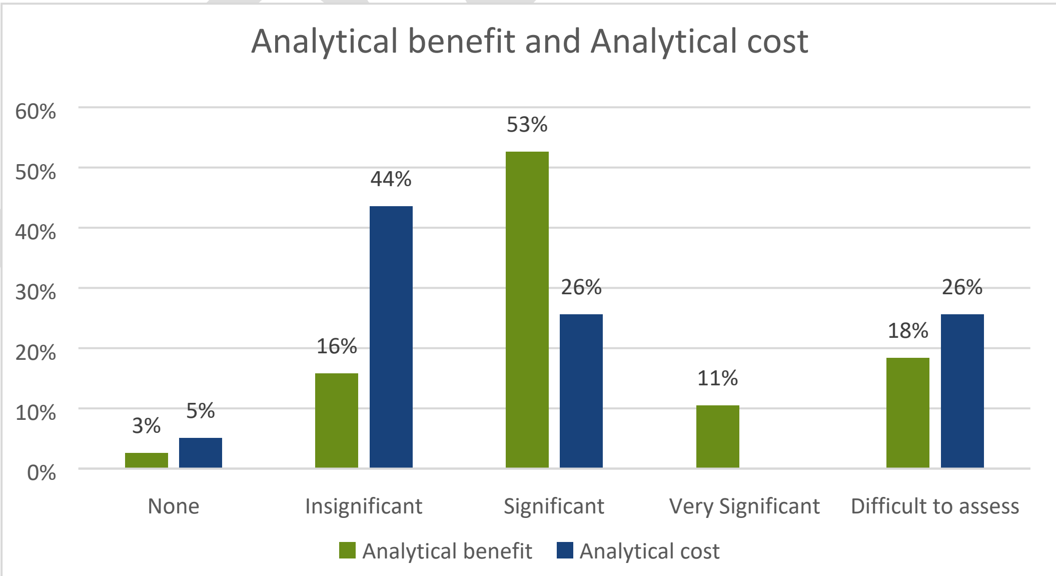


Figure 16: User views - significant of analytical benefits, costs



CHAPTER 8: EXPECTED IMPACT ON FINANCIAL STATEMENTS

8.1 When considering the expected effects on entities' financial statements it is important to keep in mind that the IASB DP is a preliminary consultation document and does not cover all the matters or the level of detail that would be expected in a final IFRS Standard.

8.2 Impact on financial statements could occur due to reclassification of financial instruments from equity to liability and vice versa. Such reclassification would or could affect reported:

a) levels of liability and equity in the statement of financial position, including related metrics such as leverage and solvency ratios;

b) financial performance and related metrics such as basic and diluted earnings per share (EPS) ratios because, in contrast to instruments classified as equity, instruments classified as liabilities give rise to income and expenses in the financial statements; and

c) volatility of financial performance because, in contrast to instruments classified as equity, instruments classified as liabilities are re-measured through the statement of comprehensive income.

Preparer feedback on impacts on financial statements

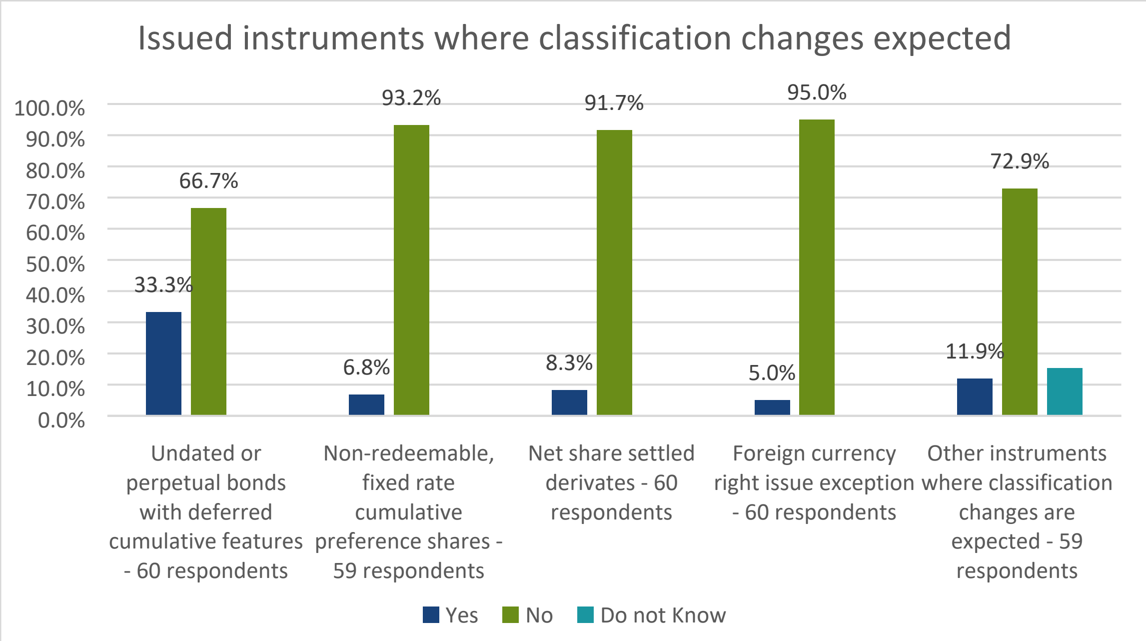
8.3 The EFRAG preparer survey sought to assess the potential impacts of reclassification at an individual company level including related to instruments where classification changes were identified[43] in the IASB DP and other instruments that may have a change in classification due to the application of the IASB DP classification principles.

8.4 The EFRAG preparer survey results (see Figure 17 below) show that most respondents did not have instruments that would be reclassified based on the proposals in the IASB DP. This perhaps explains why most preparer respondents to the survey also indicated that they expect to no to minimal costs to implement the IASB DP proposals (*see Anticipated Costs and Benefits section*).

8.5 Of those respondents that expect a change in classification, undated or perpetual bonds with deferred cumulative features was the most commonly issued financial instrument.

[43] undated or perpetual bonds with a payment deferral cumulative feature; non-redeemable fixed rate cumulative preference shares; net settled derivatives on own equity; and foreign currency rights issues

Figure 17: Issued instruments where classification changes are expected



8.6 Several preparer respondents gave an indication of other instruments (apart from the four identified[44] in the IASB DP) where an equity to debt classification is either expected or for which the classification resulting from the IASB DP is unclear. These include some instruments that are classified as AT1 under regulatory classification.

Impact of classification changes on leverage and performance measures

8.7 The EFRAG preparer survey sought feedback on the impact of instrument specific classification change on leverage and performance measures.

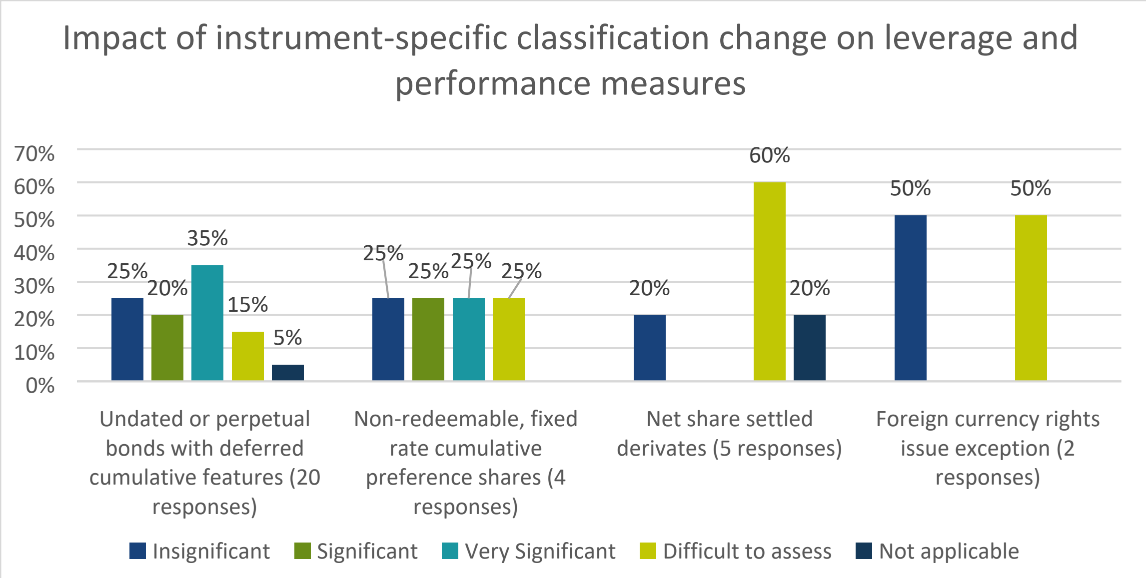
8.8 The EFRAG preparer survey results (see Figure 19 below) show that the impact of reclassification could be either be significant or very significant for entities that have issued undated or perpetual bonds and/or non-redeemable, fixed rate cumulative preference shares.

8.9 Some of the preparer respondents quantified the potential impact of reclassifying perpetual bonds with deferral cumulative feature and there is a wide range of cited impact (8% to 40% of total equity attributable to ordinary shareholders). In addition, the response to EFRAG draft comment letter by Danish Power Utility Company, Orsted indicates a potential reclassification impact of 1.8 billion euros.

8.10 Figure 18 reflects preparer responses on impact in respect or four instruments identified in DP. The EFRAG preparer survey also sought to know the impact of any other instruments where changes in classification are expected. As noted in Paragraphs 4.48 and 8.6, several preparers expect a change in classification for some of the AT1 instruments. Four preparer respondents quantified the potential impact of reclassifying some AT1 instruments (varied from 7.4% to 8.2% of total equity attributable to ordinary shareholders).

[44] Ibid-footnote 35

Figure 18: Impact of instrument-specific classification change on key metrics



8.11 The EFRAG preparer survey also sought feedback on the aggregate impact of the expected classification change on specific leverage and performance ratios (accounting leverage, regulatory capital ratios, basic and diluted EPS).

8.12 The EFRAG preparer survey results (see Figure 19 below) shows:

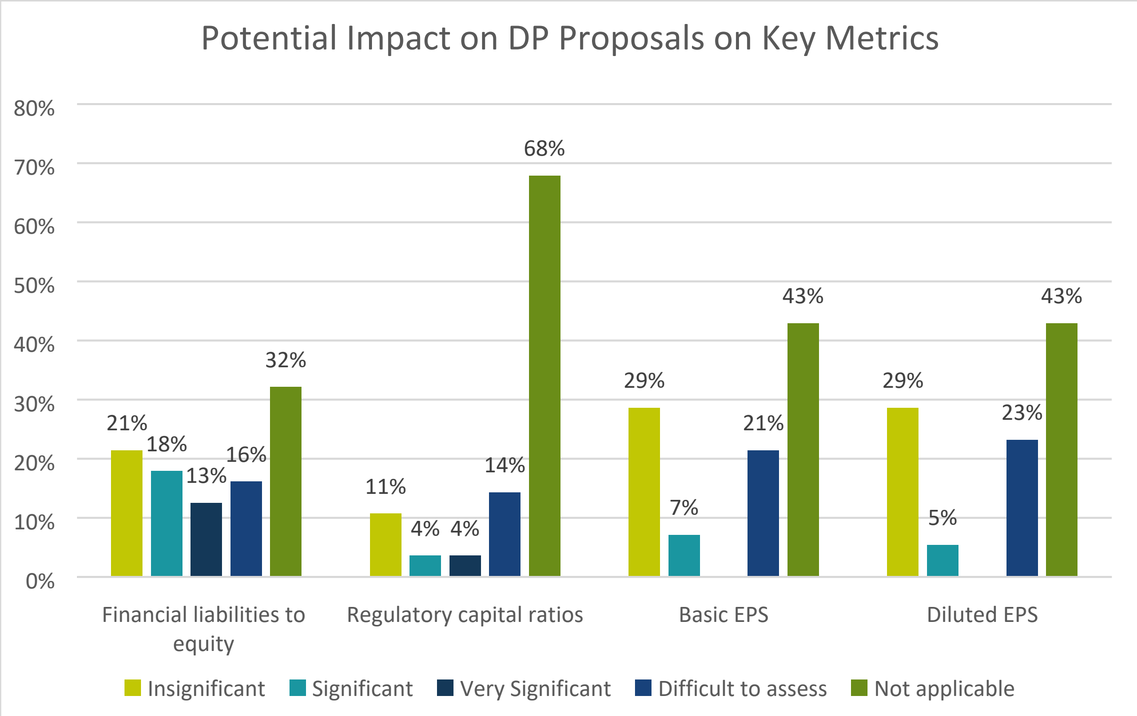
a) A sizeable proportion (33.3%) of respondent entities expect significant or very significant impact on accounting leverage (i.e. financial liabilities/total equity attributable to ordinary shareholders).

b) Only 11.3% of respondents expect a significant or very significant impact on regulatory capital ratios.

c) Minimal impact is expected on either basic or diluted EPS.

8.13 The preparer survey qualitative data provided some indication of impact on key measures of leverage and performance were entities to reclassify their financial instruments from equity to debt or vice versa. One energy utility company indicated that its financial leverage ratio net debt to EBITDA would increase from 2.4 to 3.1.

Figure 19: Potential impact on DP Proposals on Key Metrics



CHAPTER 9: REPORTING AND USE OF NON-GAAP INFORMATION

9.1 The EFRAG preparer and user survey results on the reporting and use of non-GAAP (Figures 20 and 21) indicates mixed views on whether there will be an increase, decrease or no change in the reporting of non-GAAP measures. The majority of both user and preparer survey respondents expect there to be either no impact of the IASB DP proposals on the reporting and use of non-GAAP measures or they find it difficult to assess. This result could indicate that these respondents either:

a) do not expect classification changes and/or incremental adjustments to financial liabilities and equity instruments related line items in the statement of financial position and statement of financial performance; or

b) are unsure about whether the classification principles of the IASB DP will better reflect the economic substance than IAS 32.

Figure 20: Current use of related non-GAAP measures

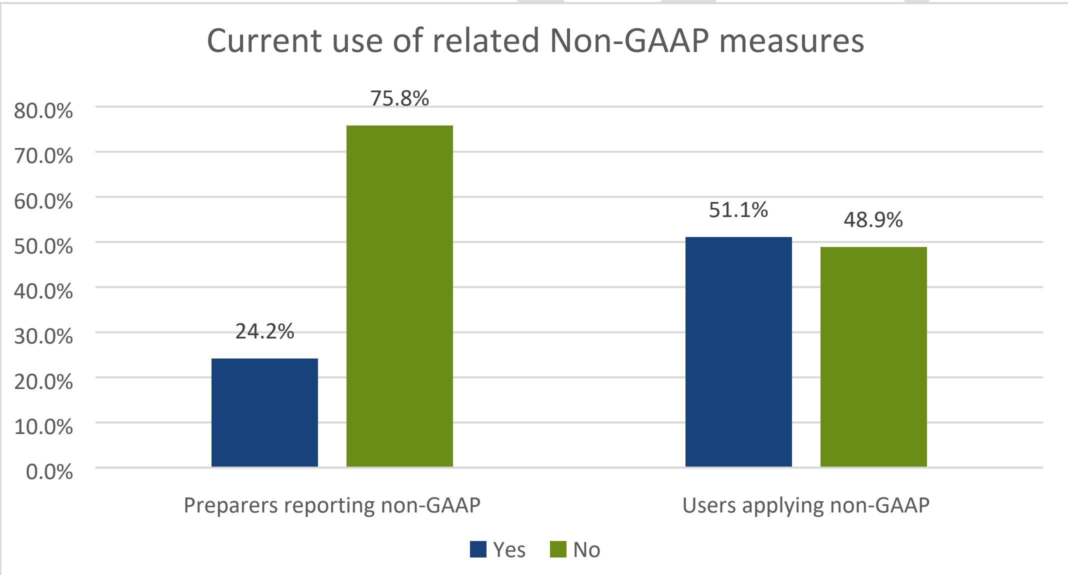
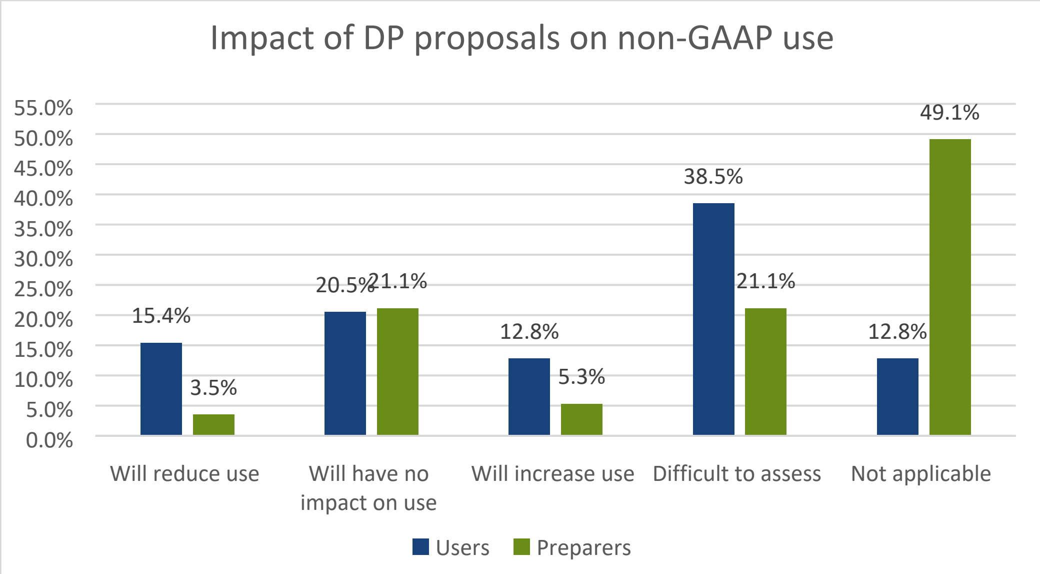


Figure 21: Impact of the DP proposals on the use of non-GAAP



Appendix 1: Current IFRS Requirements

Classification requirements

1 IFRS Standards provides a positive definition of financial liability and issued equity classification is a residual category. The entity must make the decision at the time the instrument is initially recognised and the classification is not subsequently changed based on changed circumstances (unless there is a modification of the terms of the contract).

2 IAS 32 *Financial Instruments: Presentation* states that *a financial liability* is any liability that is:

a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

b) a contract that will or may be settled in the entity's own equity instruments and is:

(iii) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(iv) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments (i.e. fixed for fixed).

3 IAS 32 requires the application of the "fixed-for-fixed" condition principle to assess whether derivative financial instruments should be classified in their entirety as either equity or non-equity (financial liabilities, financial assets). A derivative is only classified as equity if:

a) the fixed-for fixed-condition is met i.e. the exchange of a fixed amount of cash (or another financial asset) in the entity's functional currency for a fixed number of an entity's own equity instruments; and

b) the derivative is settled gross.

4 *An equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Exceptions to classification principle

5 *Foreign currency rights issue exception*: For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of 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.

6 *Puttable exception*: Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

7 *Co-operative member shares exception*: Under *IFRIC 2*, shares for which the member has the right to request redemption are normally liabilities. However, they are equity if:

a) the entity has an unconditional right to refuse redemption, or

b) local law, regulation, or the entity's governing charter imposes prohibitions on redemption. But the mere existence of law, regulation, or charter provisions that would prohibit redemption only if conditions (such as liquidity constraints) are met, or are not met, does not result in members' shares being equity.

Presentation requirements

8 In terms of presentation, for financial instruments classified as equity, IAS 32 does not specifically mention which components of equity should be presented. Nonetheless, IAS 1 *Presentation of Financial Statements* requires entities to present the following minimum line items in the statement of financial position, within equity:

a) issued capital and reserves attributable to owners of the parent; and

b) non-controlling interest.

9 In accordance to paragraph 85 of IAS 1, additional line items, headings and subtotals may be needed to fairly present the entity's financial position.

10 In regard to the statement of changes in equity, in accordance with paragraph 106 of IAS 1, entities have to present:

a) the total comprehensive income for the period, showing separately amounts attributable to owners of the parent and to non-controlling interests;

b) the effects of any retrospective application of accounting policies or restatements made in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, separately for each component of other comprehensive income;

c) reconciliations between the carrying amounts at the beginning and the end of the period for each component of equity, separately disclosing:

(i) profit or loss;

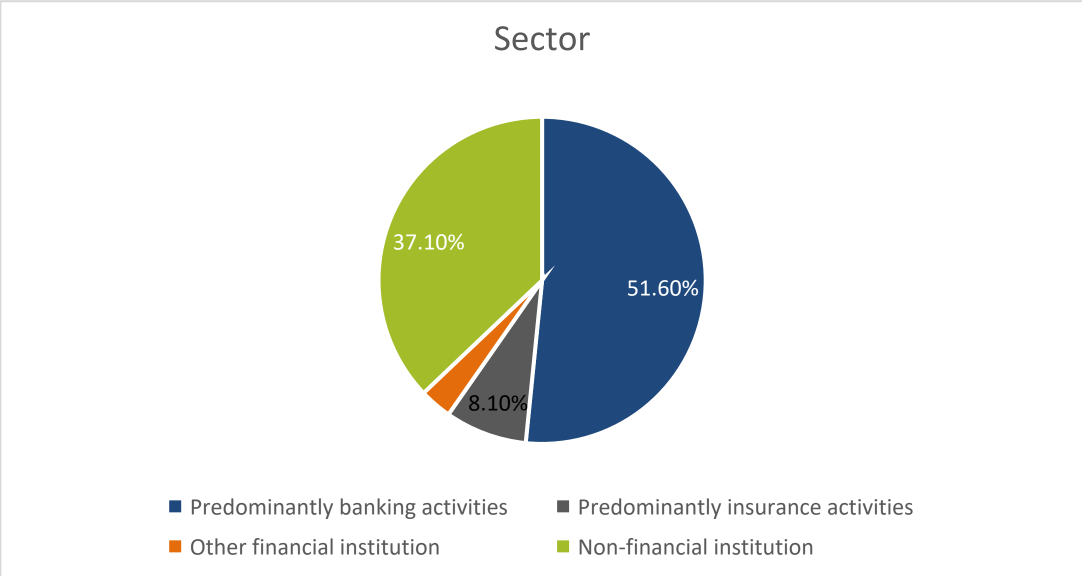
(ii) other comprehensive income; and

(iii) transactions with owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.

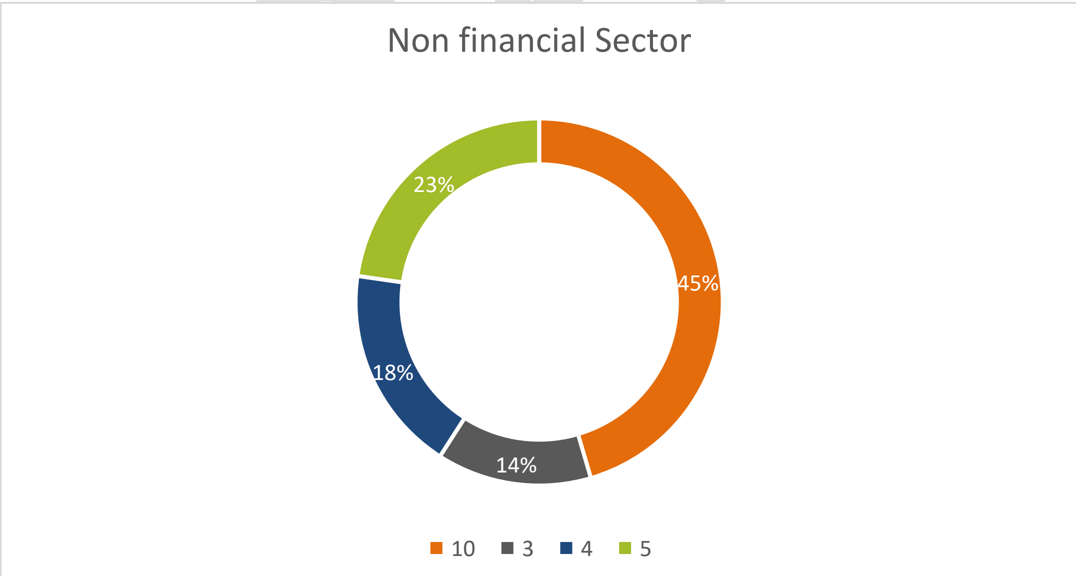
Appendix 2: Profile of EFRAG Survey Respondents

Preparer's profile

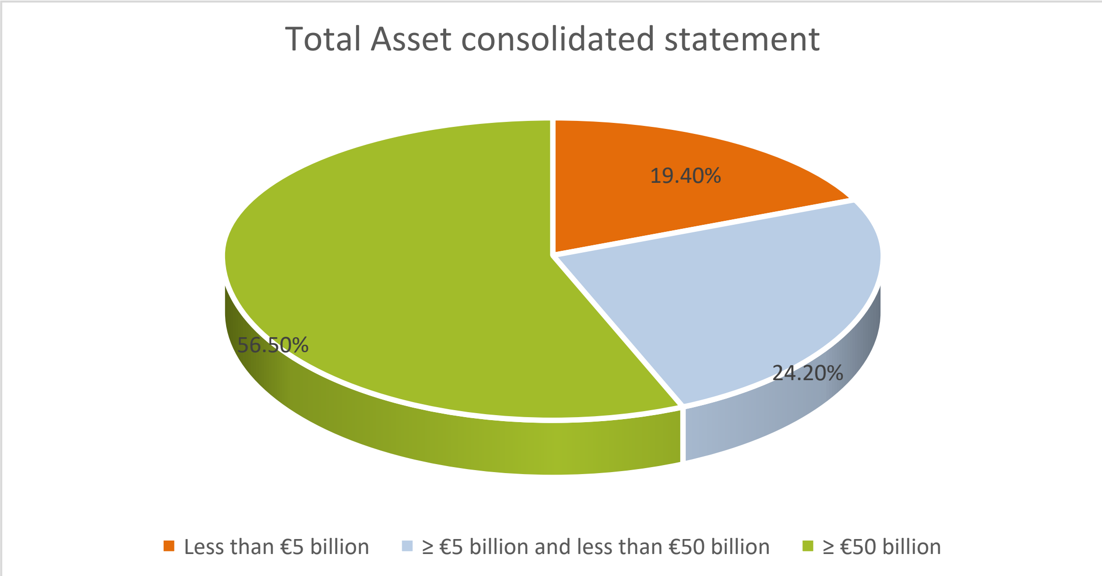
Sector



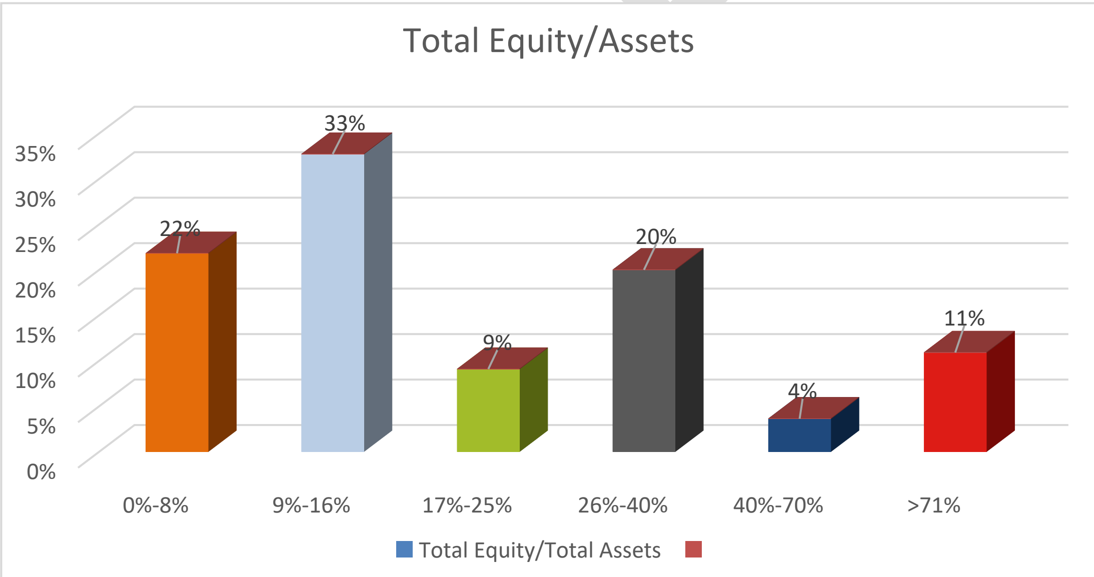
Breakdown of non-financial institutions



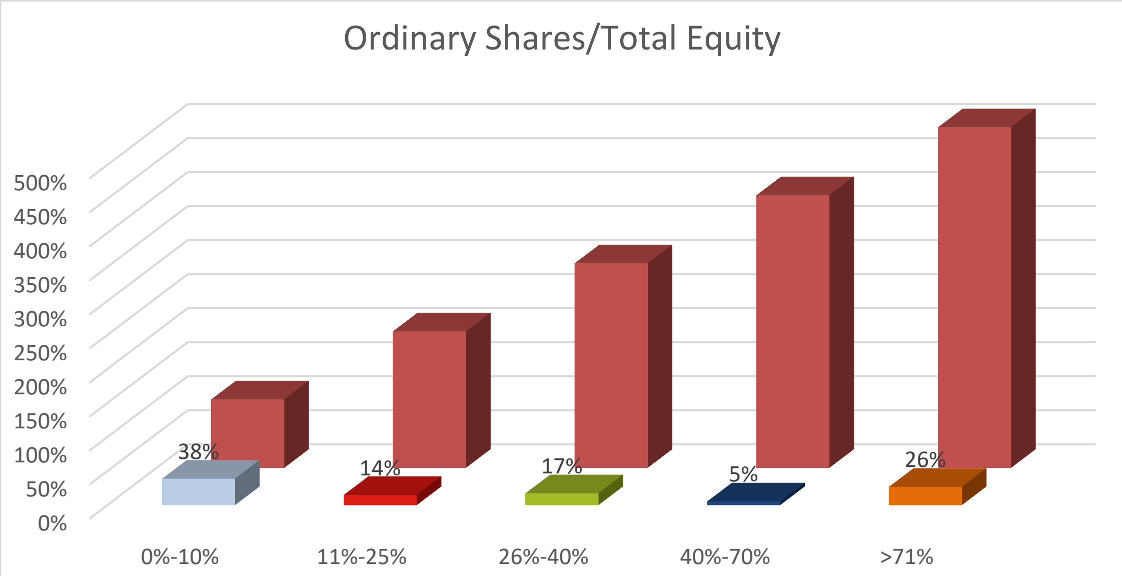
Total consolidated assets



Leverage (Total equity/assets)

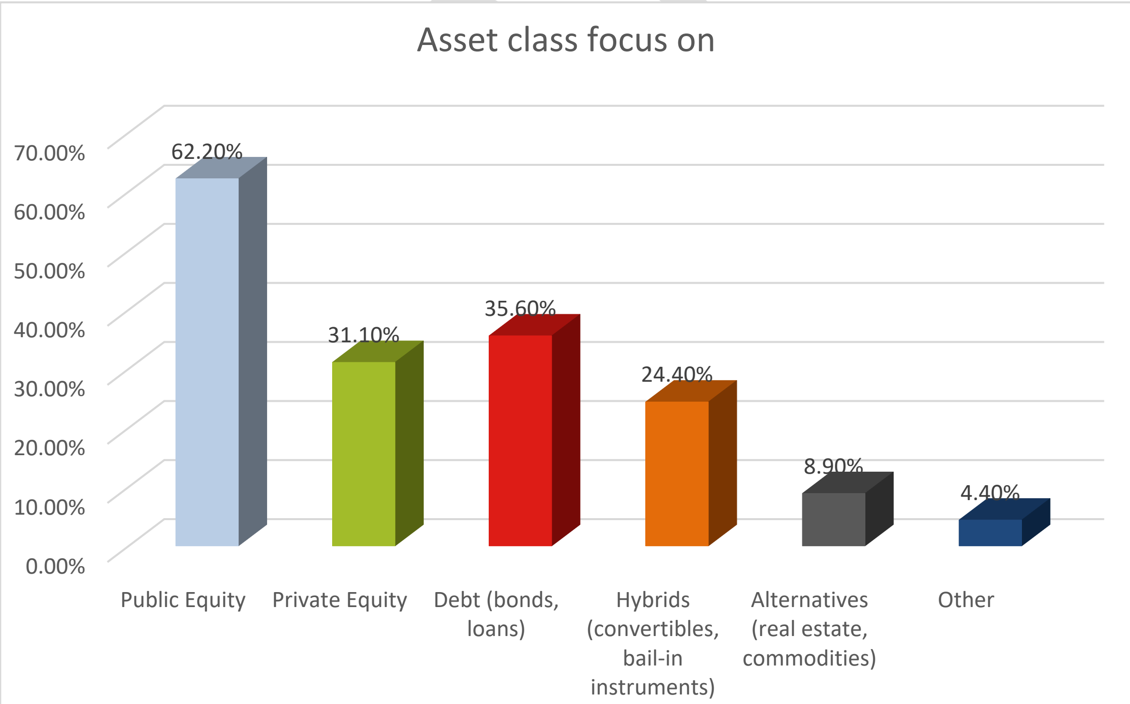


Equity composition (Ordinary shares/total equity)

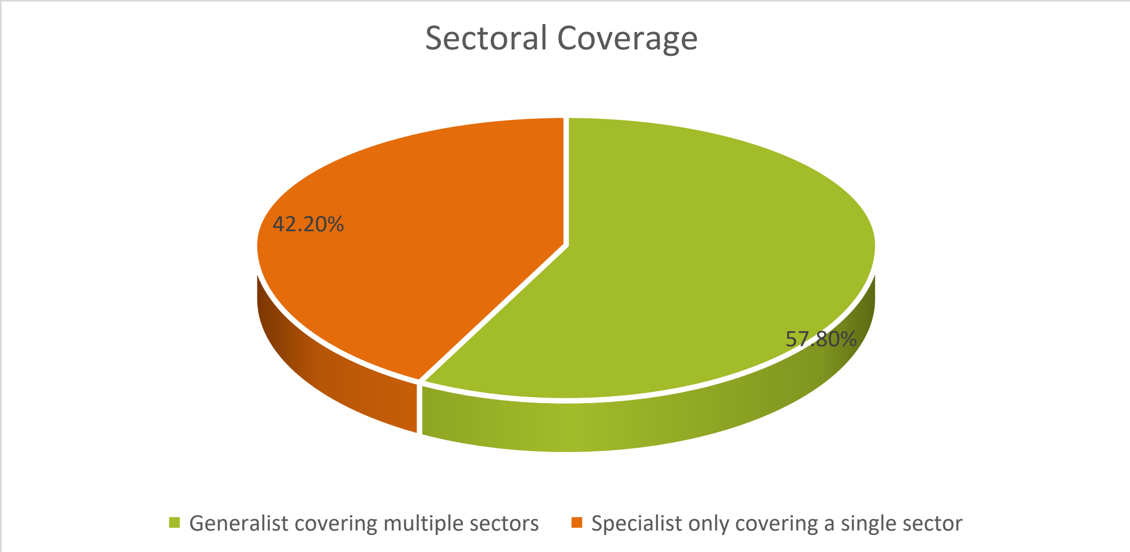


Users profile

Asset Class



Generalist versus specialist



Sectors covered by specialists