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**Re: Comments on *Financial Instruments
with Characteristics of Equity***

Contact: Ms. Raquel Zaragoza

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Comments by the European Federation of Financial Analysts' Societies (EFFAS) Commission on Financial Reporting (CFR)

Dear Sirs,

The Commission on Financial Reporting of the European Federation of Financial Analysts Societies (hereafter the “CFR”) is pleased to share with you the views of the European users of financial statements regarding the discussion paper *Financial Instruments with Characteristics of Equity* (DP/2018/1) (hereafter the “DP”) issued by the IASB. In preparing this letter, the CFR has relied on discussions held between its members and analysts and investors of different constituencies

Financial analysts and investors are among the principal users of financial reporting and more comprehensively corporate reporting. As we did previously, we continue encouraging the IASB to develop their documents and Standards avoiding density. We understand the difficulties of drafting a DP on a subject carrying the inherent complexities of FICE. Nevertheless, we think that **a document conceptually clearer and avoiding introducing new concepts and terminology would have been easier to read and understand** and would have been appreciated by stakeholders. New terminology introduces uncertainty on the concepts. Simplicity and clarity are always useful for users.

Based on the Discussion Paper, the CFR attempts to address what it considers to be the key points for which users contemplate improvements. We express our views following the questions presented in the DP although all the points are not specifically addressed.



Question 1.-

The attempt to set a clearer distinction between debt and equity in light of the complexity of *Financial Instruments with Characteristics of Equity* issued by international groups is very welcomed. We are encouraged with the initiative taken to develop a rational to make a clearer distinction. However, we also think that the challenge to have a long-lasting classification “equity vs. debt” will remain. Current financial instruments continue to evolve creating recurrent new challenges.

A purist definition of these instruments will always be a challenge. Its classification will be influenced by the angle of which the financial instrument will be looked at. As noted in paragraph 1.28 it is difficult to identify a rational to distinguish between liability and equity and, we believe, it will depend of the perspective being considered. For a holder of a FICE, it will mostly be a liability hence with an embedded equity component; for the issuer of that same instrument it will be an equity instrument hence with an embedded debt component. We believe that a “narrow” definition of equity will contribute to a clearer understanding on debt-equity classification.

Having said that, clarification is needed and particularly better disclosures. Users are challenged by distinguishing liabilities from equity and by the incomplete information disclosed for certain instruments. The terms and conditions of certain equity instruments and redemption period are not always disclosed. A balanced disclosure approach is key, and **quality of information should not be outweighed by quantity.**

We consider that by introducing additional and balanced disclosures, for instance related to amounts and redemption periods, **a new standard will not be necessary**. A new standard might imply substantial changes that will make users to spend time to understand while its benefits would have to be seen. More comprehensive disclosure requirements particularly for equity investments might be sufficient.

We will support to take a fresh look at IAS-32 in light of the numerous and complex new products that have been introduced into the markets in the past fifteen years.

Question 2.-

The CFR considers that the DP is addressing the classification between debt and equity in an appropriate way and by and large we support the approach. If an entity has to pay back a certain amount at a point in time other than liquidation and the amount is independent of the resources available to the entity this is an unavoidable obligation to be accounted for as a liability.

In this regard, however, we would like to point out that framing the transfer of the cash or another financial asset within a context of “**liquidation**” is confusing. Users work on the basis of an on-going concern and not assuming an entity’s potential “liquidation”. **We suggest revising this terminology that introduces uncertainty.**



Moreover, we believe that the approach stated in the DP regarding available resources – assets minus liabilities as in paragraph 2.15- should be clarified. To repay an obligation the entity needs cash. Admittedly an entity could repay its debt by handing over an (financial) asset but generally speaking an obligation cannot be repaid with a piece of machinery or an illiquid asset. Therefore, we would suggest being more precise on the notion of available economic resources. In this particular case, these cannot be “asset minus liabilities”. In Question 3, for instance, the DP refers to “cash or another financial asset” more in line with how we would approach the problem regarding the available resources

Moreover, we would like to underline that having the balance sheet right is key. A clear rational to distinguish between equity and liabilities is important. Having appropriate disclosures, for instance on the potential dilutive impact of derivatives, is also relevant for users as the additional information related to the financial instruments will be taken into account. Having the right additional information available will also permit users to make adjustments that they consider appropriate.

Question 3.-

The CFR considers that a non-derivative financial instrument is in fact a “plain” liability and it should be classified as such: debt. In line with our answer to the previous question, we agree with the approach.

Question 4.-

We think that the puttable exception will depend on the facts and circumstances and whether or not the entity will have to transfer cash or another financial asset to buy back its own shares. (i.e. compliance with certain capital ratios). The put could be or could not be exercised and in this case the shares will remain outstanding.

Entities cannot control whether or not holders exercise the put and then presenting the put as a liability would, in our view, be misleading. It could be argued that if the puts are into the money it would be reasonable to present the contractual relationship as a liability. However, accounting the security as a liability or as an equity depending on whether or not the put is “in or out” of the money it would not be advisable in practice.

In our view, the puttable exception could be accepted assuming that the notes disclose the precise and appropriate information regarding the outstanding instruments and terms and conditions.



Questions 5.- 6.-

We do agree with (a). A derivative on own equity should be classified in its entirety as equity or liability and its different legs should not be classified separately. A derivative on own equity should be classified as equity or as a liability if there is a right to receive cash or an obligation to pay cash before liquidation date and for an amount that is independent on the economic resources available. This, we believe, is in line with the preferred approach discussed in Section 3.

In that context we are positive about EFRAG's statement in its draft comment letter to initiate research with regard to derivatives in the context of IFRS 9. This would allow a more structured approach regarding the often-complex technicalities of derivatives.

Point (b)-(i) (*) and (ii) is too complex to be understood and clarification is needed to make a supported opinion. A simpler and clearer language and a different structure would have been more conducive to provide an opinion.

Questions 7.- 8.-

Regarding **presentation and disclosures**, we agree that companies present liabilities and equity classified in terms of seniority and priorities. Separating a company's' total capitalization between liabilities and equity and ranking securities from *Senior Secured Loan* to *Ordinary Shares* is clear and provide users with good information in terms of companies' unavoidable obligation to pay cash.

Knowing the terms and conditions of the instruments and especially providing information regarding the **potential dilutive impact** of the obligations is very relevant information for users. This type of disclosure will be undoubtedly a major improvement over IAS-32.

Nonetheless, it should be underlined that introducing too much complexity in terms of presentation -see the approach in paragraph 6.53 (a) (i)-(iii)- and classification will complicate the understanding of the income statement and the statement of financial position.

Question 9.-

We support additional information in the notes particularly reflecting companies' priorities and claims ranked from senior to junior obligations with an unavoidable cash settlement. We have however some difficulties in understanding how this should be approached and how this could work in complex (international) groups with numerous obligations outstanding in numerous places and jurisdictions.

(*) We also refer to the fact that Section 4 covers derivative financial instruments (on own equity?). That said, Section 5 then covers "Derivatives that included an obligation to extinguish an entity's own equity and derivatives embedded in compound instruments" (paragraph 4.1). That said, Section 5 is about "Compound instruments and redemption obligation arrangements". The terminology used is very confusing and adds to the complexity of the DP.



Having relevant information with regard to the terms and conditions of the instruments is very useful especially, as noted, information with regard to potential dilution. Additional disclosures will be undoubtedly a major improvement over IAS 32.

Question 10.-

We believe that as companies can change their approach in terms of the economic incentives that an issuer might have, this should not change the classification of a financial instrument. Economic incentives might be uncertain and classifying financial instruments on this basis would result in information that is no longer consistent.

We also agree with the requirements in paragraph 20 of IAS-32 as financial accounts in our view need to be complete. Indirect obligations need to be recognized in order to guarantee the relevance of the information disclosed

Question 11.-

As already expressed, we support the Board's preferred approach as far as the financial instruments are clearly defined and based on the contractual terms of the agreement.

We thank you for this opportunity to provide our views on such important aspects of financial reporting. We hope that the views of users will drive the work of the IASB and remain available for any further information.

Yours faithfully,

Javier de Frutos
On behalf of EFFAS
Commission on Financial Reporting

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 22-member organizations representing more than 16,000 investment professionals. The Commission on Financial Reporting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst and investors standpoint. CFR members are Javier de Frutos (Chairman, IEAF-Spain), Jacques de Greling (Vice-Chairman- SFAF, France), Dr. Carsten Zielke (DVFA, Germany), Friedrich Spandl (ÖVFA, Austria), Henning Strom (NFF, Norway), Serge Pattyn (BVFA/ABAF, Belgium) and Luca D' Onofrio (AIAF, Italy).