

FEEDBACK STATEMENT

ON FINANCIAL INSTRUMENTS WITH
CHARACTERISTICS OF EQUITY

EFRAG SECRETARIAT WORKING PAPER:

EARLY-STAGE ANALYSIS

Potential Effects of the IASB Discussion Paper

JULY 2019

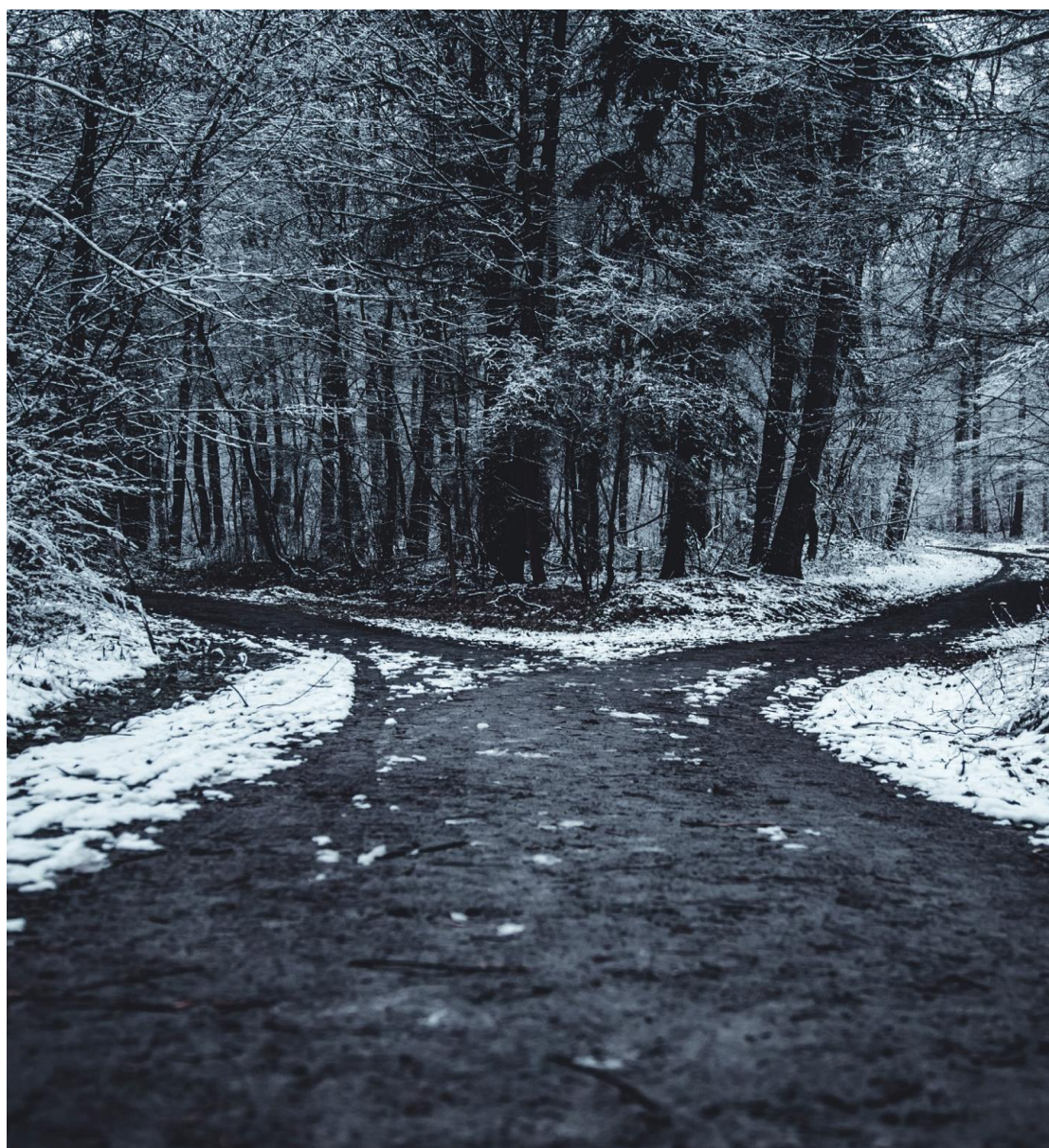


Table of Contents

Overview	3
Working Paper objective	3
Purpose and use of this feedback statement	3
Profile of responses from constituents	3
Key messages.....	4
Feedback on usefulness of the Working Paper and its findings.....	4
Suggested enhancements for future similar work on the FICE project and other standard setting projects	5
Appropriateness of early-stage analysis for other ongoing and forthcoming projects.....	6
Other feedback – comments on specific topics not related to the Early-Stage Analysis Impact....	7
Conclusion	7
Appendix – List of Respondents	8

Overview

In February 2019, EFRAG issued the *Financial Instruments with Characteristics of Equity - EFRAG Secretariat Working Paper: Early-Stage Analysis* ([Working Paper](#)). EFRAG requested public comments to be provided through either comment letter submission or by responding to an online survey that had questions on the usefulness, findings and areas for enhancement of the early-stage analysis. The EFRAG Secretariat also received feedback from respondents who were unable to submit formal written responses but were willing to give informal feedback through other channels, including email and verbal feedback. The comment period ended on 17 May 2019.

EFRAG is now issuing a feedback statement, which highlights the main comments received.

Working Paper objective

EFRAG has in the past called for an evidence-based approach through all the stages of standard setting. The Working Paper is the first early-stage analysis on a Discussion Paper issued by the IASB that EFRAG is aware of. It provides an early-stage analysis of some possible effects of the IASB's Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity* ([IASB DP](#)). Although the Working Paper was approved by the EFRAG Board for issuance in order to provide information to its stakeholders, it does not represent any EFRAG positions. EFRAG formal positions are established through an extensive due process and are articulated in the 01 February 2019 [final comment letter on the IASB DP](#).

The Working Paper is intended to inform constituents about the effect of the IASB's project and be one of the inputs to a future comprehensive impact analysis if the IASB were to proceed with the Financial Instruments with Characteristics of Equity (FICE) project.

Purpose and use of this feedback statement

As this is the first early-stage analysis conducted by EFRAG, EFRAG also sought public comments on the Working Paper to identify what analytical aspects are useful and where improvements could be made should a similar exercise be undertaken in the future.

This feedback statement has been prepared as a formal record of the responses received. It summarises the messages received from constituents and notes any key themes identified. In conjunction with the Working Paper, this feedback statement will be considered by EFRAG as one of the inputs to a future comprehensive impact analysis if the IASB were to proceed with the FICE project.

Profile of responses from constituents

EFRAG has received feedback from 13 respondents which includes nine comment letters. These comment letters are available on the EFRAG website ([here](#)). The comment letters received came from national standard setters, business associations, auditors, preparers and users of financial statements.

In addition to the nine comment letters, EFRAG also received informal feedback from two user organisations and two business associations.

Key messages

The key messages received from constituents in response to the four questions posed in the issued Working Paper are summarised below.

Feedback on usefulness of the Working Paper and its findings

Overall respondents found the early-stage analysis exercise performed by EFRAG Secretariat to be a comprehensive and useful supplement to EFRAG's current due process for influencing the development of IFRS Standards, which includes outreaches and the issuance of draft and final comment letters. Some respondents proposed that the early-stage analysis should be a standard part of EFRAG's process for key future standard setting projects.

Contribution to EFRAG's stakeholders involved in standard setting: One respondent observed that by conducting an early-stage analysis, EFRAG could encourage and contribute to the greater adoption of an evidence-based approach by the IASB and other standard setters. Another respondent suggested that the early-stage analysis can contribute to a faster endorsement process at later stages of the project. Several standard setter respondents indicated that the Working Paper findings were confirmatory of what they had heard from stakeholders in their jurisdictions. Other respondents indicated that it was useful for the smaller standard setters and their working groups who may have insufficient resources to conduct such an exercise themselves. A user respondent indicated that the inclusion of specific examples was helpful in reducing uncertainty on the topic.

Positive comments on the findings and analysis in the Working Paper included:

- *Inclusion of both preparer and user perspectives:* There was positive feedback on the inclusion of both the preparer and user perspectives in the Working Paper. A respondent found the differing views between preparers and users on the anticipated cost-benefit analysis and impact on cost of capital to be useful.
- *Coverage of economic and financial stability consequences:* Several respondents had positive comments about the Working Paper's coverage of economic and financial stability consequences. One respondent commented that a broad approach that incorporates issues of relevance to the EU added value to the document. Another respondent appreciated the consideration of the role of rating agencies' classification versus accounting classification in the issuance of perpetual hybrid instruments. Another respondent indicated that the assessment of the interaction of accounting and regulation on the FICE topic was helpful. However, there was also a recognition of the inherent difficulty in assessing economic and financial stability consequences.
- *Inclusion of quantitative aggregate data:* Positive feedback was received on the inclusion of quantitative aggregate data related to key instruments such as potential market disruption in the issuance of perpetual bonds with payment deferral features.
- *Highlighting instruments where changes in classification could occur:* A respondent had positive feedback on the brief description in Chapter 3 of potential changes in classification that were not identified in the IASB DP. One respondent also found the highlighting of potential changes in classification of some Additional Tier 1 (AT1)¹ instruments to be useful and suggested that

¹ For prudential regulation purposes, Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable non-cumulative preferred stock. Additional Tier 1 capital is defined as instruments that are not common equity but are eligible to be included in this tier.

the findings would have been more useful if aggregate data on the prevalence of potentially affected AT1 instruments were available.

However, another respondent expressed the view that the survey feedback highlighting concerns by some financial institutions on reclassification of different types of AT1 instruments may have overstated the potential changes due to the IASB DP proposals. This respondent expressed the view that the uncertainty of classification of AT1 instruments is not caused by the IASB DP proposals. They noted that potential classification changes should be analysed based on general principles of the timing and amount feature. In their view, the timing feature, in general, is not different to IAS 32 *Financial Instruments: Presentation*. The application of the amount features would be equivalent to the fixed-for-fixed condition in IAS 32 (for instruments with the conversion feature) or would bring no changes for instruments with the write-down feature. In effect, they consider that the situation in the IASB DP is unchanged to IAS 32.

Suggested enhancements for future similar work on the FICE project and other standard setting projects

Some of the respondents suggested that the impact analysis ought to be a dynamic exercise that takes account of developments in the thinking of the IASB on the FICE project and any relevant market developments.

Other suggestions to improve the usefulness of the early-stage analysis included:

- *Earlier timing and alignment to EFRAG's comment letter.* Some respondents indicated that an early-stage analysis exercise would be more useful if issued at the same time or earlier than the EFRAG draft and final comment letters. In addition, all key findings of the early-stage analysis ought to be included in the EFRAG final comment letter. Furthermore, there should be a consistent articulation of EFRAG's positions whenever similar topics are addressed across both the early-stage analysis and EFRAG's formal due process documents.
- *Broader scope:* Some respondents proposed that the scope of the analysis could go beyond the scope of the IASB DP. One respondent proposed an assessment of the impact on market development if instruments that will be settled using a variable number of the entity's own shares were classified as equity. Another respondent suggested that the early-stage analysis should include a description of the pros and cons of different alternatives for the equity versus debt classification including but not limited to the IASB DP proposals. Similarly, one respondent proposed the assessment of impacts of the application of the notion of economic compulsion versus contractual/legal rights in the classification of financial instruments.

In reaction to the concerns highlighted in the Working Paper about the potential market disruption were a change in classification of perpetual bonds with payment deferral features were to occur, one respondent indicated that further analysis on the appropriateness of the current classification of these instruments as equity would have been helpful. In the opinion of this respondent, the classification of these instruments as equity (regardless of the high step-up coupons for non-rated bonds) was potentially misleading for investors and inconsistent with the European public good. Finally, another respondent proposed that the Working Paper could have had more coverage on transitional provisions.

- *Definition and clarity on intended audience:* There was a suggestion that the intended audience for the early-stage analysis should be identified as to whether the primary audience is the European Commission or the IASB.

- *Enhance methodology and inputs for anticipating economic and financial stability consequences:* A respondent suggested that EFRAG should draw on the expertise of economists and prudential regulation experts to enrich and ensure robust analysis of economic and financial stability consequences.
- *Analytical enhancements:* Several suggestions to enhance the overall analysis were made:
 - *Critical interpretation of findings:* Some respondents suggested the need for caution when interpreting and reporting on stakeholder feedback on possible economic consequences. An example of this is highlighted above in the feedback on the Working Paper findings where one respondent stated the uncertainty in the classification of some AT1 instruments already exists under IAS 32 requirements and would not be caused by the IASB DP proposals. Another comment was made that, to avoid potential bias in the presented findings, the EFRAG Secretariat should assess the expected quantitative impacts of issues raised by constituents.
 - *More conclusive analysis:* Although several respondents acknowledged the inherent limitations of the evidence gathered at the discussion paper phase of the project which only warrant tentative conclusions being made on possible consequences, some respondents proposed the need for a more conclusive analysis by EFRAG (e.g. on the impact on the reclassification of different types of AT1 instruments, cooperative shares and perpetual hybrid bonds).
 - *Extended analysis on rating agencies' and prudential regulators' equity classification criteria:* One respondent suggested that an enhanced analysis of equity classification criteria applied by rating agencies and prudential regulators would have been useful. For example, a reconciliation between criteria used by credit rating agencies and prudential financial regulators, would allow for a comparison, highlight potential divergences between these criteria and potentially highlight the extent to which economic compulsion is considered for equity classification.
 - *User perspective on IASB DP classification criteria:* One respondent suggested that feedback from users should have been sought on whether the combination of the timing and amount features for classification purposes was useful. If not, which of the two criteria do users consider to be most relevant. This feedback is already included within the EFRAG comment letter and feedback statement on outreaches.
- *Disaggregation of analytical findings:* A respondent highlighted that it might be useful to disaggregate and distinguish the analytical findings across regional blocs within the EU that have differing levels of entities' reliance on capital markets for funding. Such a distinction would indicate how the IASB DP proposals could be perceived by stakeholders in these different regional blocs.

Appropriateness of early-stage analysis for other ongoing and forthcoming projects

Some respondents suggested that there should be a balance between the costs and benefits of performing such an assessment. Outreaches and analytical efforts should be proportional to the significance of the project. Respondents specifically asked for such an assessment for *Business Combinations under Common Control, Rate-regulated Activities* and *Primary Financial Statements*.

Other feedback - comments on specific topics not related to the Early-Stage Analysis Impact

Beyond giving comments on impacts and responding to the broad questions about usefulness of the early-stage analysis, some respondents had comments affirming their positions on the IASB DP proposals including those that had already been expressed in their comment letters. Some respondents reiterated their views on the general direction, whether there is an adequate case for change and the complexity of the FICE project.

One financial institution respondent emphasised the uncertainty on whether the classification of co-operative shares as equity would change if the IASB DP proposals were to be adopted. The respondent emphasised that the uncertainty on classification remained regardless of whether, as had been mentioned in the Working Paper, the IASB has indicated that the requirements of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* will be carried over.

A user organisation respondent reiterated their position on several aspects of reporting financial instruments with characteristics of equity including recommending that there should be sufficient disclosure with regards to individual capital instruments, emphasising the importance of disclosure of terms and conditions and an appropriate criteria for the classification of instruments as either equity or debt.

Conclusion

Overall, the early-stage analysis was well received by respondents. They also provided suggestions for the enhancement of this type of exercise. The suggestions for enhancement will be considered by EFRAG for future similar exercises to the extent that:

- They are feasible and do not adversely impact on the cost-benefit of conducting an early-stage analysis.
- They focus on impacts that can be identified by company-specific evidence and readily available aggregated empirical evidence.
- The analysis is supplemental and not duplicating areas covered by EFRAG's comment letter and outreaches (e.g. stakeholders' views on specific proposals).

Appendix – List of Respondents

<i>Respondent</i>	<i>Country</i>	<i>Type</i>
Accountancy Europe	Europe	Accountancy Association
Association for Financial Markets in Europe (AFME)*	Europe	Business Association
Business Europe*	Europe	Business Association
Comissão de Normalização Contabilística (CNC)	Portugal	National Standard Setter
Corporate Reporting Users Forum (CRUF)*	Europe	User Organisation
Erste Group	Austria	Preparer
European Association of Co-operative Banks (EACB)	Europe	Business Association
European Fund and Asset Management Association (EFAMA)*	Europe	User Organisation
European Savings and Retail Banking Group (ESBG)	Europe	Business Association
Financial Reporting Council (FRC)	United Kingdom	National Standard Setter
FSR – Danish Auditors	Denmark	National Standard Setter
Polish Accounting Standards Committee (PASC)	Poland	National Standard Setter
The European Federation of Financial Analysts Societies (EFFAS)	Europe	User Organisation

*Respondents provided informal feedback.