USER OUTREACH EVENT FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

BRUSSELS

26 NOVEMBER 2018

Photo by Yeo Khee

This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by IASB® staff and has been jointly approved for publication by representatives of EFRAG, EFFAS and ABAF-BVFA who attended the outreach event.

Introduction

EFRAG with the European Federation of Financial Analysts Societies (EFFAS), the Belgian Association of Financial Analysts (ABAF-BVFA) and the IASB® organised an event covering the IASB's Discussion Paper ('DP') *Financial Instruments with Characteristics of Equity* ('FICE'). This report has been prepared for the convenience of European constituents to summarise the outreach event held in Brussels on 26 November 2018.

Jean-Paul Gauzès (President of the EFRAG) opened the outreach event and welcomed participants.

To set the scene, Uni Choi (IASB FICE Project Lead) introduced the DP.

Andrew Watchman (EFRAG CEO and TEG Chairman) introduced EFRAG's tentative views in its Draft Comment Letter on the DP.

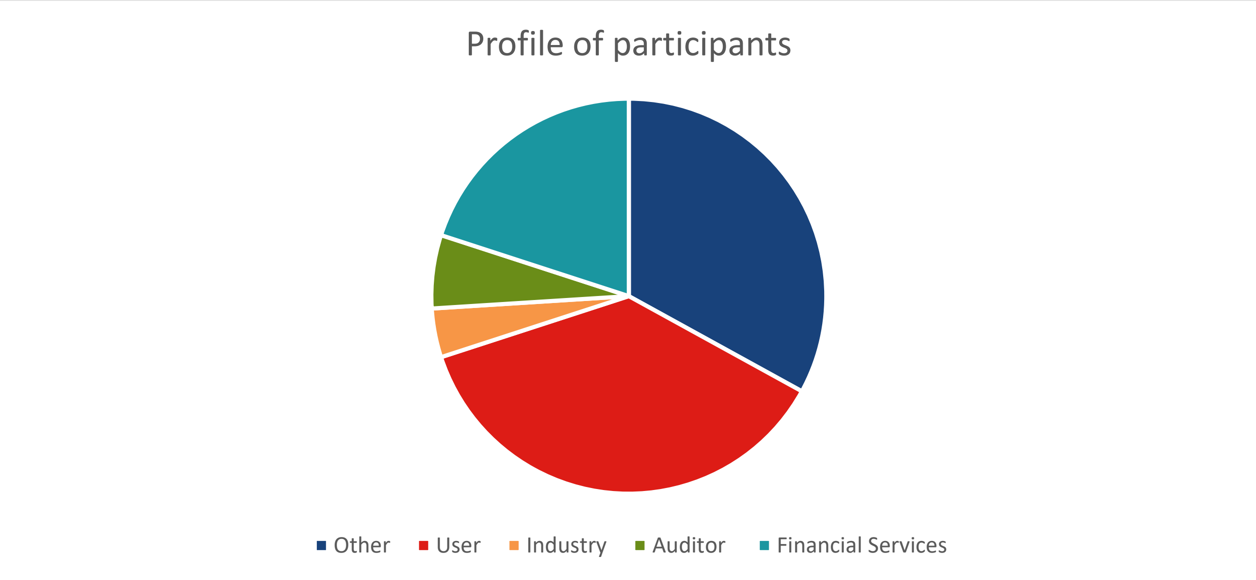
This was followed by a User Round Table discussion with the following panellists:

- Elisa Belgacem, Credit Strategist Crédit Agricole CIB
- Barbara Cohen, Head of European Credit Research, BNP Paribas Asset Management, Chairman of the SFAF Credit Committee
- Selim Gogus, Accounting and tax analyst, Credit Suisse HOLT

The User Round Table was moderated by Patricia McBride, EFRAG Technical Director, and Serge Pattyn, EFRAG User Panel member, summarised the feedback after the Round Table.

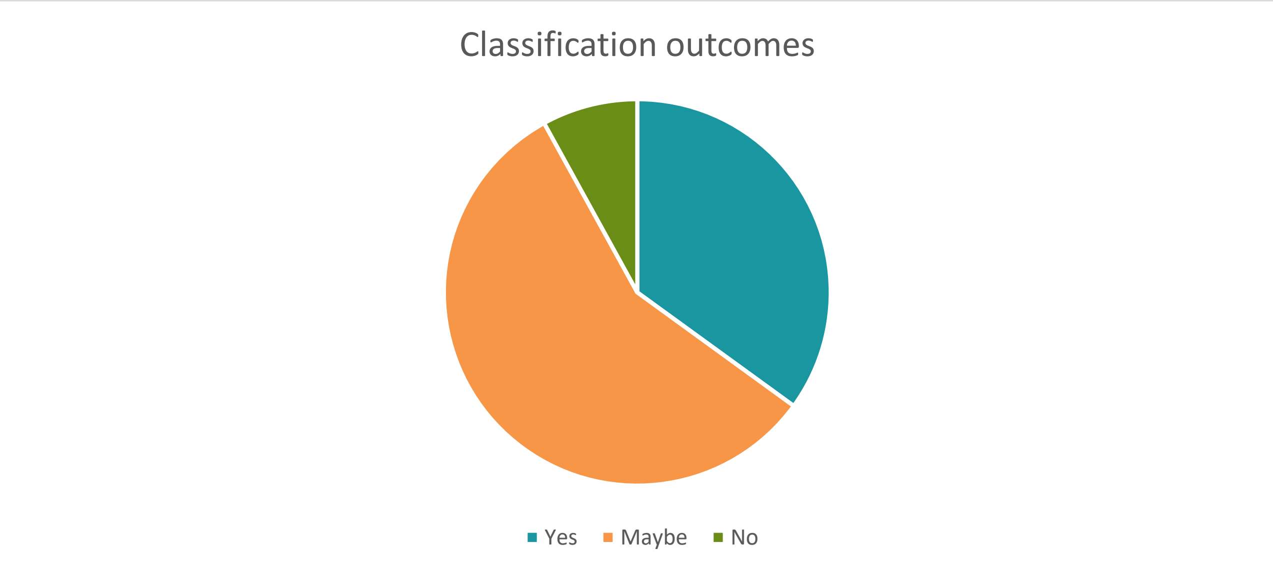
During the Round Table, attendees' views were collected through on-line questions – the results of which are shown below.

The profile of participants was as follows:



Summary of observations

Polling question: Do you consider that IAS 32[1]'s classification outcomes as debt or equity are clear, consistent and understandable?



Learning a new financial instruments language: is it really worth it? Should the IFRS classification rules change to assist in classifying future financial instruments?

A panellist noted that the benefit of having new language is that it helps entities classify instruments consistently which provides investors with more information to make their own analysis.

[1] IAS 32 *Financial Instruments: Presentation*

They highlighted that almost all corporate hybrids are perpetual and generally classified as equity at present. Currently it is fairly clear what is equity and liability. The IASB's new terminology would bring a lot of disruption to the market, particularly when considering that many of these instruments would no longer be classified as equity. Panellists expressed their concern that, under the IASB's proposals, many financial institutions would use early termination options, creating instability in the market.

They noted that the DP would provide new and valuable disclosures. Panellists acknowledged that analysts often make their own classifications by making adjustments to the entity's classification. Panellists opined that the key elements for classification have been identified, but they questioned whether both the amount and timing features are necessary for classification purposes.

Polling question: The IASB is proposing new principles as the basis for classifying debt or equity financial instruments. Should the IASB keep some of the existing exceptions such as IFRIC 2[2] and the exception for puttables?

All participants agreed that at least some exceptions should be kept.

Is the IASB's proposals on presentation useful? How would you use it?

Some panellists considered that the use of other comprehensive income (OCI) provides relevant information although this adds complexity. Other panellists questioned how the separate use of OCI is useful as one can hide things in OCI. They noted that it would be relevant to have information similar to that used for regulatory purposes in terms of layers of capital (CET 1, Tier 2 etc.). They highlighted the fact that users will adjust line items as long as there is sufficient information to do so.

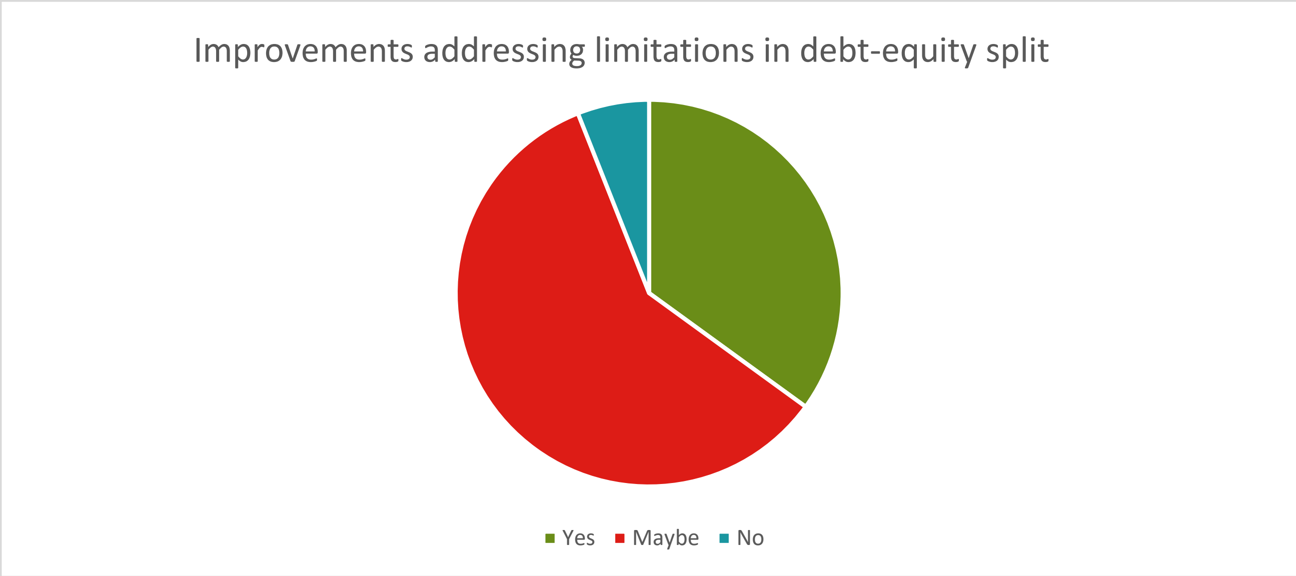
[2] IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*

From an overall perspective, what are your views on existing disclosures?

Some panellists found it useful to have the hierarchy of creditors on liquidation in the consolidated financial statements. They noted the usefulness of information on the timing of refinancing to better understand the liquidity issues that preparers may be facing, and they sought more information on the risks attached to financing instruments.

Panellists noted that disclosures on the ranking of debt were useful. However, they deemed it better to understand the seniority and layers of the capital structure. Panellists found that there is a lack of disclosures (such as sensitivity analysis) on reverse factoring.

Polling question: Do you think the improvements to presentation and disclosure in the IASB Discussion Paper can address the limitations of a binary debt- equity split? (yes, maybe-to some extent, no)



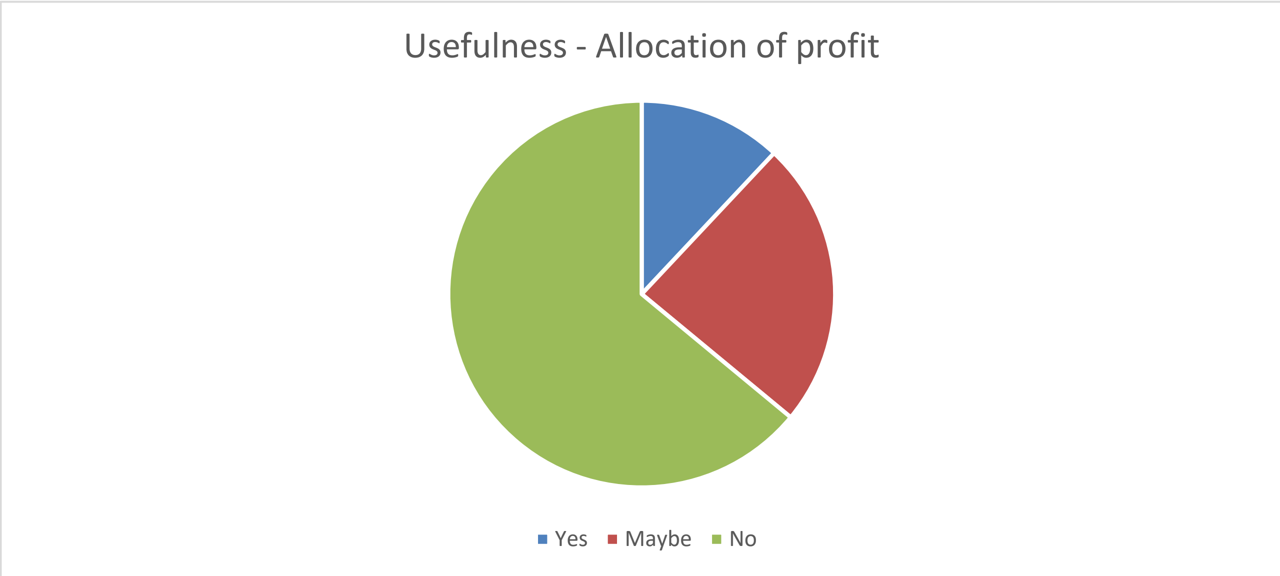
Would you find it useful if the profit for the year is shown as being distributed to both existing shareholders and potential future shareholders?

Some panellists considered that more information on potential shareholders was needed. While panellists acknowledged that the attribution proposals would bring more transparency, they were unsure how it would it affect the behaviour of users. A panellist noted that attributing profit on the face of financial statements would be more transparent than in the notes but said the attributed numbers would be more of "signposting" rather than actually being used in the analysis. A participant was unsure of the relevance of the IASB's proposals as potential shareholders do not have the right to dividends or other returns from entities.

Should information on potential dilution be improved?

Panellists found the information on potential dilution to be useful as well as to provide more transparency and encouraged disclosure of the impact on dilution that arises from IFRS 2 *Share-based Payment.* They also considered it interesting to have the information on maximum exposure to dilution.

Polling question: The IASB is considering the allocation of profit for the period between different classes of equity instrument. Do you think this would provide useful information? (yes, maybe-to some extent, no)



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

The information on the priority on liquidation is considered useful, but panellists wanted more information on the impact on covenants and resolution scenarios. They pointed out that their analyses are from the perspective of a going concern basis and not on a liquidation basis and it was noted that information about liquidation priority is less useful for equity investors. There was also agreement that it would be useful to understand in which entity in a group holds the debts instruments, for example a parent entity or an operating company as it can be hard to find information at operating company rather than parent level. Panellists also considered disclosures on terms and conditions to be very broad. They stressed the need for specific guidance on the level of aggregation in order to avoid information in a prospectus being copied into the financial statements. They suggested that an approach similar to IFRS 7 *Financial Instruments: Disclosures*.

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

Panellists highlighted the importance of having information on the key elements of the legal requirements but noted that it could be burdensome.

They acknowledged the practical challenges that arise from having subsidiaries located in many different jurisdictions with different legal environments and that would arise if economic compulsion were to be considered in classification.

And as a wrap-up – what are the messages that you want to send to the IASB? This might include additional disclosures, the balance of costs and benefits of this project from your perspective key

Panellists considered that there is a trade-off between costs and benefits, i.e. complexity versus transparency. They noted that as a result of the DP there could be a huge impact on some corporate hybrid bonds and because of the accounting, many may decide to redeem early. They indicated that users will always have their own views and were not convinced that users would look at financial instruments differently. However, this DP is an important opportunity to improve disclosures, which would bring more transparency.

Summary and closing

Key take-aways

Serge Pattyn summarised the take-aways from the User Round Table discussion and noted that there is a need to improve IAS 32 as it is an old standard. He also noted that there is a need to better understand whether the IASB's proposals will solve the issues and bring more clarity. Lastly, it is not necessary to support all of the IASB's proposals but some of them would be useful for users, particularly those on disclosures.

Closing remarks

Andrew Watchman thanked the panellists and participants and closed the event.