EFRAG European Financial Reporting Advisory Group

IFRS

DANSKE REVISORER FSR

DEBT OR EQUITY?
SUMMARY REPORT
Copenhagen 23 November 2018

Photo by Nick Karvounis

Introduction

In order to receive input from Danish constituents and to stimulate the discussion around the IASB® Discussion Paper ('DP') on Financial Instruments with Characteristics of Equity ('FICE'), EFRAG, the Confederation of Danish Industry (DI) and FSR – Danish Auditors with the IASB arranged an outreach event on 23 November 2018 in Copenhagen. This report has been prepared for the convenience of European constituents to summarise the event.

Kristian Koktvedgaard from the Confederation of Danish Industry and Torben Johansen from FSR – Danish Auditors welcomed participants.

IASB Technical Manager Uni Choi presented the FICE DP and EFRAG Senior Technical Manager Rasmus Sommer presented EFRAG's draft comment letter in response to the DP.

EFRAG Senior Technical Manager Fredré Ferreira then lead the discussion on the following topics:

- The main challenges in distinguishing debt from equity.
- The expected impact on the DP on classification outcomes.
- Whether the benefits of the information provided by the attribution approaches described in the DP exceed the related costs.
- The expected impact on accounting for puts on minority interests.

Discussion

The main challenges in distinguishing debt from equity

The DP provided the following examples of financial instruments, for which it is unclear how entities should apply the requirements in IAS 32:

- Put options written on non-controlling interests with a strike price at fair value.
- Contingent convertible bonds that pays interest at the discretion of the issuer and mandatorily converts to a variable number of the issuer's own shares if the issuer breaches its 'Core Equity Tier 1 ratio'.

Uni Choi explained that many issues arise because IAS 32 does not explain the rationale or the objective of the requirements. The main challenges with the current requirements, that EFRAG was aware of, related to accounting for non-controlling interest written put options, application of the fixed-for-fixed condition and the role of economic compulsion.

Participants explained that sophisticated financial instruments were rare among non-financial institutions in Denmark. However, an example of a hybrid bond, classified as equity currently was discussed at the event. In addition, participants noted that the DP could result in some challenges in respect of foreign exchange rate issues as the functional currency of some Danish companies was not Danish kroner – but the instruments they would issue would be denominated in Danish kroner. It was questioned whether a strong linkage between a functional currency and the 'foreign currency' could result in an instrument being classified as equity under the DP even though a fixed amount to be paid for a fixed amount of equity instruments would be in a 'foreign currency'.

The expected impact on the DP on classification outcomes

The presentations of the IASB and EFRAG showed that the proposals included in the DP would have the following impact (or not) on the following instruments:

Instrument	Classification under IAS 32	Classification under DP
Ordinary shares	Equity	Equity
Ordinary bonds	Liabilities	Liabilities
Instruments qualifying for the 'puttables' exception in paragraphs 16A – 16B or 16C – 16D	Equity	Equity
Instruments *not* qualifying for the 'puttables' exception in paragraphs 16A – 16B or 16C – 16D	Liabilities	Liabilities
Derivatives to deliver fixed number of equity instruments for a fixed amount of cash	Equity	Equity
Cumulative preference shares for which dividends for a stated rate are deferrable but not cancellable and so would trigger the amount feature under the DP	Equity	Liabilities
Cumulative undated bonds which would trigger the amount feature under the DP	Equity	Liabilities
Foreign currency rights issues meeting the exception under IAS 32	Equity	Liabilities
Net share-settled derivatives	Liabilities	Equity

Participants were generally concerned that the proposals in the DP would require at lot of work (cost) without resulting in significant improvements (benefits).

Some participants were concerned about how the DP would change the classification of a limited number of financial instruments under which the entity would deliver a fixed number of its own equity instruments for a fixed amount of a foreign currency (when other requirements included in IAS 32 are also met). As noted above, it is not uncommon that the functional currency of Danish companies is not Danish kroner.

Some participants were concerned that instruments currently qualifying as equity would be classified as liabilities and thought it peculiar to consider liquidation when classifying instruments, as liquidation did not reflect what would occur on a going concern basis. It was discussed whether probability of liquidation should be considered for classification when an amount is only payable on liquidation, but it was clarified that the probability would not affect classification under the DP. Some participants thought that economic compulsion and priority should be considered in classification.

It was mentioned that many of the issues could be solved by presentation on the statement of financial position and this would not need an approach which would change the classification of some instruments.

The comment was also made that the approach used in the DP seemed very legalistic and focused on the form rather than the substance, as the approach in the DP, could make the distinction between liabilities and equity more complex than an approach focusing on the substance. It was, however, also acknowledged that an approach focusing on the substance could result in unintended consequences, for example, in jurisdictions in which national law would require the entity to pay a minimum dividend corresponding to a certain percentage of earnings.

Clarity was sought by some participants on the effect of the proposal on various financial instruments. Among others, the effect on instruments that might be converted or written down based on solvency ratios would be useful.

Participants supported retaining the conclusions in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*.

Whether the benefits of the information provided by the attribution approaches described in the DP exceed the related costs

Some participants supported the IASB's general attempt in the DP to improve the presentation in the primary financial statements. The participants were, however, unsure about whether the proposals in the DP represented the right solution.

Participants had mixed views on whether the benefits of the information provided by an attribution approach would exceed the related costs. It was noted that the information, and the other presentation proposals included in the DP, could help some users understanding the effects of the various instruments. However, the approach also seemed complex and the cost of preparing the information could be high. A suggestion was made that it may be useful for only some instruments such as preference shares.

The expected impact on accounting for puts on minority interests

The proposed approach in the DP would mean that a written put option on minority interests would involve:

- Recognising a liability component for the redemption amount, which should subsequently be remeasured in accordance with IFRS 9 *Financial Instruments*.
- Derecognise the non-controlling interest on which the put options are written at the fair value of the ordinary shares of the subsidiary at the date of the issuance of the put option (with the separate presentation in other comprehensive income ('OCI') or profit or loss if conditions have been met).
- Recognise the difference between the liability and the derecognised non-controlling interest (assuming no cash is received) as an equity component for the implicit written call option on the subsidiary's shares (updated over time through the attribution of comprehensive income under the proposals of the DP).
- If the put option expires unexercised, then the carrying amounts of the redemption amount and the conversion option should be reclassified to non-controlling interests.

It was noted that a similar treatment should be applied for written put options on own shares. Participants noted that the DP required the value changes of some liabilities to be reported in other comprehensive income. Participants found it difficult to assess whether it was appropriate to report such changes in OCI as the IASB had not been able to provide a clear rationale for the use of OCI or recycling of amounts recognised as such. It was questioned why the changes could not be recognised directly in equity.

Jan Peter Larsen, FSR – Danish Auditors, thanked the participants and presenters and closed the meeting.