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FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Early-Stage Impact Assessment

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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 form part of EFRAG's 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, economic development and behavioural impacts including on the issuance of instruments and on covenants and compensation contracts. Highlights of our findings include the following:

a) There is no anticipated impact on competition for capital due to differences in accounting standards across different jurisdictions. At the same time, most preparer and user survey respondents did not expect a significant impact on the 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] of perpetual hybrid bonds (i.e. enforced redemption at price 101) that may encourage the early call of current issues or deter new issuances. Early calls may impose costs[2] to existing issuers and costs to investors.

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

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[1] Accounting call feature necessitates redemption by the issuer at a price of 101 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 enforced redemption amount, while costs to investors could arise if they hold perpetual bonds that are trading at above the redemption value.

[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.

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 shared their 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 aspect:

i) Any reclassification between equity and liabilities for accounting purposes could impact regulatory capital only to the extent that 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 from equity to liability could increase volatility in profit or loss should the remeasurements of the financial liabilities that were not previously classified as such. From a prudential perspective, regulatory capital volatility would also increase should the reported comprehensive income that updates CET 1 not be subject to prudential filters that strip out volatility arising from accounting remeasurement. In effect, in the absence of prudential filters, financial statement line items affected by the remeasurements (carrying value changes and interest recognised in profit and loss) could potentially affect the level and volatility of CET1 capital.

iii) The proposed attribution of comprehensive income could reduce retained earnings included in the highest quality of capital, 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.

[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.

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 IASB DP will lead to an improvement in financial reporting (see Chapter 6) shows that:

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 through classification. The IASB DP acknowledges 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.

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 no to minimal implementation costs. This seeming inconsistency could arise because these preparers could be considering other costs beyond the direct implementation costs and/or they perceive no benefits of the proposals for users of financial statements.

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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 solvency and leverage 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 statement due to the potential reclassification of some of their AT1 instruments.

c) 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.

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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 impact 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[6]. 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[7]. (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);

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

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

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

(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 user outreach event in London on 4 December 2018 (users).

c) *Aggregate data related to instruments with expected changes in classification*: The EFRAG Secretariat analysed data sourced from Bloomberg 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 (SNL, S&P Capital IQ and Orbis).

e) *High-level review of related academic evidence*: Considered a high-level review of relevant academic literature[8]. 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[9]. 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 Furthermore, the IASB DP is a preliminary consultation document that sets out the IASB's current preferred views and their rationale but does not cover all the matters or the level of detail that would be expected in a final IFRS Standard. This could result in preparers taking a "wait and see" approach before undertaking a detailed review of the implementation implications. This makes it a challenge to source implementation related data (e.g. costs) at the DP stage.

[8] 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

[9] 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.

Notwithstanding these limitations, the survey feedback provides a useful indicator of 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[10] 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).

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[10] 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 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 There is an acknowledgment that there is only so much information that users of financial statements can glean from any bifurcation of claims into liabilities or equity. In addition to classification proposals aimed at resolving IAS 32 challenges, the IASB DP includes proposals to enhance both the presentation and disclosure of financial instruments under the scope of IAS 32.

2.3 Challenges with existing disclosures is 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 need to improve disclosures of financial instruments with characteristics of debt and equity is also evidenced by the 2018 European Securities Market Authority's (ESMA) enforcement report[11].

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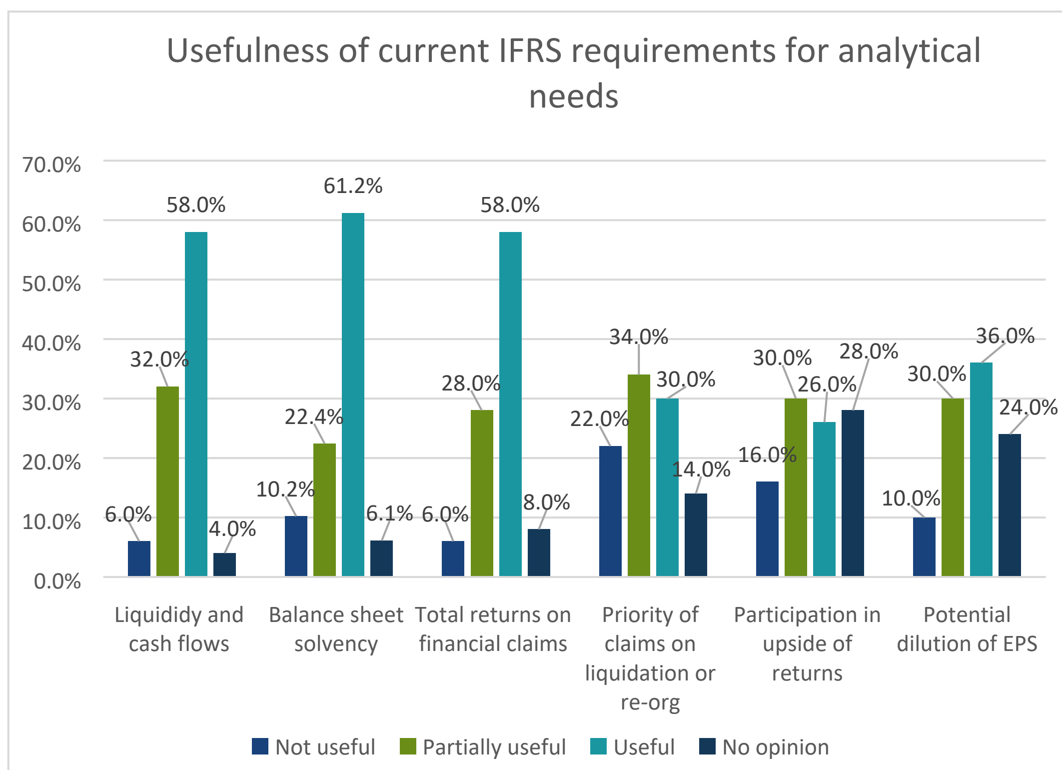
[11] ESMA Report, 2018. Enforcement and Regulatory Activities of Accounting Enforcers in 2017. The report notes that the analysis for 44 issuers carried out in the report revealed that where significant analysis was required in the classification of financial instruments either as a financial liability 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 of respondent users find current information to be useful for assessing liquidity, balance sheet solvency and total returns on financial claims (financial liabilities and equity). However, there is scope to enhance existing information so as to better inform on priority of financial claims (financial liabilities and equity), participation in upside of returns and potential dilution of earnings per share (EPS).

Figure 1: Usefulness of current IFRS requirements for analytical needs



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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 deferral cumulative feature);

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

(iii) foreign currency rights issues.

b) Change from liability to equity after considering both the timing and amount features: net-share settled derivatives on own equity that meet the "fixed-for-fixed" condition (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; net share settled derivatives on own equity; and foreign currency rights issues) 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

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clarifying guidance covers several variables[12] 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 would be accounted for as liabilities with changes in fair value presented in OCI with no recycling.

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.

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[12] 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 The assessment of economic consequences covers:

a) Competition for capital;

b) Issuance of instruments of interest;

c) Economic development; and

d) Covenants and compensation contracts.

Competition for capital

Comparison with other national GAAP reporting requirements

4.2 Accounting classification does not affect the 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 reduced 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.

4.3 We have very little evidence on the competition effects of GAAP differences but 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, a key competition issue that arises is whether IFRS reporting entities will be advantaged or disadvantaged relative to entities reporting under other national European and international GAAPs, particularly in terms of equity classification.

4.4 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 the- 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).

4.5 Assessing the proposals in the IASB DP in classification, presentation and disclosure for financial instruments with characteristics of debt and equity against 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.

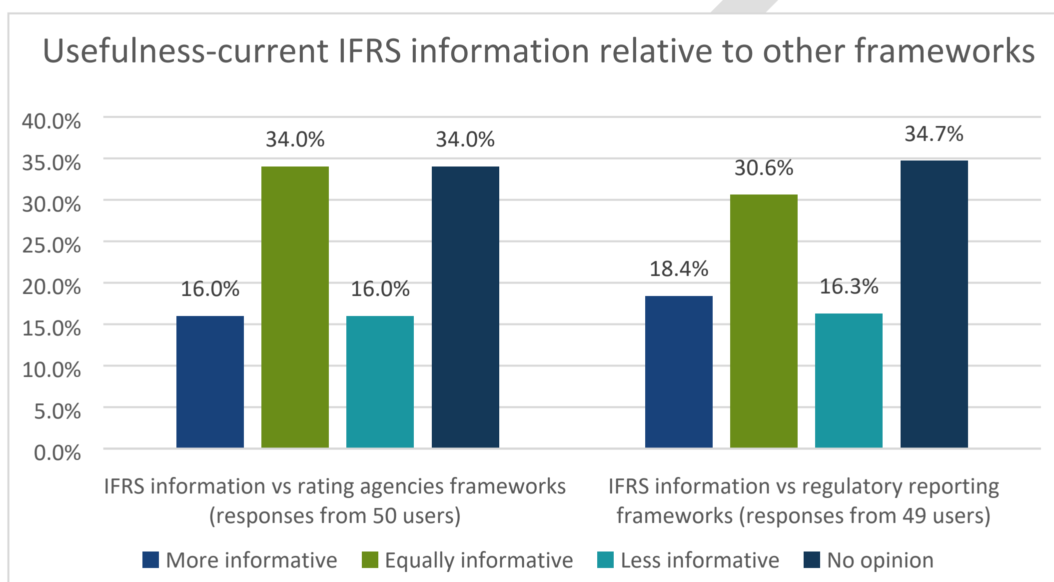
4.6 Any future comparison of IFRS requirements with international GAAPs would need to consider the developments in US GAAP. In September 2017 the Financial Accounting Standards Board (FASB) included a project on financial instruments with characteristics with debt and equity (including convertible debt) 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

Comparison with rating agencies assessment

4.7 Credit ratings play a key role in both the issuance and investor demand for financial instruments with characteristics of debt and equity. As can be seen from EFRAG survey results (Figure 2), investors and analyst rely on debt versus equity information from accounting, rating agency[13] and regulatory reporting[14] frameworks and have differing views on the information value of the debt-equity distinction in these different frameworks.

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



4.8 A key difference is that unlike the binary debt or equity accounting classification, rating agencies can grant partial equity to hybrid securities (i.e. they have more of a continuum approach compared to IAS 32). Rating agencies consider the expected maturity rather than contractual maturity and their criteria[15] for assigning equity credit differs from both the IAS 32 and IASB DP proposals criteria for distinguishing debt from equity.

4.9 A question that arises is whether the IASB DP proposals will impact on the usefulness of IFRS information for the financial capital providers that concurrently

[13] 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.

[14] 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.

[15] 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 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).

rely on rating agencies' assessment of issued instruments as an input for assessing entities.

4.10 This question on whether there will be reduced reliance on IFRS information arises particularly as stakeholders including users have expressed concerns with the complexity of the IASB DP classification proposals and anticipate interpretative challenges (see *Chapter 6: Improvements to Financial Reporting*). As can be seen from the survey results (Figure 2 above), there are some users who consider rating agencies' assessment to be more informative than IFRS information.

4.11 That being said, 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.

4.12 EFRAG also notes that 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[16] 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.

Impact on cost of capital

4.13 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.

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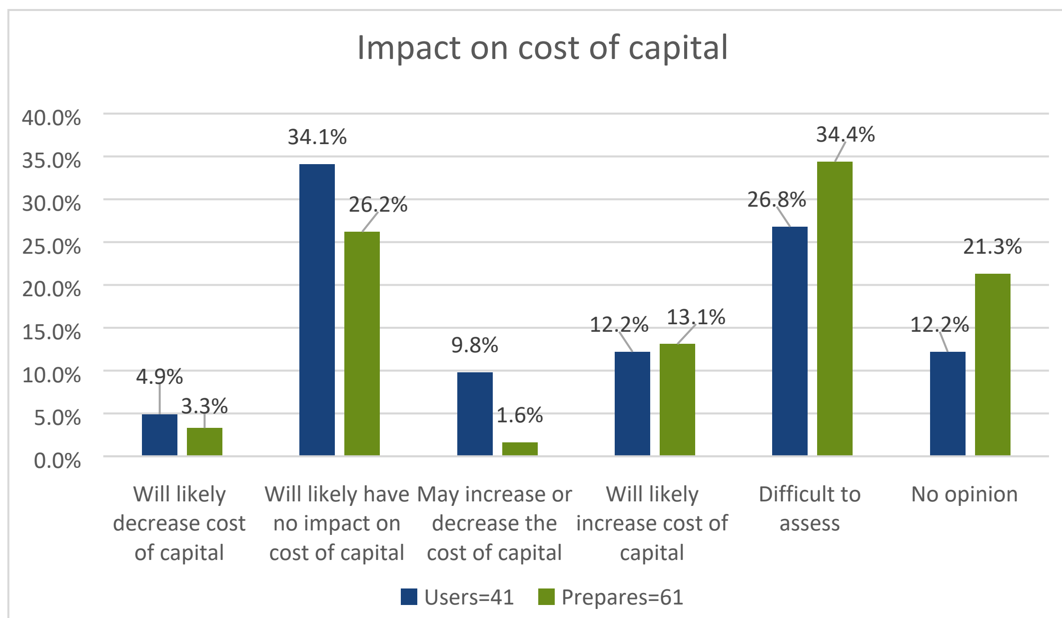
[16] Clor-Proell, S., Koonce, L. & White, B. 2016. How do experienced users evaluate hybrid financial instruments? Journal of Accounting Research, - The paper experimentally tests whether the features of hybrid instruments affect the credit-related judgments of experienced finance professionals, even 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.

Figure 3: Impact on cost of capital



Summary on competition for capital

4.14 Taken together, the analysis in the above sections shows that there is no reason to expect that IASB DP proposals will result in IFRS reporting entities being disadvantaged in competition for capital relative to entities reporting based on other national GAAP requirements. There is no reason for reduced dependence on IFRS information due to reliance on rating agencies information and there is no evidence that most stakeholders expect a significant impact on cost of capital due to the IASB DP proposals.

Impact on issuance of instruments of interest

Overview of issued instruments of interest

4.15 The IASB DP proposals addresses multiple 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 non-controlling interest puts).

4.16 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).

4.17 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.

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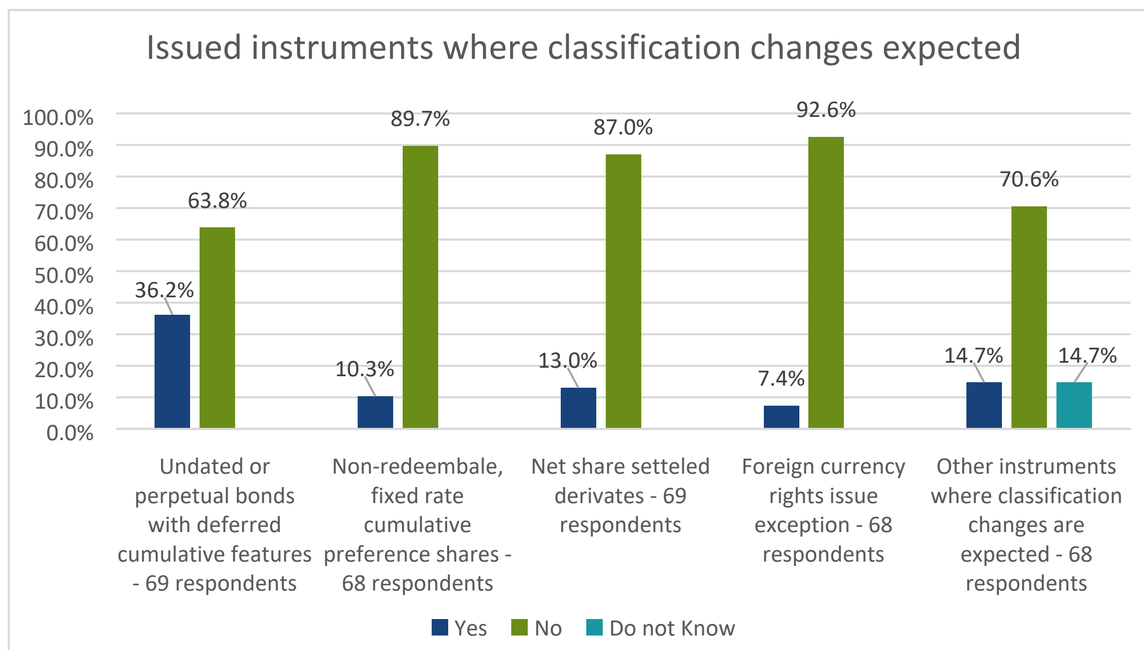
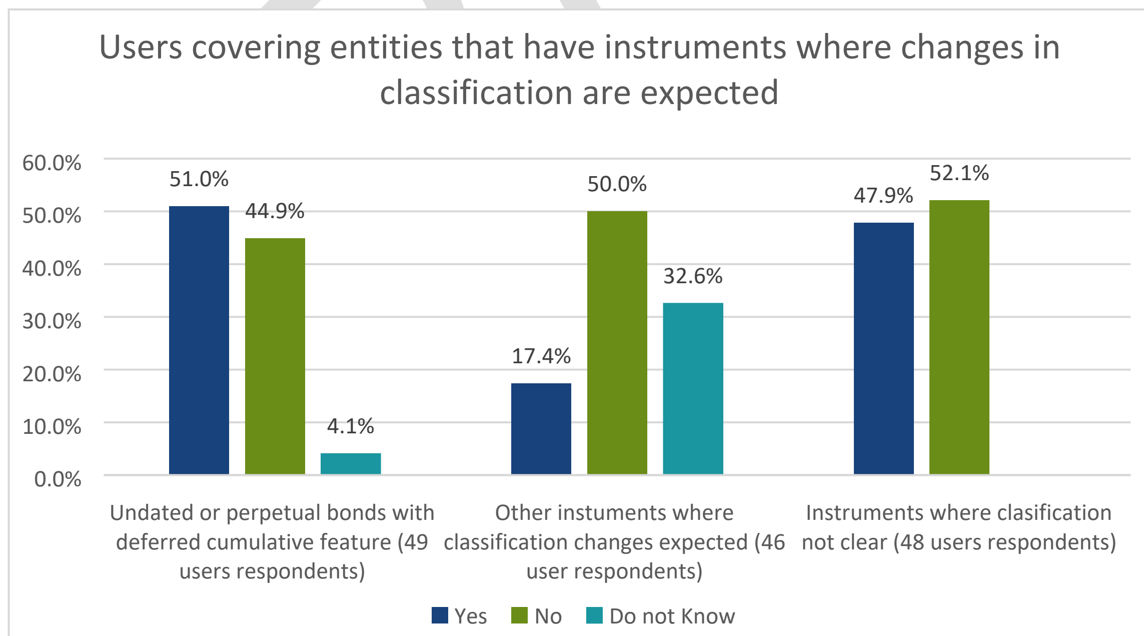
Figure 4: Issued instruments where classification changes are expected



4.18 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



4.19 Besides the four instruments identified[17] in the IASB DP, there are other instruments- where changes in classification could occur depending on the

[17] 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 changes in classification including:

a) Additional Tier 1 instruments such as perpetual bonds with discretionary dividends; and undated non-cumulative preference shares with conversion features;

b) Perpetual deeply subordinated notes with discretionary payment of non-cumulative interest; and

c) 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).

4.20 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, additional Tier 1 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

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

a) their tax deductibility;

b) the deferability of coupon and/or principal payments; and

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

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

4.23 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).

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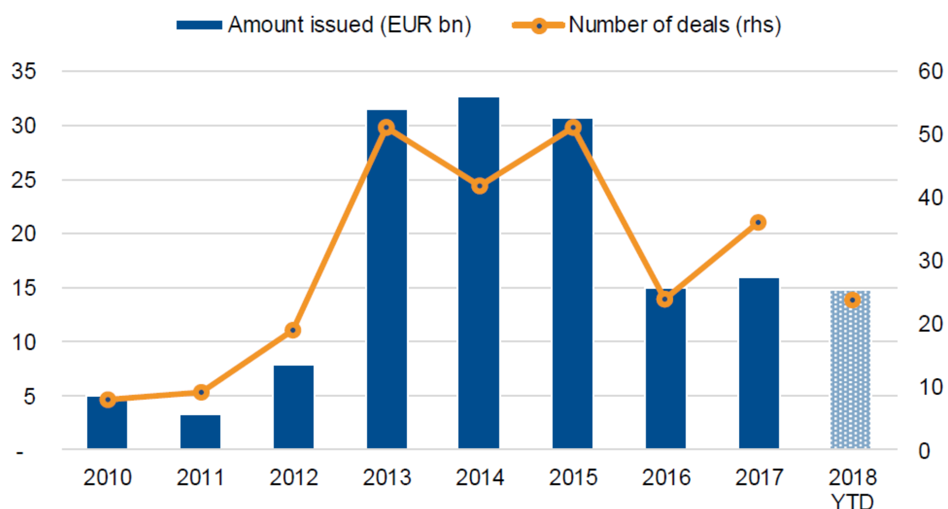
Figure 6: Volume of issuance of hybrid bonds



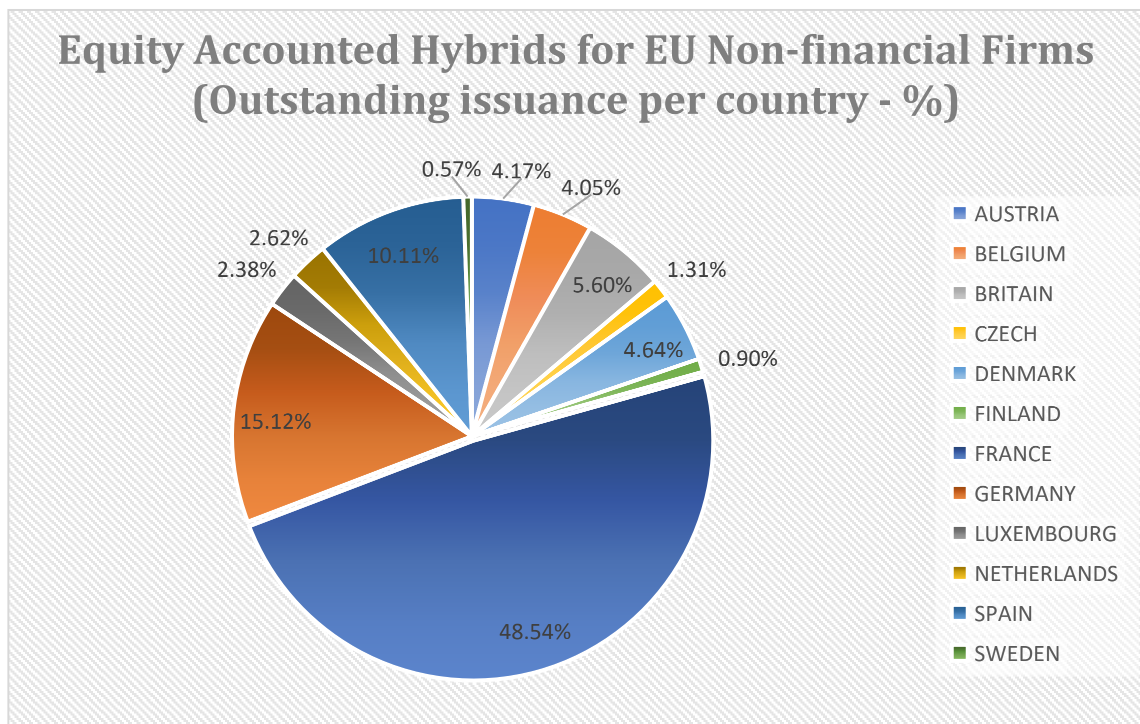
Source: Bloomberg, Scope

4.24 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[18], 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

4.25 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. Figure 7 provides a breakdown by country based on the Deutsche Bank data:

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

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



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

4.26 There is academic evidence related to US GAAP[19] and IAS 32 [20] 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.

4.27 Another anticipation of economic consequences is highlighted in a sell-side research report[21] and echoed during an EFRAG user outreach meeting pointing to the risk of market disruption due to the IASB DP proposals. The potential

[19] 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.

[20] 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.

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

disruption could arise due to the callability of perpetual bonds whereby there could be early redemption call at 101 in the event that issuers are no longer able to classify these instruments as equity (i.e. due to accounting call feature within these hybrid instruments). There could be a cost to issuers whose bonds are trading below 101 and a cost (foregone returns) to investors holding bonds trading above 101.

4.28 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.

4.29 Notwithstanding the potential impact of the IASB DP proposals, there is also evidence[22] showing that credit rating matters more than accounting classification in influencing hybrid bond issuance. The study 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.

4.30 In similar fashion, the sell-side research report, which highlighted the possibility of market disruption[23] 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 a 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[24] estimates the split between rated (78.8%) and non-rated (21.2%) hybrid instruments.

4.31 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 ramifications for economic development and financial stability. Furthermore, 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.

4.32 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.

[22] 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

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

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

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

4.33 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.

4.34 It is noteworthy that a recent Deutsche Bank sell-side report[25] 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.

4.35 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[26], 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

4.36 Contingent convertible bonds (CoCos) are a subset of hybrid bonds prevalent amongst some[27] financial institutions (mostly large EU banks) and intended for strengthening the capital base and providing regulatory buffers. The latest form of CoCos, classified as Additional Tier 1 (AT1) bonds, force losses on investors when a bank's capital falls below a certain trigger level through conversion into equity or a write-down.

4.37 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 Resolution Directive and the European Banking Authority requirements on bank's liquidity coverage ratio to prevent taxpayer bailouts after the financial crisis.

4.38 Figure 8 from a Deutsche Bank report[28] 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.

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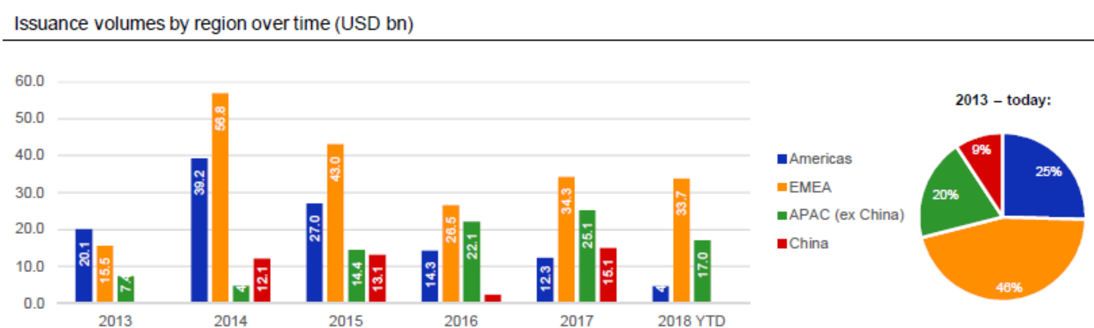
[25] Deutsche Bank Corporate and Investment Bank: IFRS Equity accounted hybrids – November 2018. Has data sourced from Bloomberg and available public information

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

[27] 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).

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

Figure 8: Issuance of AT1 instruments



4.39 The EFRAG preparer survey feedback showed that five financial institutions had concerns about reclassification of different types of AT1 instruments including (refer to paragraph 8.5 for a more detailed discussion of these instruments):

a) AT1 instruments which are callable notes issued in a foreign currency;

b) AT1 instruments which are callable and the instruments are irredeemable non-cumulative subordinated notes with discretionary dividends;

c) AT1 instrument - 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; and

d) AT1 instrument- perpetual bond with discretionary payment of non-cumulative interest.

4.40 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.

4.41 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 draft 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

4.42 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.

4.43 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[29]. A potential change in classification could have a significant impact on the reported capital structure of

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

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co-operative banks. But as noted in Paragraph ES3d), the IASB DP has indicated that IFRIC 2 will be retained.

Foreign currency rights issue

4.44 There are several indications 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 4.18 above).

4.45 Based on the noted 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

4.46 The above analysis highlights that the largest potential impacts could be with undated or perpetual bonds with deferred cumulative payment. The impact could also be significant for some AT1 instruments. 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.

Economic development

4.47 During the consultations on the IASB DP, EFRAG has not heard concerns about impact of the IASB DP proposals on economic development.

4.48 According to financial economic theory related to a firms capital structure, the economic value creation and contribution by entities to economic development depends on the profitability of their operational and investment decisions and not on their capital structure and financial engineering choices. Hence, there is no discernible reason as to why changes in the accounting classification of debt and equity would adversely impact economic development even if such changes could result in declines in the issuance of instruments that are reclassified from equity to debt (as discussed in paragraphs 4.21 to 4.46 above).

4.49 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[30] attributes the recent surge in issuance of EU corporate hybrids to the growth in merger and acquisition transactions. But this is not indicative that there is any particular instrument across the wide array of hybrid instruments that is exclusively suitable for particular investment or operational reasons.

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

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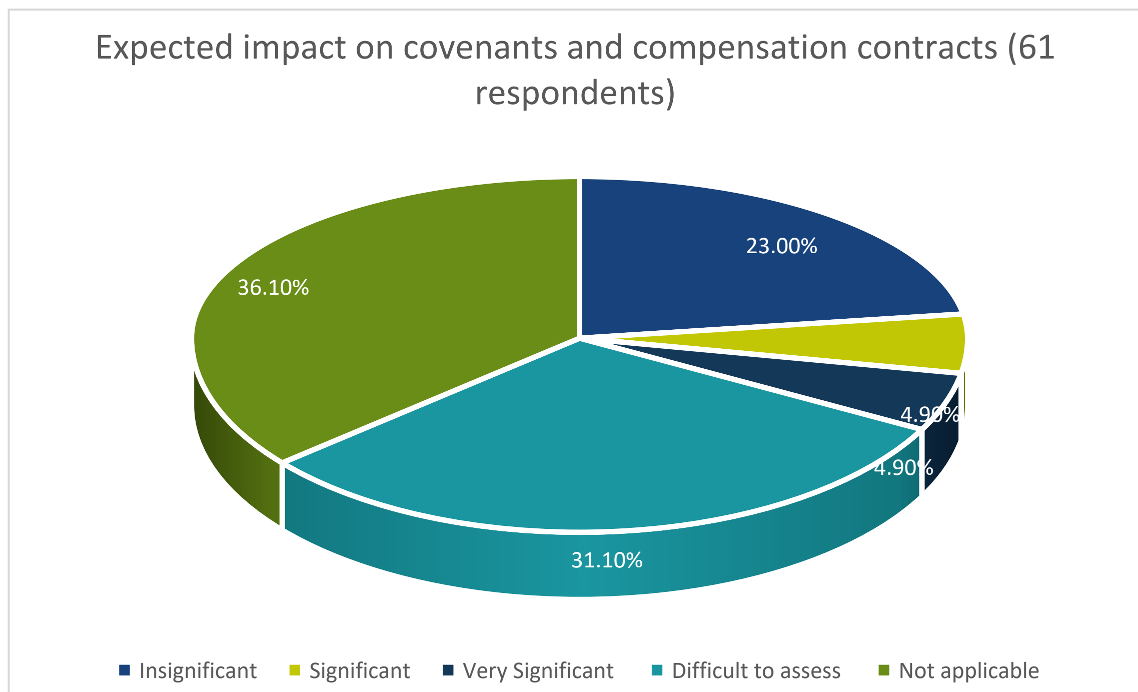
Impact on covenants and compensation arrangements

4.50 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



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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.

Interaction with bank prudential requirements

5.3 Banks have various tiers of regulatory capital including:

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

b) Additional Tier 1 (AT1): Consists of instruments not having a fixed maturity (e.g. contingent convertible bonds, cumulative preference shares) and they must contain no incentive for the issuer to redeem them.

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

5.4 Capital adequacy considers both the quantity and quality of capital (i.e. how much of CET1, AT1 and Tier 2 capital a bank holds).

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

a) Reclassification of any instrument from equity to debt under the IASB DP proposals, when such instruments are currently part of CET1 and AT1 based on existing prudential requirements and if such instruments would no longer be part of CET1 and AT1. However, as we understand, the regulatory capital classification (CET1 and AT1) categories will 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. 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 from equity to liability could increase volatility in profit or loss should the remeasurements of the financial liabilities that were note previously classified as such. From a prudential perspective regulatory capital volatility could also increase should the reported comprehensive income that updates CET 1 not be subject to prudential filters that strip out volatility arising from accounting remeasurement. In effect, in the absence of prudential filters, financial statement line items affected by the

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remeasurements (carrying value changes and interest recognised in profit and loss) could potentially affect the level and volatility of CET1 capital.

c) The proposed attribution of comprehensive income to equity instruments other than ordinary shares could impact retained earnings (currently CET1). Attribution could reduce the retained earnings included in CET1.

5.6 Members of the EFRAG Insurance Accounting working Group (IAWG) and 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.

5.7 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.

5.8 However, stakeholder feedback through both the preparer and user surveys and some of the responses to the EFRAG's draft comment letter by the European Savings Banks Group (ESBG) are indicating certain AT1 instruments where a potential change in classification is expected including:

a) Perpetual bonds with discretionary dividends (AT1) and

b) Cumulative preference shares with conversion features (AT1).

Interaction with insurance solvency requirements

5.9 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[31] 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;

[31] 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.

(ii) letters of credit and guarantees; and

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

5.10 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

5.11 The European Commission Action Plan *Financing Sustainable Growth* (EC Action Plan)[32] 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.

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[32] 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.

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

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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.

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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:

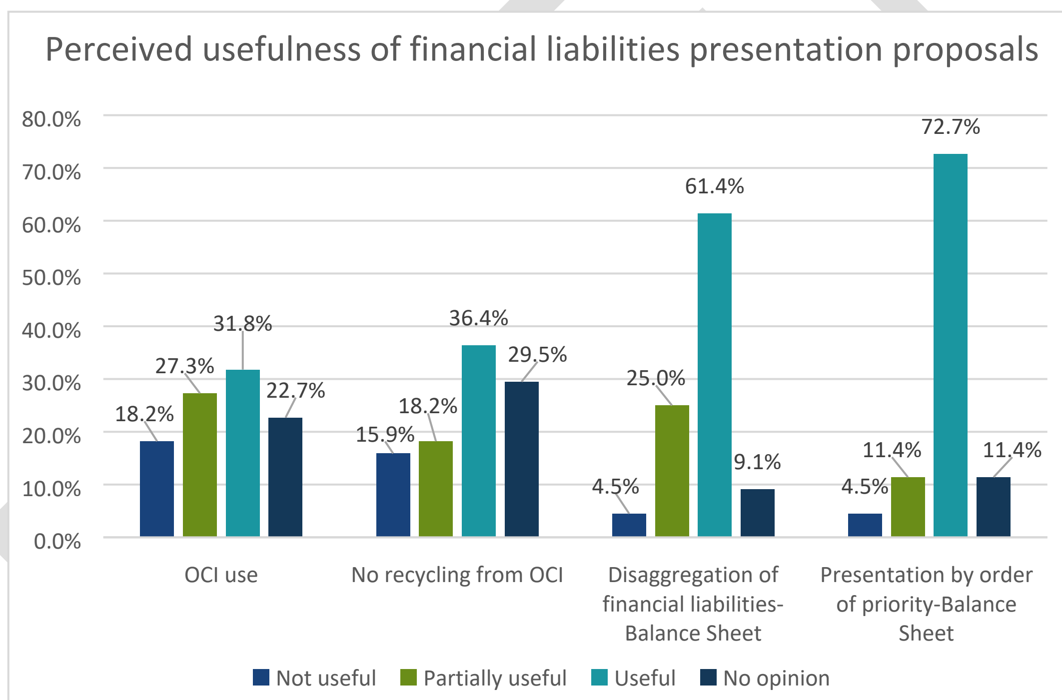
a) Use of OCI for remeasurement of financial liabilities with equity-like returns (statement of financial performance): A majority of respondents find this proposal either partially useful or useful.

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.

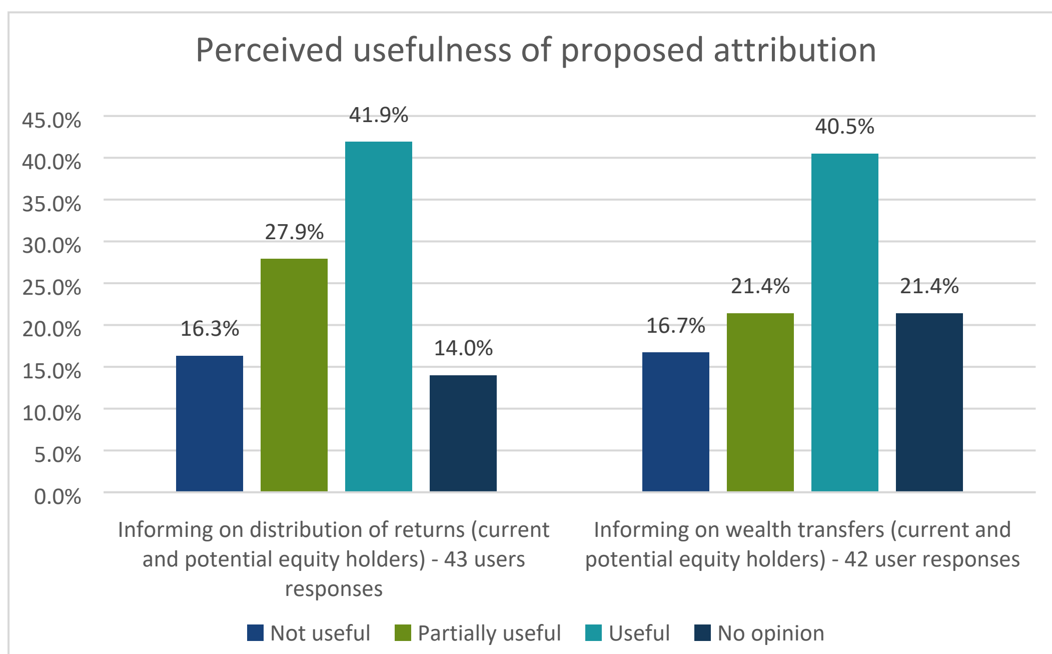
b) A sell-side equity analyst who participated in the EFRAG/EFFAS/IASB/ABAF-BVFA user event held in Brussels indicated that what gets presented in OCI usually gets ignored by the analyst community. He indicated that he was not concerned about re-measurements of liabilities through profit or loss as long 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.

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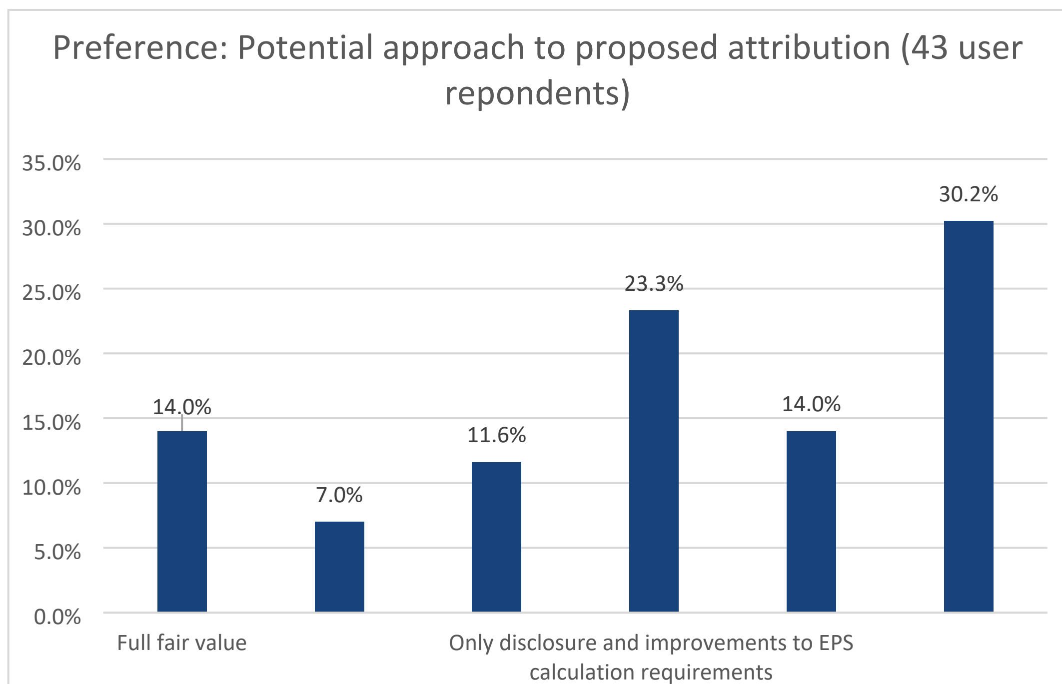
Figure 12: Preference: Potential approach to proposed attribution



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*

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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[33] 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.

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

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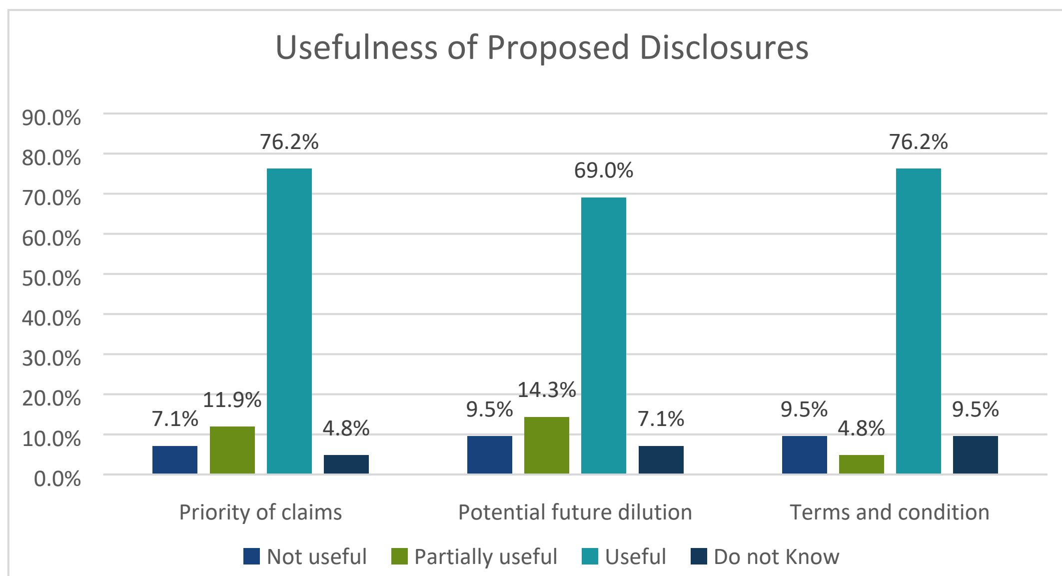
Figure 13: Usefulness of the proposed disclosures in the DP



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[34] showing that for experienced investors, disclosures are probably more important than the debt versus equity classification distinction.

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[34] 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.

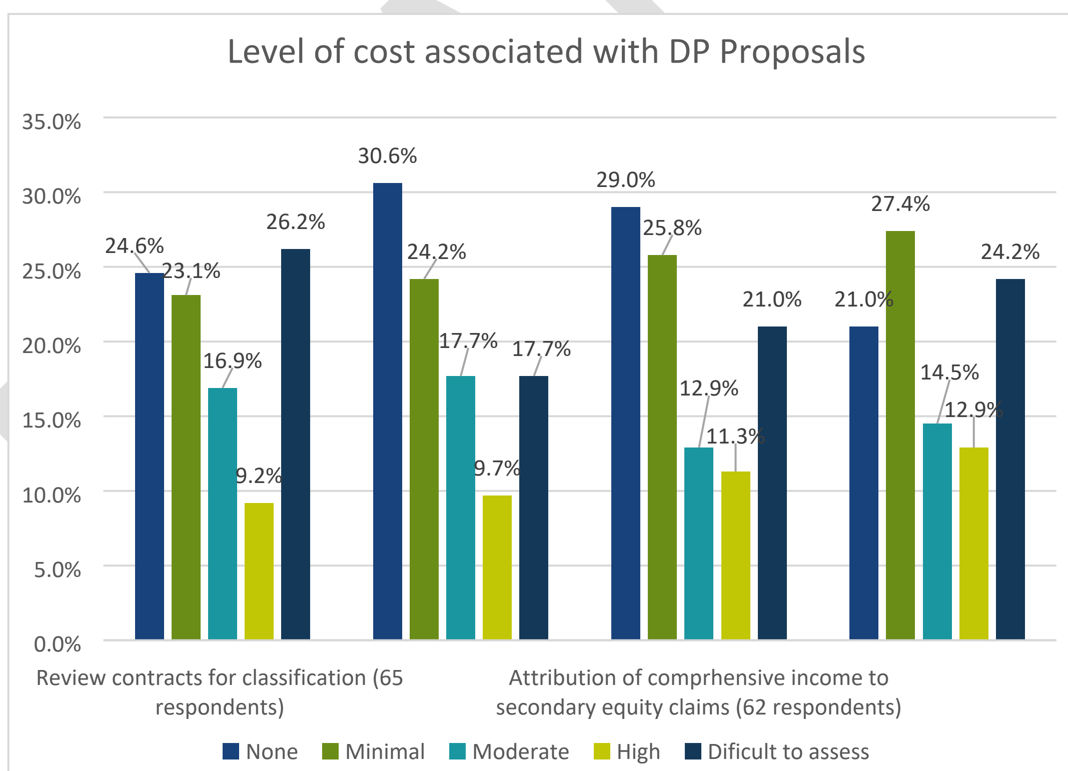
CHAPTER 7: ANTICIPATED COSTS AND BENEFITS

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 (17.7% to 26.2%) of respondents across the four cost components- indicate that it is difficult to assess the expected cost levels. 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 seeming inconsistency could arise because these preparers could be

considering costs beyond direct implementation costs and/or that they perceive no benefits of the proposals for users of financial statements.

7.4 Figure 16 shows that a majority of user respondents (63.5%) 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

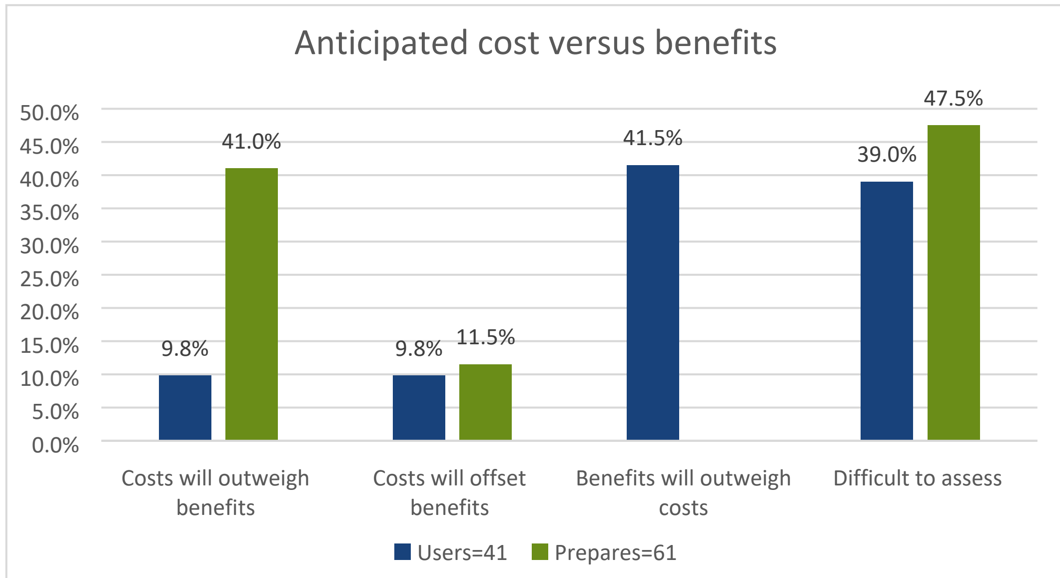
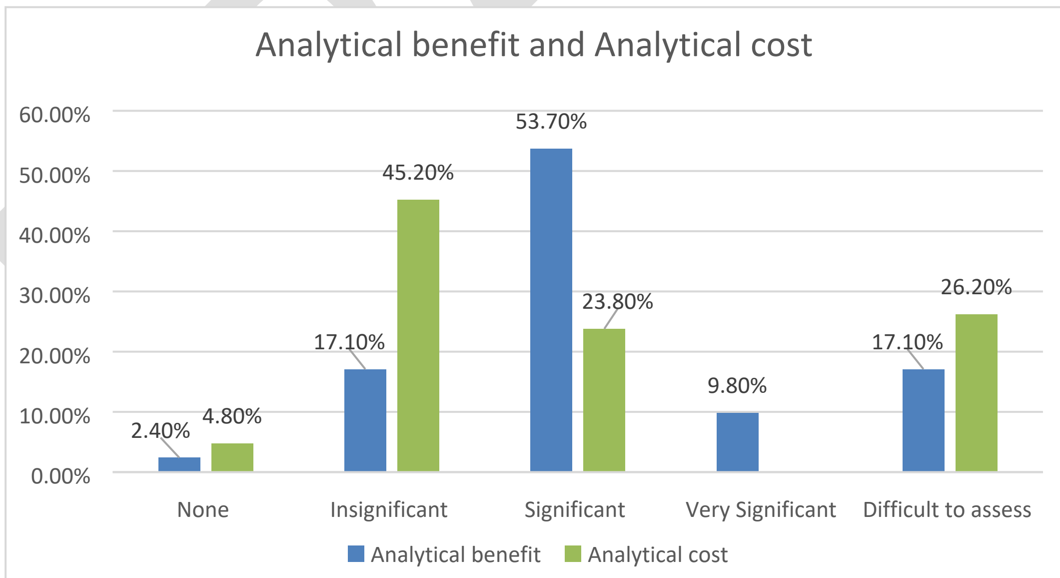


Figure 16: User views - significant of analytical benefits, costs



CHAPTER 8: EXPECTED IMPACT ON FINANCIAL STATEMENTS

8.1 Impact on financial statements could occur due to reclassification of financial instruments from equity to debt and vice versa. Such reclassification could:

a) impact on reported performance in the income statements and key metrics such as leverage and solvency ratios and basic and diluted earnings per share (EPS) ratios.

b) Impact on income statement and OCI volatility if instruments that are recorded as equity get recorded as financial liabilities as re-measurements would affect the income statement.

Preparer feedback on impacts on financial statements

8.2 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[35] in the IASB DP and other instruments that may have a change in classification due to the application of the IASB DP classification principles.

8.3 The EFRAG preparer survey results (see Figure 17 below) show that most respondents did not have instruments where they expect changes in classification. 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*).

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

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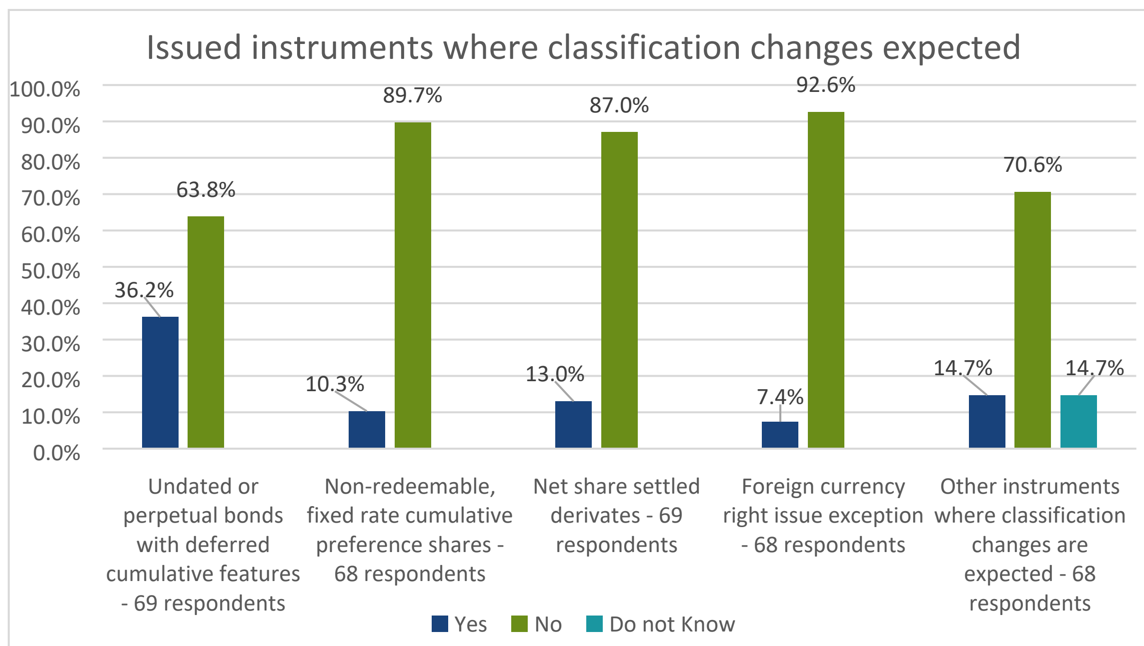
[35] undated or perpetual bonds with a payment deferral cumulative feature; non-redeemable fixed rate cumulative preference shares; net settled derivatives on own equity; and foreign currency rights issues

Figure 17: Issued instruments where classification changes are expected



8.5 Several preparer respondents gave an indication of other instruments (apart from the four identified[36] in the IASB DP) where an equity to debt classification is either expected or the classification is unclear. These include the following instruments:

a) AT1 instruments which are callable notes issued in a foreign currency (the amount feature could have the potential of classifying such instruments as liabilities as it might not be independent of an entities available economic resources);

b) AT1 instruments which are callable and the instruments are irredeemable non-cumulative subordinated notes with discretionary dividends (the amount feature could have the potential of classifying such instruments as liabilities as the preparer respondent questioned the fact that these instruments might be a compound instrument due to the fact that in some cases the holder might not recover its principal amount);

c) AT1 instrument - undated non-cumulative preference shares with conversion, which deliver a variable amount of shares upon an event outside the control of entity. The conversion rate includes a floor price on shares and dividends are discretionary and non-cumulative (Preparer respondent was unclear about the accounting of this instrument); and

d) AT1 instrument- perpetual bond with discretionary payment of non-cumulative interest (under the IASB DP approach, these instruments seems to meet the amount condition to define a liability as the redemption amount which is at face value is independent of the entity's available resources).

[36] Ibid-footnote 35

Impact of classification changes on leverage and performance measures

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

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

8.8 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.

8.9 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 4.39 and 8.5, several preparers expect a change in classification for some of the AT1 instruments. Four preparer respondents quantified the potential impact of reclassifying AT1 instruments (varied from 7.4% to 8.2% of total equity attributable to ordinary shareholders).

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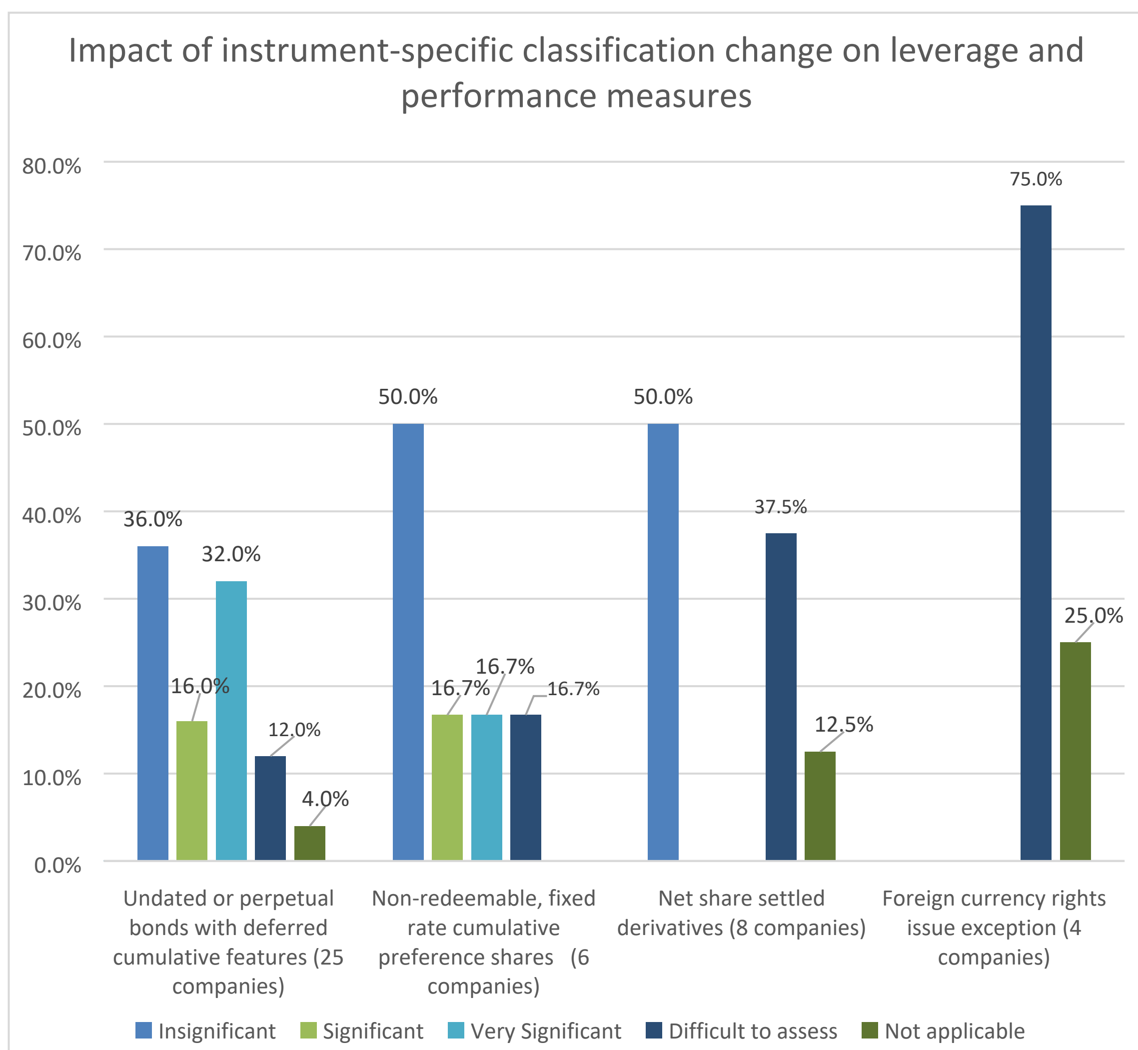
Figure 18: Impact of instrument-specific classification change on leverage and performance measures



8.10 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).

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

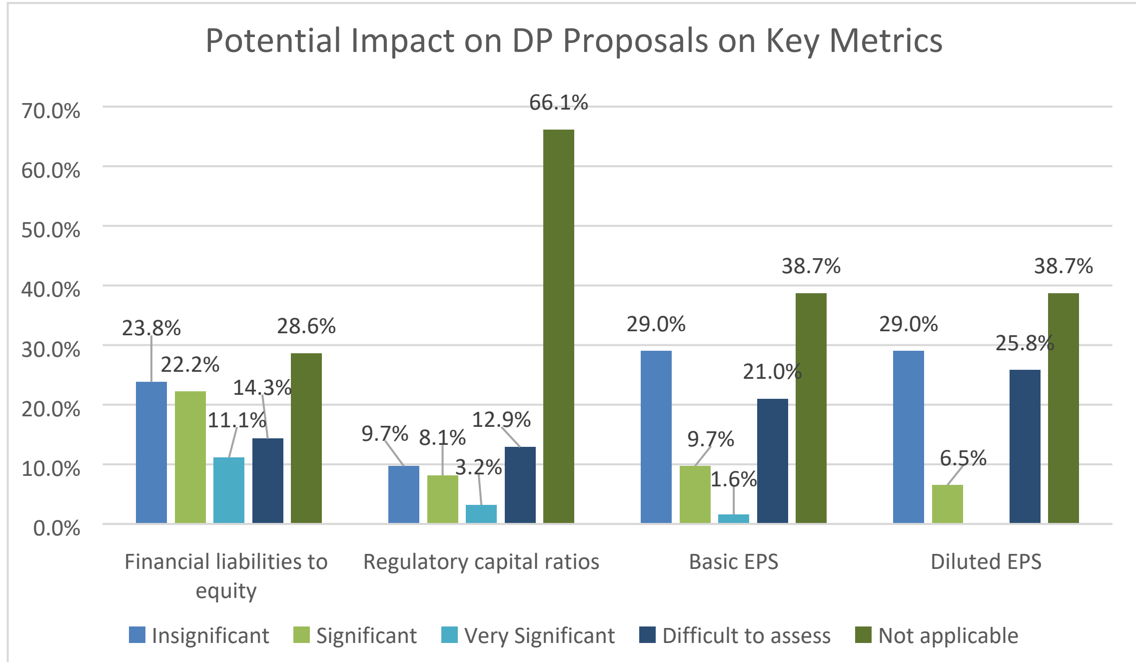
a) A sizeable proportion (33.3%) of respondent entities expect significant or very significant impact on accounting leverage (i.e. financial liabilities/total equity attributable to ordinary shareholders).

b) Only 11.3% expect a significant or very significant impact on regulatory capital ratios, probably reflecting that not all respondents to the survey are financial institutions.

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

8.12 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



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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 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

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

Figure 20: Current use of related non-GAAP measures

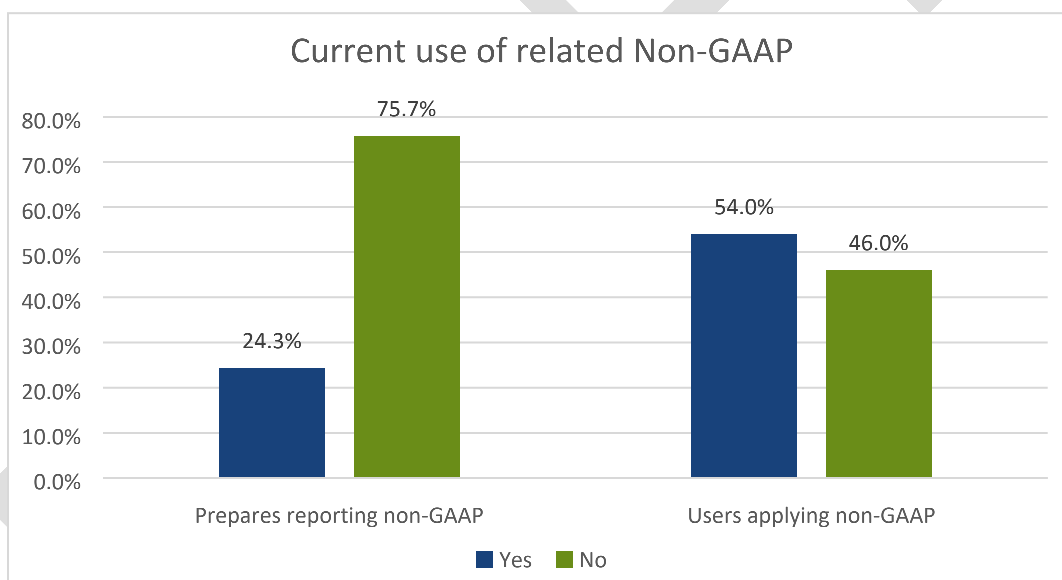
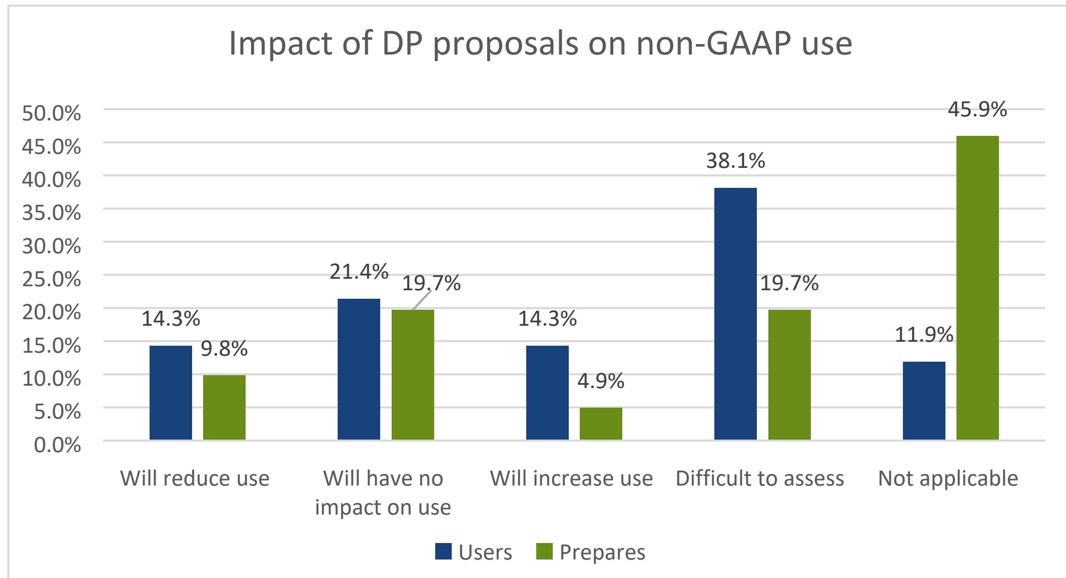


Figure 21: Impact of the DP proposals on the use of non-GAAP



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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.

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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.

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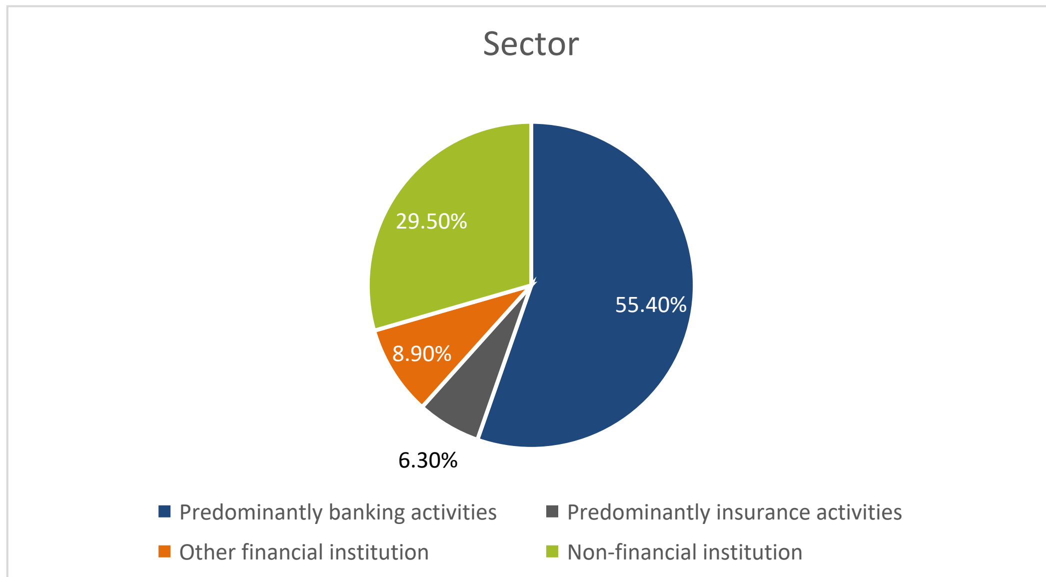
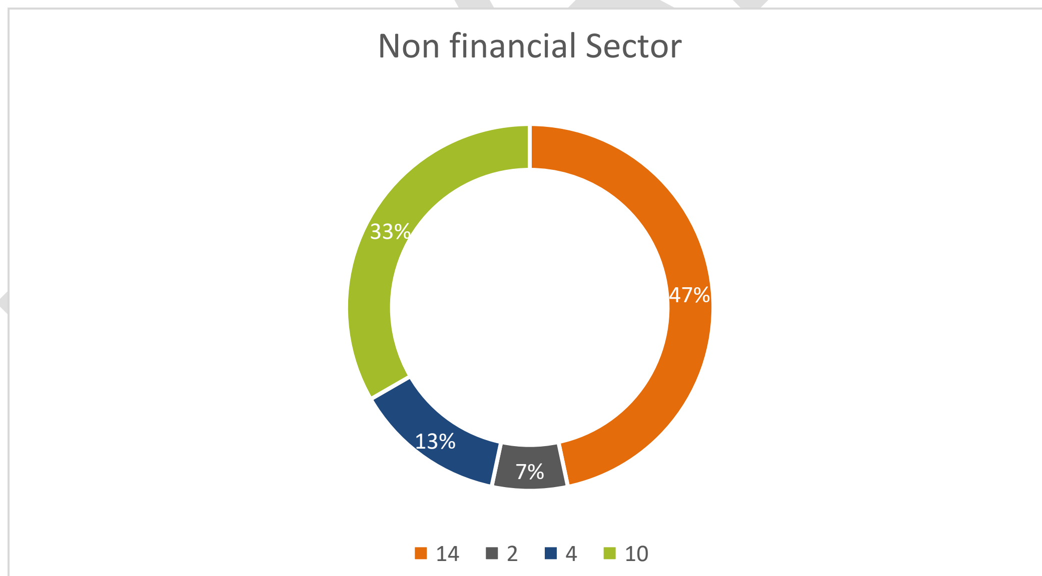
Appendix 2: Profile of EFRAG Survey Respondents

Preparer's profile

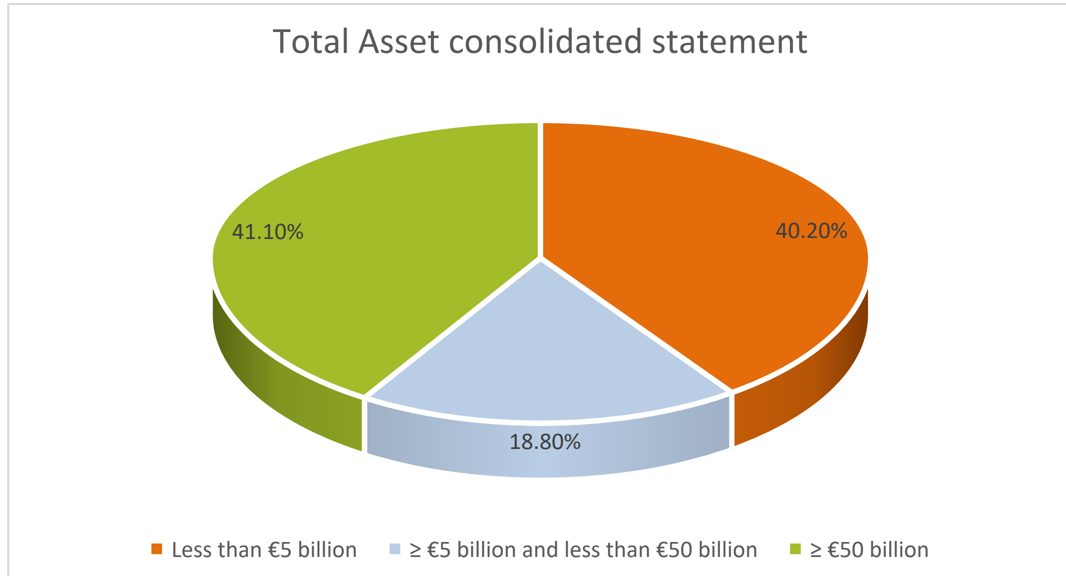
Sector



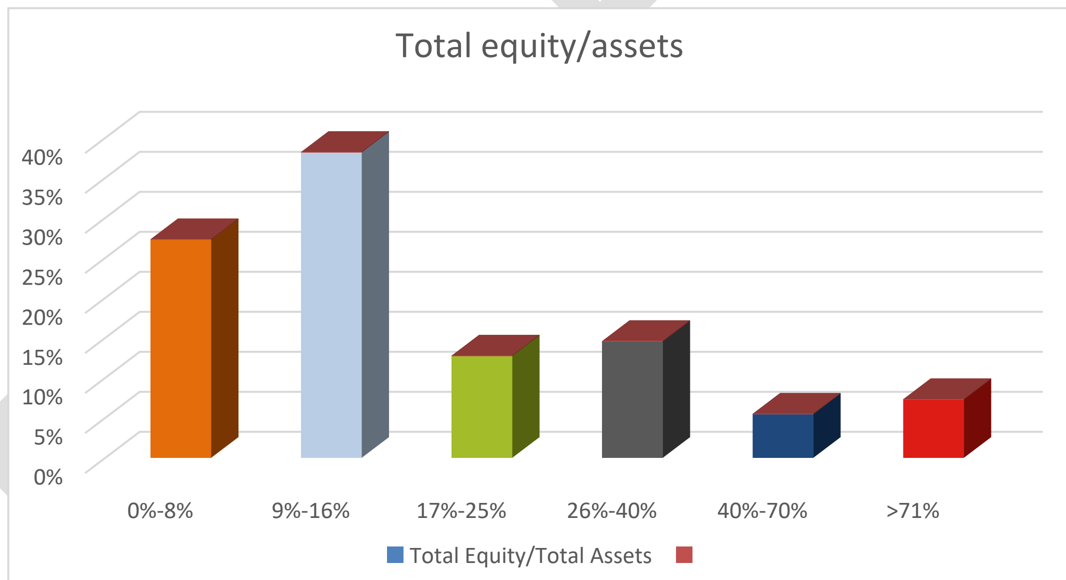
Breakdown of non-financial institutions



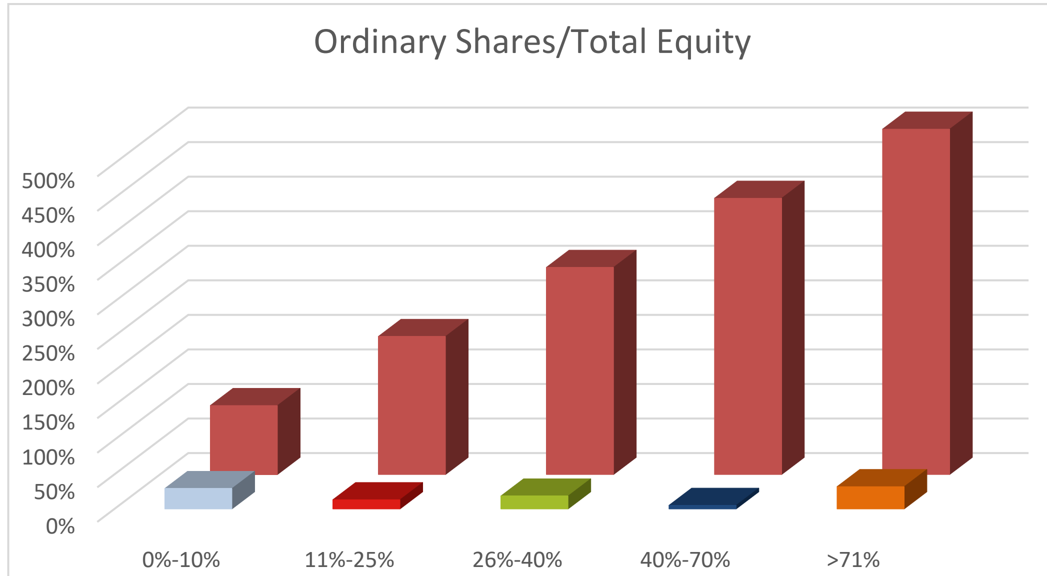
Total consolidated assets



Leverage (Total equity/assets)

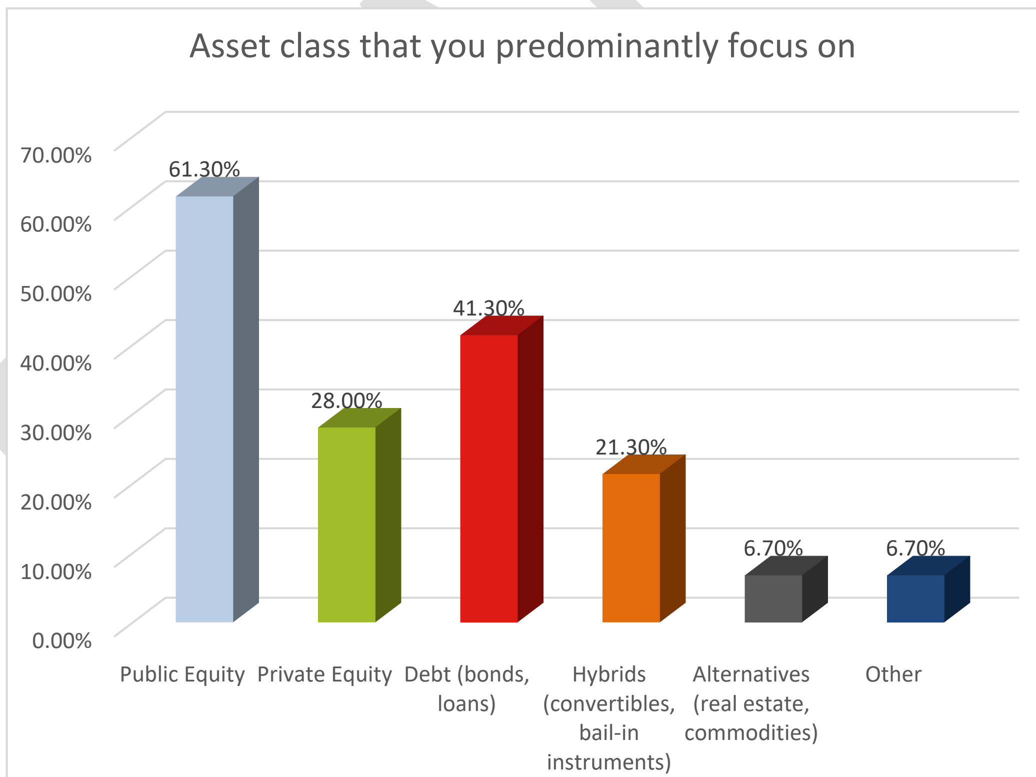


Equity composition (Ordinary shares/total equity)

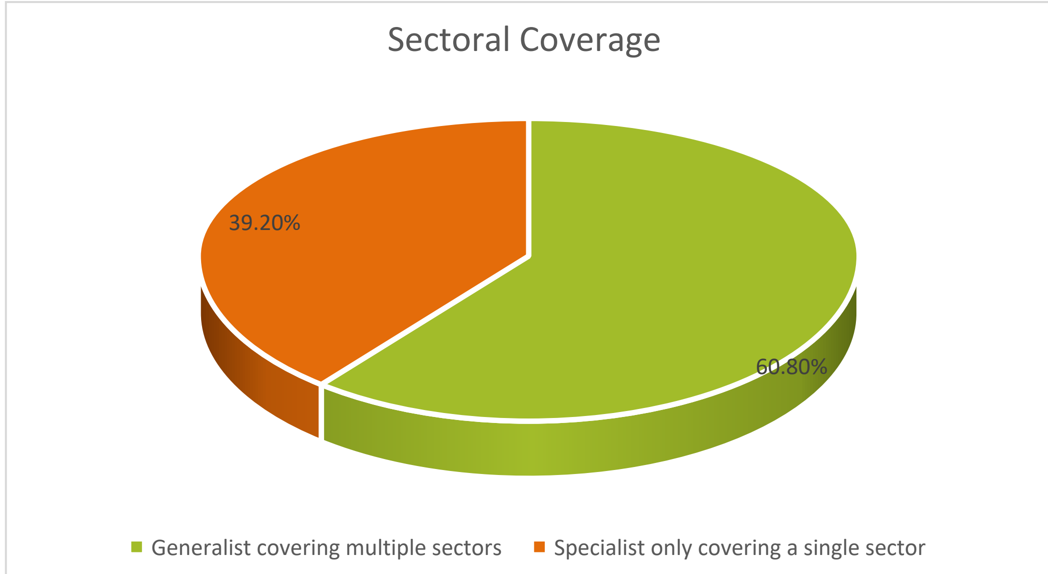


Users profile

Asset Class



Generalist versus specialist



Sectors covered by specialists