Agenda paper 11-02

EFRAG Secretariat: FICE Team

DEBT AND EQUITY DISTINCTION

EFRAG TEG-CFSS meeting 26 September 2018

EFRAG

European Financial Reporting Advisory Group

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OBJECTIVE, SCOPE AND CHALLENGES

- In section 1 of the Discussion Paper, the IASB describes the objective of the project, its scope and the application challenges that arise with IAS 32
- Subsequently, the IASB asks whether these challenges are pervasive enough to require standard-setting activity

EFRAG DCL

- EFRAG considers that the application issues that arise with IAS 32 are pervasive enough to require standard-setting activity and welcomes the IASB’s efforts to respond to existing application issues
- EFRAG considered that the scope of the project and the DP's proposals, taken as a whole, are very ambitious
- The IASB should develop material that provides a clear explanation of how the IASB’s preferred approach addresses the challenges identified. EFRAG included an Appendix 2 where it assesses whether and how the DP’s proposals addresses the issues that arise in practice

IASB PREFERRED APPROACH

- Under the IASB's preferred approach a claim would be classified as a financial liability if an entity has to transfer economic resources before liquidation (timing) and/or the claim is for an amount that is independent of the entity's available economic resources (amount). This is the key principle that guides the classification of both non-derivatives and derivatives
- Other features of claims (e.g. priority) would be provided through presentation and disclosures

EFRAG DCL

- The approach in the DP introduces completely new terminology and this would require preparers and auditors to reconsider some past classification decisions. In EFRAG's view a careful weighing of the potential benefits of a better articulation of the principles in IAS 32 against the potential risks of unnecessary disruption and unintended consequences is essential
- EFRAG welcomes the IASB's efforts to make improvements not only to classification requirements but also to the presentation and disclosure requirements to address the challenges that arise from a binary approach, particularly on the equity side

CLASSIFICATION OF NON-DERIVATIVES

- The DP explains how the new classification principle applies to non-derivative instruments. For example, it provides guidance on when an amount is ‘independent of the entity’s available economic resources’
- Under the IASB’s preferred approach the classification outcomes are broadly aligned with IAS 32, however some classification changes are expected, such as cumulative preference shares and cumulative undated bonds. The IASB also explains that the existing puttable exception would still apply

EFRAG DCL

- EFRAG is not convinced that the identified changes in classification outcomes relate to areas of IAS 32 that are problematic and considers that the IASB does not clearly explains why the IASB’s preferred approach leads to a better accounting outcome
- EFRAG expresses reservations about the use of new terminology when applied to non-derivatives, particularly on the notion of an ‘amount independent of the entity's available economic resources’
- EFRAG welcomes the IASB decision to retain the puttable exception

CLASSIFICATION OF DERIVATIVES

- A derivative on own equity would be classified as a liability if it is net-cash settled (timing) and/or the net amount is affected by a variable that is independent of the entity's available economic resources (amount). Thus, all derivatives settled in a foreign currency would be classified as liabilities and fixed-for-fixed net-share settled derivatives would be classified as equity
- The 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

EFRAG DCL

- Questions the relevance of having financial instruments that currently meet the foreign currency rights issue exception in IAS 32 being classified as financial liabilities and net-share settled derivatives being classified as equity
- EFRAG considers that the IASB should further analyse the option of accounting for all derivatives on own equity as derivative assets or liabilities under the scope of IFRS 9
- EFRAG welcomes the additional guidance on fixed-for-fixed condition but concerned that the proposed guidance for derivatives on own equity differs significantly from current guidance, particularly in terms of terminology

COMPOUNDS AND REDEMPTION OBLIGATIONS

- The DP explains how the IASB's preferred approach would apply to compound instruments and instruments that have a redemption obligation (e.g. NCI written put). In particular, it explains the importance of recognising the redemption obligation amount and provides additional guidance on the accounting within equity, particularly when an entity issues NCI puts
- For compound instruments and instruments that contain alternative settlement at the entity's option, the IASB generally retains current requirements but explores ways of providing additional information

EFRAG DCL

- EFRAG is not convinced that the accounting for a written put option on own shares that is issued together with ordinary shares should be the same as the accounting for a convertible bond
- If the IASB rejects putting all derivatives within the scope of IFRS 9, EFRAG recommends the IASB to consider the possibility of requiring symmetrical treatment between asset/equity exchanges and liability/equity exchanges
- Whilst the DP clarifies the accounting for NCI puts, it does not deal with certain conceptual and application issues that have been raised in the past

PRESENTATION OF FINANCIAL LIABILITIES

- The DP proposes that financial liabilities and derivatives for which the amount is not independent of the entity's available economic resources should be separately presented in the statement of financial position and statement of financial performance (in OCI without recycling)
- The DP discusses alternative approaches for derivatives for which the net amount is partly independent of the entity's available economic resources and considers separate presentation for all embedded derivatives

EFRAG DCL

- The IASB should start by clearly identifying all the cases which currently lead to counter-intuitive accounting under IFRS Standards and further discuss the scope of the separate presentation requirements for financial liabilities
- EFRAG considers that there are strong arguments in favour of requiring recycling on settlement date, when the gain or loss is realised
- Separate presentation requirements should only apply to liabilities, derivatives and embedded derivatives that are currently separated from the host which are solely dependent on entity's available economic resources

PRESENTATION OF EQUITY INSTRUMENTS

- For financial instruments classified as equity, the DP proposes the attribution of comprehensive income to ordinary shares and equity instruments other than ordinary shares and the use of that attribution to update the carrying amount of equity instruments other than ordinary shares
- The DP provides different approaches for the attribution of non-derivatives and derivative financial instruments

EFRAG DCL

- EFRAG acknowledges that the attribution approach has some benefits, however, notes that the introduction of subclasses of equity and attribution mechanism will introduce significant complexity and increase costs for preparers. EFRAG questions whether the benefits of the information provided by the attribution approaches would exceed the related costs
- EFRAG recommends the IASB to discuss improvements to existing presentation requirements without the attribution mechanism (i.e. more disaggregation of equity components on the face of the financial statements to distinguish existing shareholders from potential shareholders) and provide information about dilution through improvements to IAS 33 and disclosures

DISCLOSURES

- The 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

EFRAG DCL

- EFRAG considers that disclosures are a key part of the project and welcomes the IASB's discussions. We acknowledge that the proposed disclosures would represent a significant extension of existing disclosures, however they would provide a greater level of detail about equity instruments, making the level of disclosure more similar to financial instruments classified as liabilities
- In regard to disclosures on priority on liquidation, EFRAG notes that some considerations would have to be taken into account in terms of the reporting entity which is being considered
- In regard to disclosures on potential dilution, EFRAG recommends the IASB to further discuss the scope of such disclosures
- EFRAG provides a number of suggestions to improve current disclosures

CONTRACTUAL TERMS

- The DP proposes that economic incentives should not affect the classification of financial instruments, that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained and that the classification of claims should only be based on the contractual terms of a financial instrument (and not consider the law)

EFRAG DCL

- EFRAG welcomes the discussion on the role of economic incentives for classification purposes and agrees that economic incentives that might influence the issuer’s decision to exercise its rights should not be considered for classification purposes
- EFRAG considers that improving the indirect obligations requirements in IAS 32 may alleviate some of the issues related to economic compulsion
- EFRAG generally supports retaining the focus of the classification on the substance of the contractual arrangement. However, EFRAG highlights some of the challenges that arise in practice and recommends the IASB to further discuss this issue with regulators

OUTREACH ACTIVITIES

- During its comment period, EFRAG plans to:
    - Organise outreach events to obtain views of European stakeholders
    - Launch surveys and other activities to gather data on expected effects and costs/benefits from national standard setters, users of financial statements, preparers, regulators, business associations and other accounting experts
    - Issue one or more stakeholder bulletins
- EFRAG's aim is to develop an 'early stage impact analysis' of the IASB's proposals

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THANK YOU

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