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European Accounting Association – European Financial Reporting Advisory Group (EFRAG) – International Accounting Standards Board Research (IASB) Workshop

Financial Instruments with Characteristics of Equity (FICE)
March 2024

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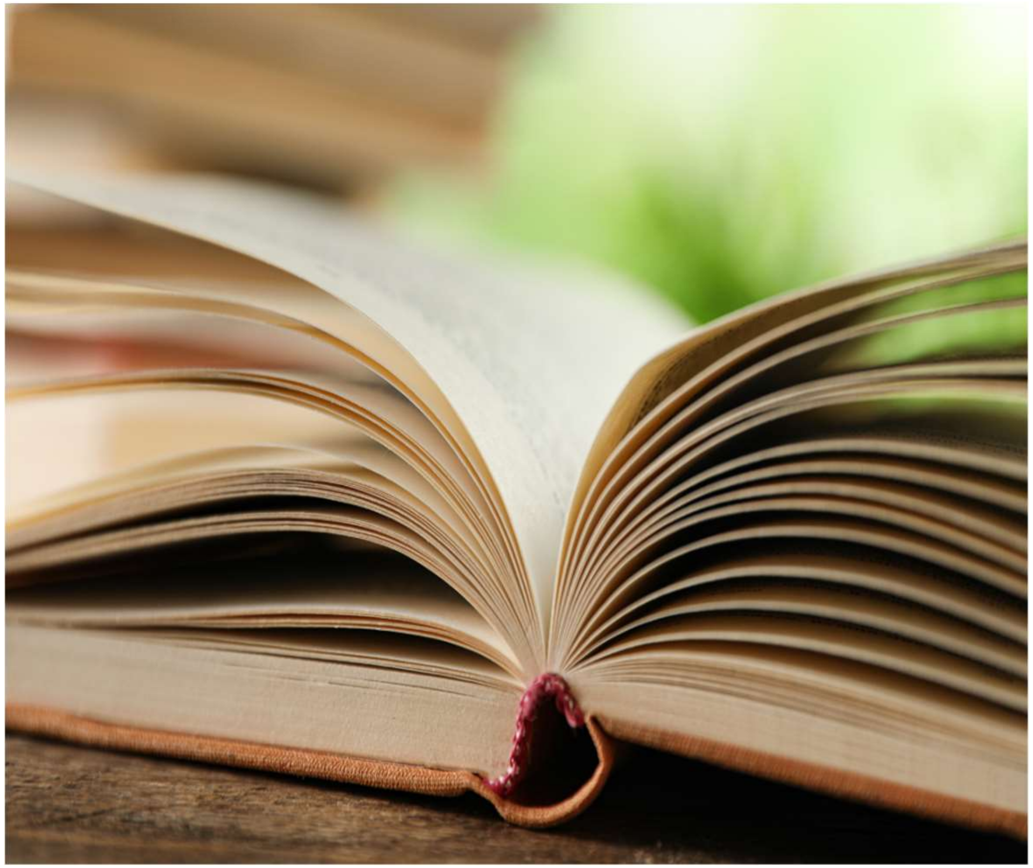
Objective of this workshop

- Provide an overview of the Exposure Draft *Financial Instruments with Characteristics of Equity–Proposed amendments to IAS 32* Financial Instruments: Presentation, *IFRS 7* Financial Instruments: Disclosures, and *IAS 1* Presentation of Financial Statements.
- To highlight academic research that is relevant to the proposals in the Exposure Draft
- To stimulate academic research in areas where there are gaps in the academic literature



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Financial Instruments with Characteristics of Equity (FICE)

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Purpose of this session

- Provide an overview of:
  - the FICE project;
  - the presentation proposals with illustrative examples; and
  - the disclosure proposals with additional explanation and illustrative examples.

Background information

Overview of the project

Improve information entities provide in their financial statements about financial instruments that they have issued

Approach:

- Improve presentation and disclosure
- Address practice issues by clarifying underlying classification principles
- Provide application guidance and illustrative examples

A snapshot and webcast series is also available on our website.

Address challenges in applying IAS 32:

- The effects of relevant laws or regulations
- Fixed-for-fixed condition for derivatives
- Obligation to purchase an entity's own equity instruments
- Contingent settlement provisions
- Shareholder discretion
- Reclassification of financial liabilities and equity instruments

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Next steps

29 Nov 2023

Exposure Draft published

29 Nov 2023– 29 Mar 2024

Consultation period

Q2 2024 onwards

Feedback analysis and redeliberations

Link to the consultation:
https://www.ifrs.org/projects/work-plan/financial-instruments-with-characteristics-of-equity/exposure-draft-and-comment-letters/

Consultation closes 29 March 2024

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Perpetual instruments

'In good times, behaves like debt, in bad times, behaves like equity.'

- Stated coupon
- Issuer call option
- Coupon and principal can be deferred
- Subordinated/loss absorption

Regulatory Capital

Restricted Tier 1 (RT1)
Additional Tier 1 (AT1)

Corporate Hybrids

Utilities
Telecommunication
Oil and Gas
Automobile

Regulatory Environment

A change in accounting classification is not expected to affect the regulatory capital classification

Feedback from equity investors

Most equity analysts preferred financial liability classification

If equity classification is retained, separate presentation and additional disclosures in the notes would provide useful information

What is the IASB proposing?

- No change in classification
- Develop presentation and disclosure requirements

Presentation proposals

Presentation—Proposed amendments to IAS 1

To ensure amounts attributable to ordinary shareholders are clearly visible on an entity's statement of financial position, statement(s) of financial performance and statement of changes in equity, an entity will be required to present:

Equity

- Ordinary shareholders of parent
- Other owners of the parent

Balance sheet
Line items on issued capital and reserves shown separately

Statement of financial performance
Results attributable shown separately

SOCIE
Each class of contributed equity shown separately
Distributions shown separately

Illustrative presentation

Statement of profit or loss (extract)	2020 CU million	2019 CU million
Profit attributable to:		
Ordinary shareholders of the parent	82,000	39,400
Other owners of the parent	15,000	13,000
Non-controlling interests	24,250	13,100
Profit for the year	**121,250**	**65,500**

Balance sheet (extract)	2020 CU million	2019 CU million
Share capital	642,000	600,000
Retained earnings	200,500	127,700
Other reserves	10,200	21,200
Equity attributable to ordinary shareholders of the parent	**852,700**	**748,900**
Equity attributable to other owners of the parent	51,000	34,000
Non-controlling interests	70,050	48,600
Total equity	**973,750**	**831,500**

Proposed improvements to presentation in the financial statements

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Illustrative presentation (continued)

Statement of changes in equity (extract)	Share capital	Retained earnings	Other reserves	Equity attributable to ordinary shareholders of the parent	Equity attributable to other owners of the parent	Non-controlling interests	Total equity
Balance at 1 January 20X6	**600,000**	**97,500**	**(400)**	**697,100**	**21,000**	**29,900**	**748,000**
Changes in equity for 20X6							
Dividends	–	(10,000)	–	(10,000)	–	–	(10,000)
Total comprehensive income for the year	–	40,200(a)	21,600	61,800	13,000	18,700	93,500
Balance at 31 December 20X6	**600,000**	**127,700**	**21,200**	**748,900**	**34,000**	**48,600**	**831,500**
Changes in equity for 20X7							
Issue of share capital	42,000	–	–	42,000	8,000	–	50,000
Dividends	–	(9,000)	–	(9,000)	(6,000)	–	(15,000)
Total comprehensive income for the year	–	81,600(b)	(10,800)	70,800	15,000	21,450	107,250
Transfer to retained earnings	–	200	(200)	–	–	–	–
Balance at 31 December 20X7	**642,000**	**200,500**	**10,200**	**852,700**	**51,000**	**70,050**	**973,750**

(a) The amount included in retained earnings for 20X6 of 40,200 represents profit attributable to ordinary shareholders of the parent of 39,400 plus remeasurements of defined benefit pension plans of 800.

(b) The amount included in retained earnings for 20X7 of 81,600 represents profit attributable to ordinary shareholders of the parent of 82,000 plus remeasurements of defined benefit pension plans of 400.

Disclosure proposals

Disclosures—Proposed amendments to IFRS 7

Not applicable to stand-alone derivatives

Terms & Conditions

- Debt-like characteristics
- Equity-like characteristics
- Characteristics that determine the classification

Other disclosures

- Reclassifications
- Remeasurement gains or losses on liabilities based on entity's performance/net assets
- Obligations to redeem own equity instruments
- Significant judgements
- Terms that become/stop being effective with passage of time
- Compound instruments–initial allocation between components

Priority on liquidation

- Nature and priority of claims against an entity
- T&Cs about priority on liquidation for particular instruments

Potential dilution

- Maximum number of additional ordinary shares
- Reduced by minimum number of shares for repurchase

Scope of IFRS 7

Equity instruments issued

Disclosures–terms and conditions

Objective

Help investors better understand the nature, amount, timing and uncertainty of cash flows arising from issued financial instruments

Scope

- Financial instruments with characteristics of both debt and equity
- Includes compound instruments
- Excludes standalone derivatives

Requirements

Highlight:

- cash flow characteristics that are not 'typical' of the instrument's classification
- key features that determine classification
- the amounts allocated initially to the financial liability and equity components of compound financial instruments

Debt-like characteristics in equity instruments

Even though the entity has no contractual obligation to deliver cash, contractual terms:

- give rise to cash flows that have similar characteristics of nature, timing or amount to those of a financial liability; or
- may cause an entity to deliver debt-like cash flows.

- For example, preference shares not redeemable by the holder, classified as equity because the entity has the contractual right to avoid/defer payment until liquidation.
- Debt-like characteristics—fixed cumulative coupon amounts, specified coupon payment dates and fixed principal amount.

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Equity-like characteristics in financial liabilities

- Contractual terms that give rise to cash flows that have similar characteristics of nature, timing or amount to those of ordinary shares.
- Do not negate any contractual obligation on the issuer to deliver cash but may affect the amount or timing of the cash flows an entity has a contractual obligation to deliver.
- May result in an entity delivering its own equity instruments to settle an obligation or not paying the full amount of the obligation.

For example, a financial liability that requires an entity to settle the instrument by delivering a variable number of own shares to the holder.

Terms and conditions illustrative disclosure

Perpetual subordinated notes

At 31 December 2020, the total perpetual subordinated notes outstanding amounted to CU3,986 million and are included in Company X's equity. The table below includes the **key terms of these financial instruments.**

	Notional amount	Initial call date	Coupon reset after initial call date	2020 CU million	2019 CU million
5.5% Fixed Rate Subordinated Notes	USD 1,000m	January 2025	10.5%	690	714
4.5% Fixed Rate Subordinated Notes	EUR 750m	March 2028	Market rate	647	658
4% Fixed Rate Subordinated Notes	EUR 2,000m	October 2032	Market rate	1,724	-
3% Fixed Rate Subordinated Notes	GBP 1,000m	January 2027	Market rate	925	910
				3,986	**2,282**

Terms and conditions illustrative disclosure (continued)

Coupon

These notes bear a fixed rate of coupon until their initial call dates. After the initial call dates, if they are not redeemed, the coupon on the notes reset. The coupon on the USD subordinated notes reset to 10.5%. The coupon on the other notes are fixed periodically in advance for five-year periods, based on prevailing market interest rates plus credit spreads of Company X, fixed at issuance.

Company X has discretion to defer coupons on these notes. The deferred coupons accumulate and become payable at the call date if the notes are called, or when Company X is liquidated, if the notes are not called.

Company X is prevented from paying dividends or other distributions in respect of its ordinary shares, or from repurchasing its ordinary shares, until the cumulative coupons on the perpetual subordinated notes have been paid in full.

Terms and conditions illustrative disclosure (continued)

Redemption option

These notes are redeemable at the option of Company X at the initial call date or any fifth anniversary after this date. The amount redeemable will be the notional amount plus accumulated coupons.

Classification

These notes are classified as equity instruments because Company X has the unconditional contractual right to defer coupons and principal repayments until liquidation of Company X.

Disclosures–Priority on liquidation: nature and priority of claims

Objective

Provide information about nature and priority of claims against the entity that arise from financial instruments

Scope

All financial liabilities and equity instruments within the scope of IAS 32

Requirements

Categorise financial instruments by differences in nature and priority, distinguishing between:

- secured and unsecured
- contractually subordinated and unsubordinated
- issued/owed by parent and issued/owed by subsidiaries

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Priority on liquidation illustrative disclosure

Nature and priority of claims

As at 31 Dec 2020 (CU million)			
		Issued / owed by	
	Consolidated	Parent	Subsidiaries
Secured and unsubordinated			
Senior secured debt (a)	1,200	–	1,200
Lease liabilities (a)	920	780	140
Unsecured and unsubordinated			
Trade and other payables	1,450	320	1,130
Senior unsecured debt (a)	450	–	450
Unsecured and subordinated			
Subordinated liabilities (see note 15)	590	480	110
Classified as financial liabilities	4,610	1,580	3,030
Unsecured and subordinated			
Perpetual notes (see note 18)	200	200	–
Irredeemable preference shares (See note 19)	400	400	–
Non-controlling interest	1,350	–	1,350
Other reserves	15,000	10,000	5,000
Ordinary share capital	8,500	8,500	–
Classified as equity	25,450	19,100	6,350
Total	**30,060**	**20,680**	**9,380**

(a) Included in the “Borrowings” line item in the statement of financial position.

Disclosures–Priority on liquidation: contractual terms about priority

Objective

Provide information about the risks and returns of financial instruments on liquidation of the entity

Scope

- Financial instruments with characteristics of both debt and equity
- Includes compound instruments
- Excludes standalone derivatives

Requirements

Disclose terms and conditions about priority of financial instruments on liquidation, including:

- terms that indicate priority
- terms that could lead to changes in priority
- details of intragroup arrangements such as guarantees

Priority on liquidation illustrative disclosure

Priority on liquidation—subordinated notes

In the event of the respective issuer's liquidation, any amounts due in respect of the subordinated notes rank junior to all present and future unsubordinated claims of the respective issuer and rank senior to the respective issuer's ordinary shares, and if any, preference shares. Subordinated notes do not rank pari passu with one another. Some subordinated notes are contractually subordinated to other subordinated notes.

	2020 CU million	2019 CU million
USD 1,000m 5.5% Fixed Rate Subordinated Notes due January 2025	690	714
EUR 750m 4.5% Fixed Rate Subordinated Notes due March 2028	647	658
EUR 2,000m 4% Fixed Rate Subordinated Notes due October 2032	1,724	-
GBP 1,000 3% Fixed Rate Subordinated Notes due January 2027	925	910
	3,986	**2,282**

Disclosures—maximum dilution of ordinary shares

Objective

- Provide information about dilution that could arise from any potential increase in number of issued ordinary shares
- Not to replace IAS 33 Diluted EPS calculation

Scope

- All instruments and transactions settled by delivering ordinary shares
- Includes IFRS 2 instruments and transactions (entities can leverage existing IFRS 2 disclosures)

Requirements

- Underlying principle is for an entity to assume:
  - maximum possible increase in number of shares for instruments that could be settled by delivering own shares
  - minimum reduction in number of shares for instruments to repurchase own shares
- Disclosures include key terms and conditions relevant to understanding the likelihood of maximum dilution and the possibility for unknown dilution

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Maximum dilution illustrative disclosure

Instruments	Maximum number of additional ordinary shares	Key terms and conditions relating to the instrument/transaction
Convertible bonds B	250	In the event of a change of control of Company X prior to the conversion date, the conversion ratio is adjusted downwards to a pre-determined strike price.
Convertible bonds D	350	Issuer holds an option to settle in shares or cash (equal to the value of the shares).
Convertible bonds (A and C)	600	Holder holds an option to convert the bond at a specified conversion date using a specified conversion ratio.

Maximum dilution illustrative disclosure (continued)

Instruments	Maximum number of additional ordinary shares	Key terms and conditions relating to the instrument/transaction
Mandatorily convertible note F	100	Subject to a cap of 100 shares and a floor of 10 shares.
Number of share options in the scope of IFRS 2 outstanding at reporting date	100	Refer to note x (IFRS 2 disclosures on share options).
Number of known unvested shares from share awards in the scope of IFRS 2 at reporting date	100	Refer to note y (IFRS 2 disclosures on share awards).

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Maximum dilution illustrative disclosure (continued)

Instruments	Maximum number of additional ordinary shares	Key terms and conditions relating to the instrument/transaction
Maximum number of additional ordinary shares	**1,500**	
Unknown number of additional ordinary shares	unknown dilution from Share-settled bond E	The number of shares will depend on the share price at settlement date
Total maximum number of additional ordinary shares	**1,500 + unknown dilution from Share-settled Bond E**	
Less: minimum reduction in the number of ordinary shares		
Share buy-back	(100)	Commitment to buy 100 –500 shares.
Net maximum number of additional ordinary shares	**1,400 + unknown dilution from Share-settled Bond E**	

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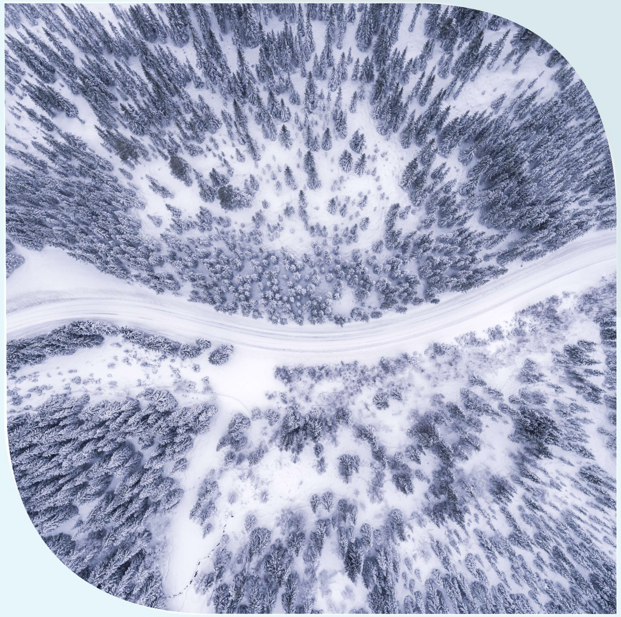
OVERVIEW ON FICE

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

EAA Virtual Research Workshop, 11 March 2024

Sapna Heeralall



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OVERVIEW

- EFRAG's draft comment letter
    - Presentation proposals
    - Disclosure proposals

EFRAG's draft comment letter - Presentation

PRESENTATION PROPOSALS

- EFRAG supports the IASB’s proposals to separately present the amounts attributable to ordinary shareholders from other owners of the parent in the primary financial statements
  - Fundamental for the users of financial statements to have information about multiple equity providers and financial instruments not aggregated in a single line
  - Will help users better understand how the proceeds will be distributed on the sale of a business and evaluate the ordinary shareholders’ value

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IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

What is a written put option over non-controlling interest (NCI put)

An instrument that obliges an entity in the consolidated group to purchase shares of its subsidiary that are held by a non-controlling-interest shareholders

Initial recognition

<table>
<tr><th>IASB proposals</th><th>NCI puts are presented on the Balance sheet as a financial liability and also presented as a debit to Parent Equity (gross presentation)</th></tr>
<tr><td>EFRAG's draft comment letter</td><td>Disagree with the IASB's proposals regarding presentation of NCI puts as a debit to Parent Equity
EFRAG considers that NCI puts should be presented as a debit to Equity relating to NCI
Also, the IASB should explore the alternative model to treat contracts meeting the definition of a derivative as stand-alone derivatives (net presentation)
Results in no or limited financial liability and no or limited impact on Parent Equity or NCI equity</td></tr>
</table>

IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

Subsequent measurement

IASB proposals	Changes in the financial liability are presented in the Statement of profit or loss
EFRAG's draft comment letter	• Many stakeholders disagree with the resulting presentation in the Statement of profit or loss • Would be in conflict with the requirements to account in equity for transactions with owners in their capacity as owners • Would be counterintuitive to have measurement changes being presented in profit or loss because performance decreases when the value of the shares subject to the put option increases, and vice versa

EFRAG's draft comment letter - Disclosures

DISCLOSURE PROPOSALS

EFRAG welcomes the improvements to disclosures on issued instruments

Field-testing will be essential to ensure that these disclosures are:

- Clear
- Able to be implemented by entities
- Balanced between the benefits to users and the costs for preparers

EFRAG has the following concerns and suggestions:

1. Disclosures on contractual nature and priority on liquidation.
   - Entities may face challenges in determining whether priority on liquidation stems from contracts or law/regulation.
   - Suggest to provide information on subgroups located in different jurisdictions and on how the group structure affects priority on liquidation
2. On terms and conditions of financial instruments with both financial liability and equity characteristics disclosures.
   - Useful to provide disclosures on the effects of law on classification as financial liabilities or equity instruments.

DISCLOSURE PROPOSAL ON RECLASSIFICATION

IASB proposals	Disclosures on terms and conditions that become, or stop being, effective with the passage of time
EFRAG's draft comment letter	EFRAG expresses concerns on the prohibition to reclassify 'passage-of-time changes' while requiring disclosures on terms and conditions that become, or stop being, effective with the passage of time • Would reflect the substance of the contractual terms for the remaining life of the instruments • If disclosure is useful for users, why is it not relevant that the instrument be reclassified

APPENDIX: IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

Simplified fact pattern

- The parent owns 70% of the subsidiary
- The value of 100% of the subsidiary’s net assets is CU 1 000, of which CU 700 represents the parent’s share and CU 300 represents the non-controlling interest’s share
- The parent writes a put option which allows the non-controlling shareholder to sell its holding to the parent. The discounted value of this put option’s exercise price is 350 at its issuance (T0) and 400 1 year later (T1)
- The subsidiary’s results in year 1 is CU 100, of which CU 70 represents the parent’s share and CU 30 represents the non-controlling interests share

IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

Summary of three approaches

	Approach 1	Approach 2	Approach 3
	(IASB proposal - Debit Parent Equity at T0 and liability changes to P&L)	(Alternative - Debit Equity NCI at T0 and liability changes to parent equity)	(net presentation)
Balance sheet @ T1			
Assets:			
Net assets - subsidiary	**1.100**	**1.100**	**1.100**
Liabilities:			
Financial liability	400	400	0
Equity:			
Equity - parent	370	720	770
Equity - NCI	330	-20	330
Total liabilities and equity	**1100**	**1100**	**1100**
Profit of loss in Y1			
Parent share	20	70	70
NCI share	30	30	30
	50	**100**	**100**

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THANK YOU

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Financial reporting

EAA Reporting Standards Workshop on FICE

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Tobias Bornemann

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1. Overview

Overview

- **Focus on the empirical evidence around two leading questions:**
  1. Classification: Do users of financial statements “look through” the accounting classification of HFIs?
  2. Disclosure and presentation: Which features are important to users of financial statements?
- **Not covered, but important in the literature:**
  Effect of classification principles on firms’ decision to issue certain types of HFIs or structuring of HFIs
  Fargher, Sidhu, Tarca, and, van Zyl (2019, AF)

HFIs: CHB market

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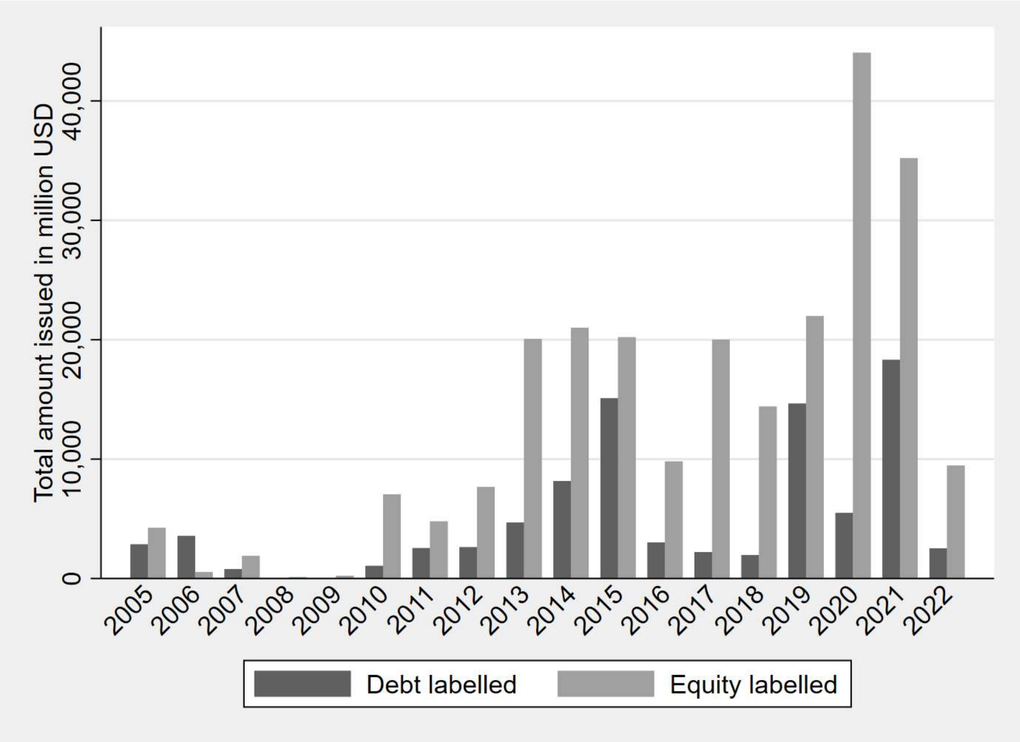
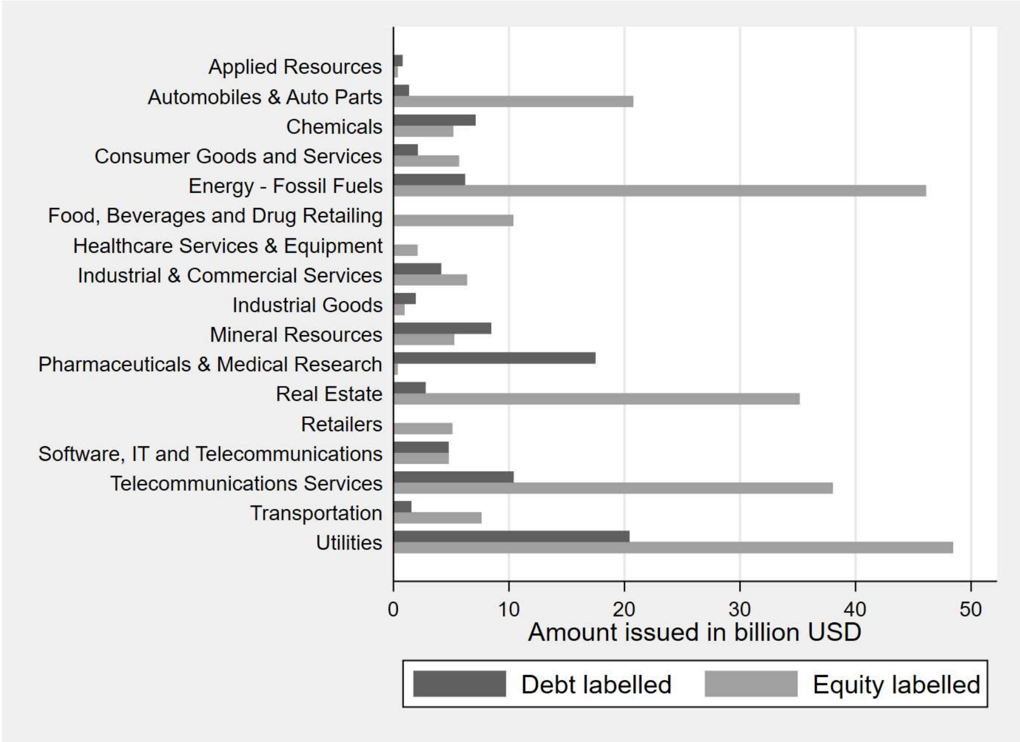
Volume by year



Volume by industry



~ USD 330bn market

Source: Bornemann and Novotny-Farkas (2024, WP)

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2. Classification

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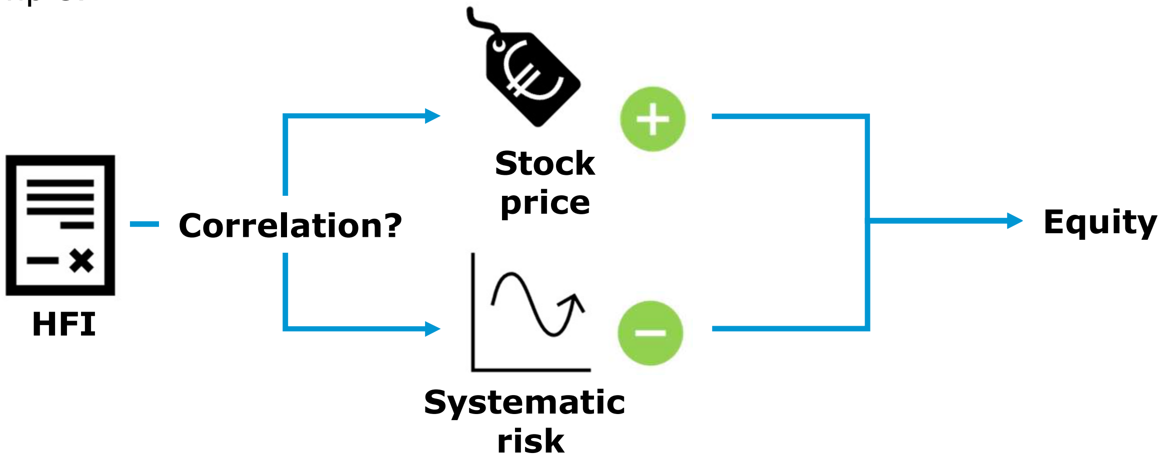
Do users of financial statements “look through” the accounting classification of HFIs?

Market perception of HFIs: Introduction

- How do capital markets perceive HFIs? As debt, equity, or something in between?
- Underlying idea: Analyze the economic substance of HFIs to classify them as either liabilities or equity
- Example:



- Necessary condition: Users of financial statements are able to "look through" the label and correctly incorporate the underlying features of HFIs

Market perception of HFIs: Evidence I

1. **Some evidence that users are able to "look through" the classification of (hybrid) financial instruments**
   - Mandatorily Redeemable Preferred Stock (MRPS) does not exhibit a debt-like or equity-like relation with systematic risk or price
     Kimmel and Warfield (1995, TAR); Cheng, Frischmann, and Warfield (2003, RAR)
   - Employee stock options (ESOPs) are negatively correlated to common equity risk and expected returns, suggesting that ESOPs are not priced as liabilities
     Barth, Hodder, and Stubben (2013, RAST)
   - Cash and share-put warrants are priced as debt or equity in line with their solvency characteristics and independent of their accounting classification as liabilities (SFAS 150)
     Terando, Shaw, and Smith (2007, RQFA)
   - In an experiment, experienced finance professionals rely on HFIs' contractual features when evaluating a firm's creditworthiness and in their lending decisions
     Clor-Proell, Koonce, and White (2016, JAR)

Market perception of HFIs: Evidence II

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2. **A bit of evidence suggesting users price HFIs in line with their classification**
   - Buy-side analysts price MRPS in line with their accounting classification
     Hopkins (1996, JAR)
   - Markets price perpetual corporate hybrid bonds (PCHBs) as debt around their offering but as equity when presented as equity in F/S
     Bornemann and Novotny-Farkas (2024, WP)
     - Cumulative abnormal returns around PCHB offerings are comparable to straight debt offerings
     - However, the value relevance of PCHBs suggests equity-like pricing when presented in F/S

Market perception of HFIs: Evidence II

3. **However, the market's perception is context-specific and likely depends on the attributes of…**

   a) **… the security**

   - Once MRPS includes more equity features (esp., conversion features or voting rights), MRPS is priced more equity-like
     Kimmel and Warfield (1995, TAR)

   - Finance professionals rely on five key features to rank HFIs along the debt-equity continuum: *maturity, priority in liquidation, voting rights, settlement in cash or common stock, dependence on profitability*
     Clor-Proell, Koonce, and White (2016, JAR)

   b) **… the firm**

   - Market perception of MRPS as liabilities or equity depends to some extent on firms' size
     Cheng, Frischmann, and Warfield (2003, RAR)

   - Investors price preferred stock as more equity-like (liabilities-like) when the firm is financially distressed (healthy)
     Linsmeier, Partridge, and Shakespeare (2023, WP)

Classification changes: Evidence

1. **No studies that analyze whether reclassifications of (hybrid) financial instruments provide more useful information to users**

2. **Literature supports that firms adjust financing or instruments in response to classification changes**

   a) **FAS 150: reclassified MRPS from mezzanine to liabilities around 2003**

   - Firms redeemed MRPS early before the adoption of FAS 150 to avoid negative effects on debt covenants
     Moser, Newberry, and Puckett (2011, RAST)

   - Firms issued fewer MRPS and restructured MRPS after the adoption of FAS 150
     Levi and Segal (2015, EAR); Hanlon (2019, AJM)

   b) **IAS 32: reclassified most preferred shares from equity to liabilities**

   - Majority of affected firms either buy back or restructure preferred shares in response to IAS 32
     De Jong, Rosellón, and Verwijmeren (2006, AiE)

Classification: Conclusion

1. **Some evidence that users "look through" the classification of HFIs even in low-disclosure settings** (e.g., no information on MRPS' attributes was disclosed in the analyzed U.S. settings)
2. **A bit of evidence that users price HFIs in line with their classification**
3. **The perception of HFIs as debt-like or equity-like is context-specific and depends on**
   - The features of the instrument
   - The economic attributes of the firm
   - (The type of user of financial statements)
4. **No evidence that reclassification of (certain) HFIs provides more useful information**

2. Presentation and Disclosure

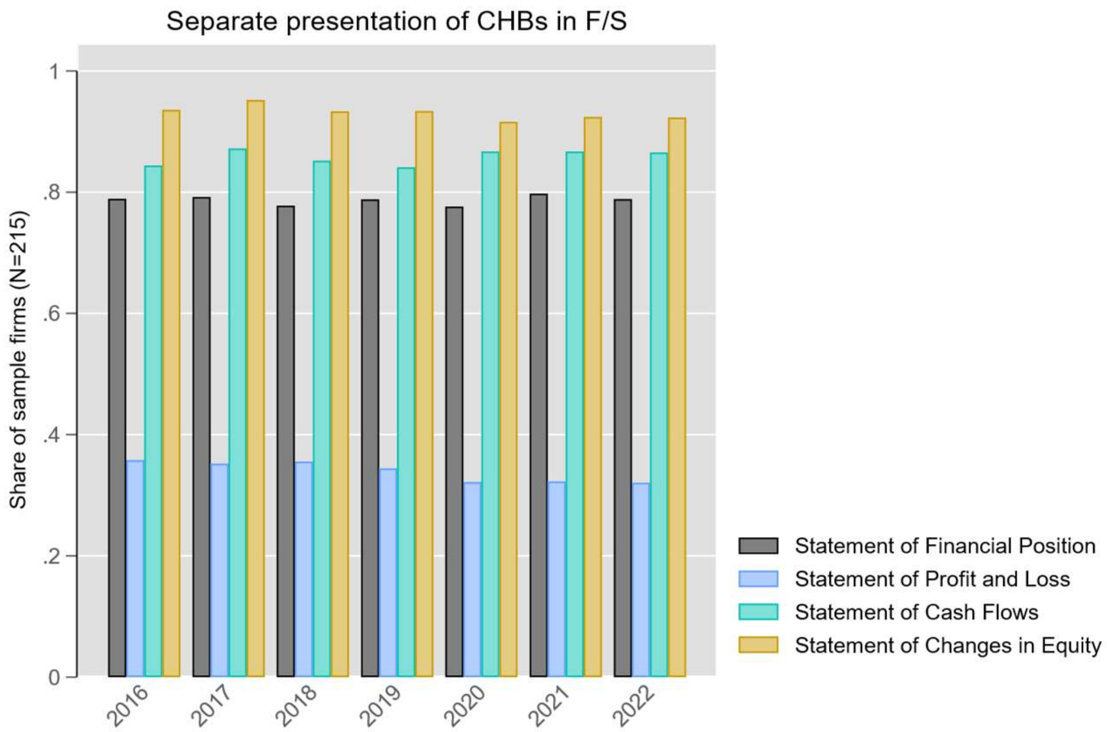
Which features are important to users of financial statements?

Disclosure: Introduction

- Contractual features of HFIs are typically public information after their offering
- Nevertheless, disclosure of contractual features in the *Notes to the Financial Statements* can have two effects:
  1. reduces information asymmetry across different types of users of financial statements
     (“levels the playing field”)
  2. reduces information processing costs of users of financial statements
     Blankespoor, deHaan, and Marinovic (2020, JAE)

Disclosure: Anecdotal evidence

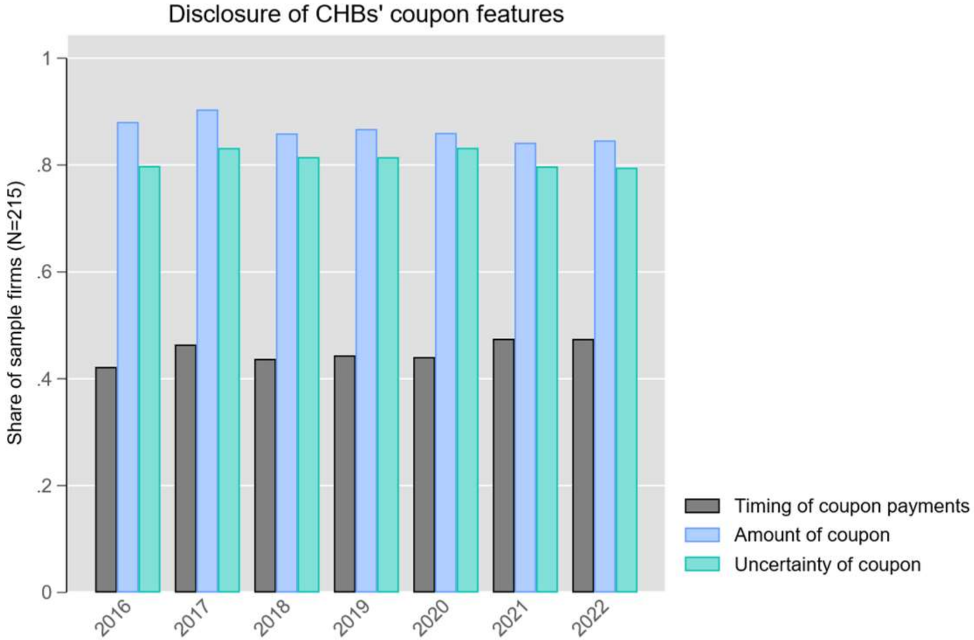
- **Transparency on perpetual hybrid bonds varies across firms**

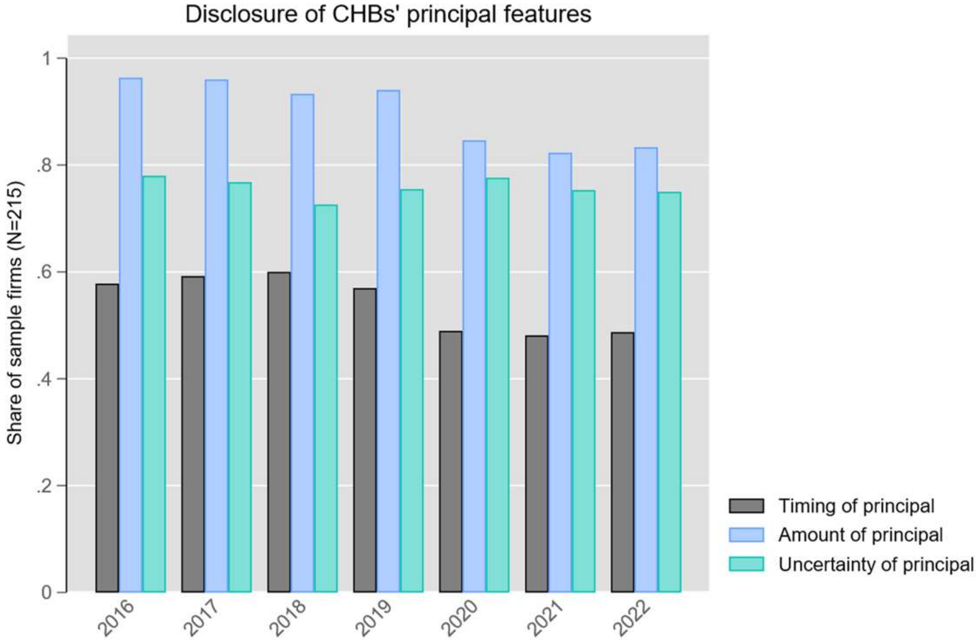


Source: Bornemann and Novotny-Farkas (2024, WP)

Disclosure: Anecdotal evidence

- **Transparency on perpetual corporate hybrid bonds (PCHBs) varies across firms**





→ **Lacking disclosures on seniority, voting rights, and dilution effects of PCHBs**

Source: Bornemann and Novotny-Farkas (2024, WP)

Disclosure: Evidence

- **Some evidence that HFIs' features differ in their importance to certain users**
  ("experienced finance professionals conducting credit-related judgments")
  Clor-Proell, Koonce, and White (2016, JAR)
  - *Maturity* and *priority in liquidation* matter most in assessing an HFI as equity-like or debt-like
  - *Voting rights, settlement in cash or common stock, and dependence on profitability* matter less
  - However, no broad agreement on the relative importance of features
  - → **No evidence that these results generalize to other types of users**
- **Some descriptive evidence that disclosure guidance improves disclosure of HFI features**
  Marquardt and Wiedman (2007, AH)
  - Disclosure of conversion features and impact on diluted EPS was low pre-2004, esp. for firms with high
  - Disclosure of conversion features of COCOs improved after disclosure guidance by FASB in 2004
- **Separate presentation of CHBs in F/S is associated with lower forecast error and dispersion of analysts**
  Bornemann and Novotny-Farkas (2024, WP)

Differences in disclosure for similar instruments

- **Under IFRS 7, no specific disclosures are required for instruments classified as equity**

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Bonds and Notes

	Nominal volume as of Dec. 31, 2019	Carrying amount as of Dec. 31, 2019 € million	Nominal volume as of Dec. 31, 2020	Carrying amount as of Dec. 31, 2020 € million
Hybrid bonds[1]				
Hybrid bond 2014/2024[2]/2074	EUR 1,500 million	1,497	EUR 1,500 million	1,497
Hybrid bond 2015/2022[2]/2075	EUR 1,300 million	1,295	EUR 1,300 million	1,297
Hybrid bond 2019/2025[2]/2079	EUR 1,000 million	990	EUR 1,000 million	991
Hybrid bond 2019/2027[2]/2079	EUR 750 million	746	EUR 750 million	747

Hybrid bonds

The hybrid bonds issued by Bayer AG are subordinated, and 50% of their amount is treated by the rating agencies as equity. They therefore have a more limited effect on the Group's rating-specific debt indicators than senior borrowings.

In 2019, Bayer AG repurchased the €1.75 billion hybrid bond maturing in 2075 (callable on July 1, 2020) before the first call date. The repurchase was financed through the issuance of two hybrid bonds with nominal volumes of €1 billion and €750 million.

Pursuant to IAS 32, the following hybrid bond issued by Group companies must be classified as equity:

Hybrid bonds Issuer	Nominal value	First call date	Coupon in % p.a.[1]
RWE AG	£750 m	2019	7.0

1 Until the first call date.

Proceeds from the bond issue were reduced by the capital procurement costs and added to equity, taking account of taxes. Interest payments to bondholders will be booked directly against equity, after deduction of taxes. Such payments can be deferred by the company; under certain circumstances, however, they must be made up again, for example if the Executive Board and Supervisory Board propose to the Annual General meeting that a dividend be paid.

Disclosure: Conclusion

- The existing disclosure requirements (e.g. IFRS 7 and IFRS 9) and the complexity of the features of HFIs are unlikely to provide sufficient information to allow users to reclassify instruments (e.g. from debt to equity)
  Fargher, Sidhu, Tarca, and, van Zyl (2019, AF)
- However, features are important to allow users to assess the financing of the firm and the characteristics of HFIs
- No consensus on which features matter most to characterize HFIs, but users rely on:
  - Maturity
  - Priority in liquidation
  - Voting rights
  - Settlement in cash or common stock
  - Dependence on profitability

3. Conclusion and Outlook

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Conclusion

1. No consistent evidence that the reclassification of certain types of instruments provides more useful information to users
2. Some evidence that users do not assess the same type of instrument consistently
3. Instead, the assessment of HFIs is likely context-specific and relies on the attributes of the instrument and the firm

→ **A dichotomous classification of HFIs does likely not communicate important information relevant to HFIs**

→ **Disclosure of underlying features allows users to (more cost-effectively) evaluate them**

Caveats and outlook

- **Existing empirical and experimental evidence is largely limited to**
  - U.S. settings
  - specific types of HFIs (mainly MRPS)
  - specific types of users (buy-side analysts, finance professionals making credit-related decisions)
  - sample periods before 2000
  - equity market effects
- **Avenues for future research**
  - Differences in perception of HFIs across different types of users, esp. less experienced users
  - Differences in perception of HFIs across debt and equity markets
  - Identification of attributes that are important to different users to assess HFIs’ underlying characteristics