IFRS

STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Summary of feedback: users of financial statements		
CONTACT(S)	Angie Ah Kun	aahkun@ifrs.org	+44 (0) 20 7246 6418
	Uni Choi	uchoi@ifrs.org	+44 (0) 20 7246 6933
	Fred Nieto	fnieto@ifrs.org	+44 (0) 20 7246 6956

Objective

1. In this paper the staff summarise the detailed feedback received from comment letters and outreach with users of financial statements such as investors and analysts (hereafter 'users') on the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP).

2. Most of the feedback came from user outreach which is described in Appendix A. We also received five comment letters from users and considered specific user feedback gathered through outreach performed by national standard setters. We did not consider it necessary to identify or distinguish the feedback obtained from comment letters from the feedback obtained from outreach.

Overview

3. This paper is structured as follows:

   (a) Overall comments on the DP (paragraphs 6-11);

   (b) Comments on specific sections of the DP (paragraphs 12-61):

        (i) Presentation (paragraphs 12-27);

        (ii) Disclosure (paragraphs 28-45);

        (iii) Classification (paragraphs 46-60);

        (iv) Other feedback (paragraph 61).

    (c) Appendix A containing:

        (i) a summary of user outreach (paragraphs A1-A3); and

        (ii) demographic information on the user feedback (paragraphs A4-A7).

4. The DP includes an array of topics. Not all users provided comments on every area of the DP—most users responded to selected sections and questions. Users were generally more interested in some topics than others—namely presentation and disclosure—because these were the areas that the DP proposed more significant changes in terms of reporting outcomes or that they found more relevant due to challenges with classification.

5. In this paper we summarise the feedback received on the sections that generated the largest volume of responses from users. The limited feedback from users related to classification was incorporated and mentioned separately in Agenda Papers 5A-5E of the June 2019 Board meeting where appropriate, but has been included in this paper again for completeness. We consulted with users specialising in different asset classes and have also highlighted the areas where it was clear that they were of more interest to equity analysts or to debt analysts.

Overall comments on the DP

6. A few users acknowledged that there will be a trade-off between costs and benefits ie complexity vs transparency in making changes to IAS 32 *Financial Instruments: Presentation*.

7. Most users supported the additional disclosures proposed in the DP, particularly the disclosures relating to terms and conditions of financial liabilities and equity instruments because they acknowledged that it is often difficult to understand what the key features are that lead to the classification as equity or liability. They also said that information is often lacking and additional disclosures will bring

more transparency and help them understand the financial instruments so that they can perform their own analyses and valuations. Equity investors and analysts particularly supported the disclosures relating to potential dilution of ordinary shares. On the other hand, debt investors and analysts particularly supported the disclosures relating to priority on liquidation.

8. There was limited support for the attribution of total comprehensive income to classes of equity instruments, in particular derivative equity instruments, with most users citing complexity as the main drawback.

9. Most users supported the separate presentation of financial liabilities that have equity-like returns but there were mixed views on whether these returns should be presented in Other Comprehensive Income (OCI) or within profit or loss using a separate line item and if presented in OCI, whether gains or losses should be recycled to profit or loss when these liabilities are settled.

10. Limited feedback was provided on the classification proposals. Some users acknowledged that analysts often make their own classifications by making adjustments to the entity’s classification. However, some users did comment on classification issues, particularly debt analysts and investors in perpetual financial instruments with fixed cumulative returns. They were particularly concerned about the change in classification of these instruments under the DP and the potential market disruption if accounting call options are exercised.

11. A few users questioned the scope of the project and its interaction with other IFRS Standards. They asked whether the presentation and disclosure proposals in the DP would apply to employee share-based compensation within the scope of IFRS 2 *Share-based payment*, for example when disclosing the maximum dilution of ordinary shares. They pointed out that employee share-based compensation is often the most common source of dilution. They also mentioned that one of the problems with the current earnings per share (EPS) requirements in IAS 33 *Earnings per Share* is that it does not take into account anti-dilutive instruments.

Comments on specific sections of the Discussion Paper

Presentation: Attribution of total comprehensive income to equity instruments

12. The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares.

    (a) For non-derivative equity instruments, in the Board's preliminary view, the attribution should follow the existing calculation for basic EPS in IAS 33, which most commonly involves dividends paid or declared. Entities would present these amounts on the face of the financial statements separately from dividends paid on ordinary shares.

    (b) For derivative equity instruments three approaches to attribution are considered in the DP and the Board has not reached a preliminary view on which method is preferred. The Board is aware of challenges posed by these approaches and may consider a disclosure-only approach.

13. Overall, there was limited support from users (including CMAC members) for attribution of total comprehensive income to classes of equity instruments, in particular derivative equity instruments. Although some users mentioned that the objective of the attribution requirements would be useful, they acknowledged that the information given would be a 'nice to have' rather than a necessity. Others believe it is not appropriate to allocate current period profit to future or potential shareholders for example, parties that have yet to exercise their share options because these potential shareholders do not have the right to dividends or other returns of the current reporting period. It was also mentioned that remeasurement of equity after initial recognition is unnecessary because they believe estimating the fair value of derivative equity instruments implicitly requires a perpetuity valuation of the reporting entity at each period end and that this remeasurement is misleading about performance and value creation.

14. Some users acknowledged they had a limited understanding of the attribution methods for derivative equity instruments. A few users said they would favour the disclosure-only approach mentioned in the DP ie disclosure about dilutive

earnings per share, potential dilution and fair value. They expressed the following concerns about using fair values of derivatives on own equity in the attribution approaches:

(a) many factors affect fair value, including management assumptions, valuation models and other market factors. The attribution outcome will significantly depend on the reliability of the calculation of each instrument's fair value.

(b) total comprehensive income is a result of a mixed measurement model ie by applying IFRS Standards, some assets and liabilities are measured at fair value while others are measured at historical cost. The amount of comprehensive income attributed to ordinary shares is not very meaningful to users when it is calculated by subtracting income attributed to other equity instruments on a fair value basis from total comprehensive income determined under a mixed-measurement basis.

(c) these users said they are more interested in cash flows or the disposal value for each class of equity.

(d) Such approaches may be difficult to apply to non-public entities that do not currently apply IAS 33.

15. Nonetheless, some CMAC members said they consider information on the fair value of derivatives on own equity particularly important for analysing the entity's equity value and it would be useful for entities to provide such information in the disclosures.

16. However, some users mentioned that attribution would be particularly useful to equity investors. They said it is important to split out profits for each claim so that they can readjust performance to align more closely with their own understanding of repeatable performance. A few users mentioned that information about potential shareholders (ie holders of unexercised options) would be useful for the convertible bond market.

17. There was some support for attribution for non-derivative equity instruments for example, non-cumulative preference shares based on the existing requirements in IAS 33. These users said presenting dividends paid to ordinary shares and other

equity instruments separately on the face of the primary financial statements would be useful.

18. Some users were unsure whether the information arising from the attribution proposals would actually be used in their analyses. Instead they expressed a preference for other types of information for example, dividend payment by type of equity, participation curves for each class of equity or the attribution of revenue or operating income to holders of non-controlling interests. A user said they preferred the idea of showing enhanced EPS workings because they believed the fair values would be too subjective to be a solid basis for attribution. They also said such disclosure would be helpful for users with limited incremental cost for preparers.

Presentation: Financial liabilities with equity-like returns

19. The DP has proposals for the separate presentation of financial liabilities that for example, contain no obligation for an amount that is independent of the entity's available economic resources ie financial liabilities with equity-like returns. The proposals would apply to for example, ordinary shares redeemable for a cash amount equal to the fair value of the ordinary shares. Under both IAS 32 and the DP, these instruments are classified as financial liabilities because they include an obligation to pay cash other than at liquidation. However, their amounts are linked to the "residual value" of the issuer. Income and expenses on these types of liabilities are currently accounted for in profit or loss, for example as part of financing costs, often without separate disaggregation. However, under the DP, the carrying amounts of these instruments should be presented separately in the statement of financial position and the income and expenses would be presented in OCI and not recycled. This means the gains or losses would not affect the company's profit or loss even when the liabilities are settled. The Board also considered whether or not it should require separation of embedded derivatives for presentation purposes from hybrid instruments that are designated at fair value through profit or loss.

20. Many users supported separate presentation in the statement of financial position and statement of financial performance saying these liabilities are sufficiently

different in nature that it would be useful to be able to analyse them separately. In contrast, a few users did not support the separate presentation proposals because they believe the proposals introduce too much complexity which will complicate the understanding of the statement of financial performance and the statement of financial position.

21. A user supported the separate presentation proposals for the statement of financial position but strongly disagreed with the presentation proposals for the statement of financial performance. They do not believe the accounting standards need to address the accounting mismatch or counter-intuitive effect on the income statement for financial liabilities that contain an obligation for an amount that is affected by changes in the entity's available economic resources. Instead they believe it should be enough to disclose separately details of income and expenses arising from these financial instruments in the notes to the financial statements.

22. The users that supported the separate presentation proposals for the statement of financial performance expressed mixed views as to whether income and expenses from financial liabilities with equity-like returns should be presented in OCI or in profit or loss. They also expressed mixed views about whether amounts presented in OCI should be recycled to profit or loss when these liabilities are settled. In addition, a few users said they did not have a strong view on where this income and expense should be presented as long as they were able to distinguish them from income and expenses from other types of financial liabilities.

23. Some users preferred presentation in profit or loss but in a separate line item, saying that OCI lacks transparency and can be used to hide volatility in earnings and for this reason not many analysts focus on it. A user viewed the income and expenses from liabilities as a financing cost and for that reason preferred recognition in profit or loss. Another user did not support presentation in OCI and was particularly concerned that presentation in OCI without recycling would erase the important information from profit or loss about the increase in the amount of the future cash outflow when the payment is made.

24. However, other users favoured the DP's proposal of presentation in OCI without recycling because they do not consider income and expenses from these types of liabilities as a measure of the issuer's core operational performance. A few users

said presentation in OCI is consistent with the presentation of the effects of changes in own credit risk when applying IFRS 9 *Financial Instruments* to financial liabilities designated at fair value through profit or loss. They also believe a non-recycling approach removes the profit or loss volatility in future periods and avoids potential manipulation of earnings. A user specifically said they are not an advocate of recycling as their valuation analysis is performed based on instruments in issue and therefore after they are settled any gains or losses relating to the settlement become irrelevant. They further said performance in the period will not be clearer with recycling and they would need to reverse any items of this nature as a one-off movement when doing their analysis of performance.

25. Some users preferred presentation in OCI but with recycling saying that the timing of realisation should be very clear (ie gains or losses should be recycled upon settlement) and recycling is consistent with the Conceptual Framework for Financial Reporting. A user said they would like to have the gain or loss in profit or loss when it crystallises, but they do not like to see the noise impacting profit or loss before settlement.

26. Similarly, a few CMAC members specifically said they supported reporting the effect of remeasurement (for example, mark-to-market movements) in OCI, while the ultimate cash amount settled should be recycled. They also expressed a view that cash coupon payments on these types of financial liabilities should be reflected in profit or loss. In their view, such reporting would contribute to the income statement reflecting the true performance of the entity for the period.

27. In response to the issue of requiring separation of embedded derivatives from hybrid instruments measured at fair value through profit or loss for presentation purposes, a user suggested the Board further investigate the nature of embedded derivatives to assess the cost of application.

Disclosure: Priority of claims on liquidation

28. The Board's preliminary view is that information about the priority of financial liabilities and equity instruments on liquidation, on the statement of financial position or in the notes, would be useful to users of financial instruments. The

objective of these disclosures would be to provide information to users about the relative ranking of financial liabilities and equity instruments on liquidation and not to depict the value of those instruments in a hypothetical liquidation.

29. These disclosures were mostly supported by debt analysts. They said they found the disclosures useful because it will help them better understand which instruments of the capital structure have access to the operating cash flows of an entity. In contrast, some users said they were not concerned about priority of claims on liquidation—particularly equity analysts, investors in high quality instruments and those users that believe the perspective of financial statements and their analysis is on a going concern basis not a liquidation basis.

30. Some users noted that there would be implementation challenges and expressed concerns that these challenges may lead to limited or only high-level information being provided, which in turn, might reduce the usefulness and reliability of the disclosure. They highlighted the following implementation challenges:

    (a) ranking information about financial liabilities and equity instruments in complex (international) group structures that may continuously change is challenging;

    (b) difficulty in capturing structural subordination within the group structure ie debts issued by operating subsidiaries tend to have higher priority than those issued by the parent;

    (c) disclosures could be misleading if they exclude non-financial liabilities or provide information without details eg the quality of the security for a secured loan;

    (d) information on priority based only on contractual terms without considering laws and regulations (and changes therein) may be incomplete; and

    (e) the expected priority of claims in a bankruptcy situation could change based on what is decided through negotiation between the entity and creditors.

31. However, despite these challenges, some users still expressed support for disclosure of priority of claims because they would not need to presume the

priority based on limited information or track down information from historical annual reports or other company reporting/filings. These users believe ‘some information is better than none’. In response to the challenges highlighted for complex group companies, a CMAC member suggested that sub-consolidation of the operating subsidiaries could be used where relevant.

32. Some CMAC members said that even if an entity is unable to provide this information, the disclosures of that fact and the reasons for such a conclusion would be useful. For example, an explanation of what the priority depends on, such as an insolvency administrator’s interpretation and decision would be useful. This information would help the holders of financial instruments to make judgements on what they might be able to get under different liquidation scenarios. However, another CMAC member said that the explanation of why companies cannot provide this information might result in ‘boilerplate’ disclosure.

33. A user specifically said this information should be provided in the notes to the financial statements rather than on the face of the statement of financial position.

34. Some users commented that they would favour this disclosure reflecting carrying amounts rather than fair values on the basis that the information can be directly reconcilable to the information presented in the statement of financial position or that carrying amounts may more closely reflect the settlement cash flows. A few users said that the recovery value on liquidation is important to them suggesting that neither the carrying amounts nor the fair value as at the reporting date are of direct use to them.

35. Some users stressed the importance of providing information on the individual entity within the group that is issuing the instruments. A few users mentioned that if there are parent-subsidiary guarantee arrangements, then the group view would be important, and they would like information to be clear on when subsidiaries’ debts are guaranteed by the parent.

36. Some users said disclosure of the timing of refinancing will be useful for example, call dates to better understand the liquidity issues that preparers may be facing. A user said that the timing of refinancing can create ‘a subordination’ for example, some debts may have a lower priority on liquidation than other debts but they could be repaid before others if it has an earlier redemption date.

Disclosure: Potential dilution of ordinary shares

37. The Board's preliminary view is that information in the notes to the financial statements about the potential dilution of ordinary shares would be useful to users of financial instruments. The objective of these disclosures would be to help users assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares for example, convertible bonds and derivatives on own equity.

38. A few CMAC members noted they currently try to estimate the maximum dilution of ordinary shares when the information available allows them to do so. Some users mentioned that the potential dilution information is useful for equity analysts in particular. Most equity analysts supported the proposed potential dilution disclosures, saying it would provide more transparency and information. They noted that such disclosure:

    (a) would help them to assess

        (i) the effects of dilution;

        (ii) participation in upside of returns; and

        (iii) the distribution of returns among equity instruments and how this may change in the future; and

    (b) could be helpful for small companies as there can be IPOs with a lot of issued warrants where it is not easy to understand the dilution.

39. Some CMAC members suggested supplementing the maximum dilution disclosures with scenario or sensitivity analysis for example, if share price increases by x%, maximum dilution would be Y. However, other members preferred having sufficient information about the inputs to enable them to do their own analysis and said this could be more dynamic than relying on the output of scenarios based on management's assumptions.

40. A user also believed more information is needed than the proposed disclosure because they were also interested in the likelihood of dilution for example, the likelihood of the options being exercised but they conceded they could do this analysis in combination with a summary of the key terms and conditions.

Disclosure: Terms and conditions

41. The Board's preliminary view is that information in the notes to the financial statements about the terms and conditions of both financial liabilities and equity instruments that affect the amount and timing of cash flows would be useful to users of financial instruments. These disclosures would help users make assessments of the company's financial position and performance.

42. Most users found the proposed disclosure of terms and conditions the most important of the proposed disclosures in the DP. They view it as a source of information from which analysts can perform their own scenario analyses (for example, the pay-out for a range of outcomes) and potential lenders can perform their own fair value valuations. These users believe the information would be very helpful and timesaving because they would not need to look back into historical annual reports or consult past prospectuses/offering documents. It was also noted that users are generally interested in understanding the future cash flows of the entity as they evaluate investment alternatives and their evaluation can be assisted by quality disclosures of contractual terms of equity instruments.

43. Many users acknowledged that the financial statements do not currently provide comprehensive disclosure about terms and conditions for financial instruments. A few users mentioned that suitable disclosures about the contractual terms and conditions would also support the classification outcomes. They would find this useful because it is often difficult to understand what the key features are that lead to the classification as equity or financial liability. Other users specifically said it would be useful to disclose particular terms and conditions affecting cash flows for example, early redemption and step-up clauses and information about covenants associated with outstanding claims.

44. However, most users suggested that for information to be useful, there should be a balance between providing information that is sufficiently granular and avoiding disclosure overload. To avoid disclosure overload, some users suggested providing a summary of key features and material information about the entity's capital or financing structure (for example, a table of key terms with one line per instrument) and including references or hyperlinks (if possible) to other documents outside the financial statements for further information for example,

prospectuses, general documents for note programmes, specific indentures, etc. CMAC members echoed the appropriateness of this suggestion to avoid disclosure overload. A user however, expressed a concern that the prospectus may not reflect information that is current at each reporting date for example, if any instrument has been early redeemed. Other suggestions included narrowing down the disclosure based on categories such as instruments giving rise to dilution and those that are hybrid instruments.

45. A CMAC member also noted that if this disclosure is required by IFRS Standards, it would improve the consistency of the level of information provided by companies across different jurisdictions. A few users noted that for banks, similar information is currently required by Basel III Pillar 3 *Disclosure Requirements* and an exemption for banks would be necessary to limit the scope of the disclosure requirements only to solvency capital instruments as otherwise, it could lead to high costs and complexity as well as disclosure overload.

Classification: non-derivative financial instruments

Classification approach

46. The Board’s preferred approach to classification is based on two features—the timing and the amount feature. The timing feature is aimed at providing information about how the financial instrument can affect the liquidity and cash flows of the issuer. The amount feature is aimed at providing information about how the financial instrument can affect the solvency of the issuer and assessing whether the issuer has produced enough returns to meet the return that it has promised. The Board’s main objective with respect to classification of financial instruments is to provide clarified principles that can be consistently applied while limiting changes to classification outcomes of IAS 32 that are well understood today.

47. Some users welcomed clarified classification principles that could be applied consistently and were less concerned about a particular classification outcome. This is because they acknowledged that analysts often make their own classifications by making adjustments to the entity’s classification and that a classification principle cannot satisfy everyone. Furthermore, they noted that users

amongst themselves have different focus areas or interests eg credit analysis and equity valuation pursue different objectives. For this reason, these users strongly supported improving the required disclosures which would result in more transparency and allow each type of user to conduct its own assessment when considering a particular instrument. A few debt analysts also indicated that users will always have their own views and were not convinced that users would look at financial instruments differently based on the proposals in the DP.

48. Some users mentioned that they are challenged by distinguishing liabilities from equity and viewed the classification approach as complex and difficult to understand. For this reason, a few users admitted they could not decide how significantly the proposed approach in the DP would increase the usefulness of information. More than one user said they considered the proposed approach that combines two criteria to be appropriate. However, a few users mentioned that financial analysis is done on the basis of a going concern assumption ie not assuming an entity's potential liquidation. They therefore believe the 'amount feature' proposed in the DP is inconsistent with that assumption and that its description may need to be revised because considering the transfer of cash or another financial asset in a liquidation context is confusing. Another user however explicitly disagreed with this comment that the amount feature is in conflict with the going concern assumption. An equity analyst questioned whether the timing feature is in conflict with the going concern assumption because this feature also considers liquidation ie whether there is an obligation to transfer economic resources at a specified time other than at liquidation.

49. A user acknowledged that although some instruments which possess features of debt and equity could be considered as belonging to a class of their own, the creation of a 'mezzanine' category on the balance sheet would create other difficulties. Another user explained that investors are interested in how a financial instrument is settled ie in cash or own shares. Despite this, they did not think that the manner of settlement should necessarily affect the classification and said this information could rather be disclosed.

50. Some users argued that there are many complex instruments that attempt to qualify as equity but are not ordinary shares. An equity analyst mentioned that because they focus on ordinary shares, they treat instruments other than ordinary

shares as liabilities. Another user said that if an instrument participates in the upside potential of the entity, they see it as an equity instrument. Some alternative definitions of equity participants and equity were also proposed:

(a) A user explicitly said they supported a narrow definition of equity or basic ownership approach. They distinguished ‘claims’ from ‘equity participants’ and defined ‘equity participants’ as “the lowest ranking group that would be entitled to distribution collectively at the same point in time; and neither there is an obligation nor an option for an entity to transfer economic resource(s) to such a group.”

(b) A user would characterise as equity any instrument in issue, or contractually obliged to be issued on sale of a business, as equity where the instrument participated without upward limit on the sale of the business.

51. When asked about the adequacy of the information currently provided about compound instruments, a few users mentioned that they would like to better understand the potential dilution of ordinary shares. In relation to separately classifying equity and liability components of a compound instrument, an equity analyst shared the view that to his knowledge more users prefer a no-separation approach because of its simplicity but acknowledged that recognising an equity component may better reflect the economics. This respondent added that the fair value of a convertible instrument provides a useful indication about how the instrument is expected to settle, eg if the instrument is trading close to the par value (redemption value), it indicates that cash settlement is likely.

Classification outcomes

52. The DP noted that there would be changes to the classification outcomes for some financial instruments compared to applying IAS 32. In particular, perpetual financial instruments with fixed cumulative returns, such as cumulative perpetual preference shares, would change from equity to financial liabilities. This is because on liquidation there is a contractual obligation to pay an amount independent of the entity’s economic resources. Under IAS 32, these instruments would have been classified as equity because payment could be deferred until liquidation. These perpetual financial instruments that have cumulative coupons

are commonly referred to in practice as ‘corporate hybrids’ or ‘Additional Tier 1 capital instruments’ in the banking industry.

53. Some investors who invest in these corporate hybrids were concerned about the change in classification of these instruments under the DP because they believe the current accounting classification is clear and well understood and they do not like changes (eg in accounting or tax). Furthermore, if the proposals are finalised, a debt analyst said the market may transition from cumulative to non-cumulative instruments to achieve equity classification, at least in part. In response to these concerns, a CMAC member said that such instruments are deemed to be liabilities for the purpose of financial analysis regardless of their current accounting treatment. These types of financial instruments bear service costs (eg coupon payments) that are expected to be paid while the reporting entity is a going concern and commonly result in an ultimate cash payment on redemption—all characteristics of what in their view would be deemed a liability.

54. In addition to the issuer’s option to call at a specified date, these instruments also often contain accounting call options that allows the issuer to call the instruments at a fixed price before its fixed call date in the event of a change in accounting classification. Some debt analysts were particularly concerned about potential market disruption and other unintended consequences for the wider capital markets if the DP proposal results in a classification change and accounting call options are exercised. A debt analyst explained that the accounting call option may impact the valuation of the corporate hybrids. They believe valuation volatility is more important than accounting classification and further explained that the accounting call option matters to the extent that it affects the valuation of the corporate hybrids ie if valued at a premium in excess of the call price. They expressed concern for those investors with holdings in corporate hybrids that have been purchased at prices significantly above par, since those investors would suffer capital losses in the event of a redemption triggered by an accounting call option exercisable at for example, 101% of the par value.

55. A CMAC member said that a potential solution to this concern about market disruption for the banking sector may be to allow transition through a “phase-in” arrangement similar to that allowed by prudential regulators for regulatory capital purposes.

56. Other users were less concerned with a change in accounting classification of such perpetual instruments with cumulative returns for the following reasons:

(a) an accounting change may have a limited impact on investing policy because the primary investment decision is based on an assessment of the issuer and the corporate hybrid is a way to get a higher yield on debt-type instruments. A user pointed out that investors will need to replace their investments if they are called.

(b) the accounting classification will not result in a change in the rating methodology. These users said there is currently diversity in practice amongst rating agencies and analysts—some analysts assign half equity, half liability to their classification of corporate hybrids while others treat these corporate hybrids as debt. They explained that these instruments provide an important buffer with loss absorption capacity between debt and equity i.e. they act like debt in good times and equity in bad times. They noted that for non-rated issuers, the accounting classification will be more important and thus the consequences of any reclassification from equity to liability would be considered even more detrimental by non-rated issuers.

Classification: Other issues

57. A few users specifically mentioned that they would support retaining the exception for puttable instruments in IAS 32 which results in equity presentation of otherwise debt instruments if specific criteria are met. A user said that a strict application of the criteria for classification may result in a counter-intuitive financial presentation ie all the instruments being classified as liabilities when there is indeed permanent and loss-absorbing financing of the entity. Another user commented that disclosure of financial instruments with puttable features is vital.

58. Some users agreed that economic compulsion should not affect the classification decision:

(a) they acknowledged the practical challenges that would arise if economic compulsion were to be considered. These users prefer disclosure of management’s intentions or expectations so that they can understand the expected outcomes for example, disclosures about the likelihood of conversion into shares and the expected cash payment based on the conditions as at the reporting date. They said that companies should also disclose management assumptions and observable data used in assessing the potential settlement outcomes.

(b) in the context of instruments where the issuer has the option to settle in cash or in shares, they noted that the expected settlement will often be idiosyncratic to each issuer and classification outcomes reflecting such idiosyncrasy could reduce comparability.

(c) if economic compulsion was brought into the classification decision this would affect the classification of ordinary shares which are subject to the market expectation that they will pay dividends because the entity has economic incentives to meet that expectation.

59. However, a few users highlighted that consideration of economic incentives to some extent may be necessary for financial reporting to reflect ‘substance over form’.

60. A few users agreed that laws and regulations should not affect classification and acknowledged the practical challenges that arise from having subsidiaries located in many different jurisdictions with different legal environments. These users prefer disclosures of whether and how laws and regulations can affect settlement outcomes. However, in contrast, a user disagreed with the Board’s classification approach of limiting its scope to the contractual terms of a financial instrument. They said it will be very detrimental to the interest of users because users include all claims in their analysis. They therefore strongly recommended a disclosure note that completely and comprehensively includes all types of claims.

Other feedback

61. A user expressed a view that increasing complexity in financial instruments obscures the risk and rewards inherent in those claims. They suggested a preferred path forward for the Board to consider that focuses on improving disclosures of debt and equity instruments as a short-term priority because with improved disclosures they believe stakeholders will be better informed to address the

classification issue. They believe the classification and presentation of debt and equity instruments can be addressed later based on a more complete view of the types of instruments that need to be assessed under a broader project. They therefore requested the Board to expedite its process to publish an exposure draft that covers disclosure as soon as possible. In addition, this user provided illustrative examples of a waterfall table of claims arising from senior secured, senior unsecured, junior, subordinated claims and residual interest distributable to equity participants (see paragraph 50(a) of this paper).

Appendix A

Summary of user outreach

A1. Most feedback was received through user outreach undertaken from July 2018 to January 2019 by Board Members, the FICE project team and the investor engagement team. Meetings covered a wide variety of users from those specialising in banking to others covering the markets more generally. Users who participated in meetings included both buy-side and sell-side institutions and both equity and debt analysts.

A2. Meetings were either conducted in-person or via telephone and video conference calls. Some meetings were with individuals and others were with user groups at a number of formal group meetings, some of which were conducted in public. These included the following:

(a) November 2018 and March 2019 Capital Markets Advisory Committee (CMAC) meeting;

(b) User panel discussion organised jointly with the European Financial Reporting Advisory Group (EFRAG) in Brussels; and

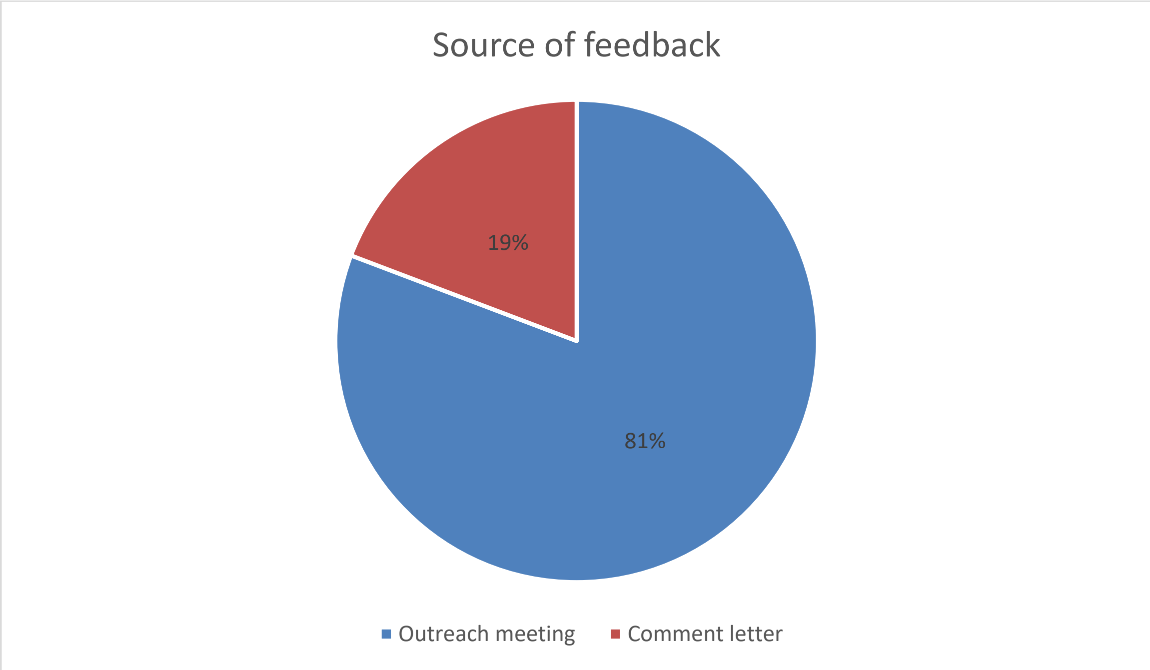
(c) UK Corporate Reporting User Forum (UK CRUF) meeting

A3. Users represented a geographically diverse mix of investment professionals based in various geographic locations. In addition, the market coverage of these professionals could be wider than their geographic location.

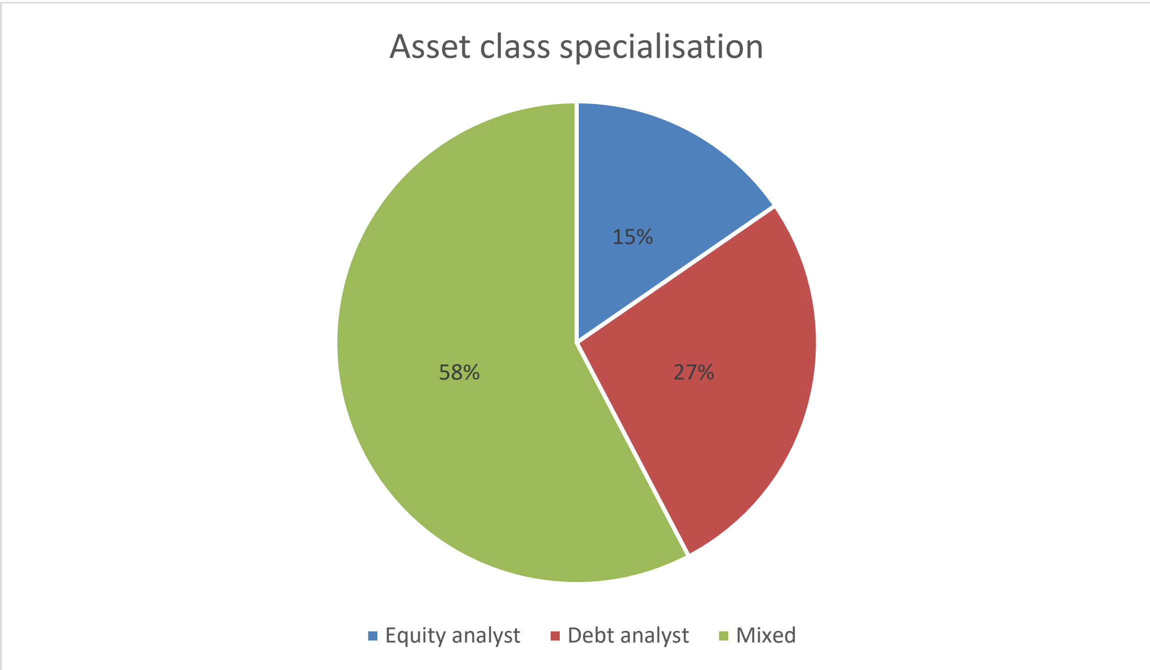
Demographic information on the user feedback

A4. The pie charts below do not include the specific user feedback gathered through outreach by national standard setters.

A5. The following pie chart illustrates the breakdown of feedback by source:



A6. The following pie chart illustrates the breakdown of feedback by asset class specialisation of users:



A7. The following pie chart illustrates the breakdown of feedback based on geographic location of users: