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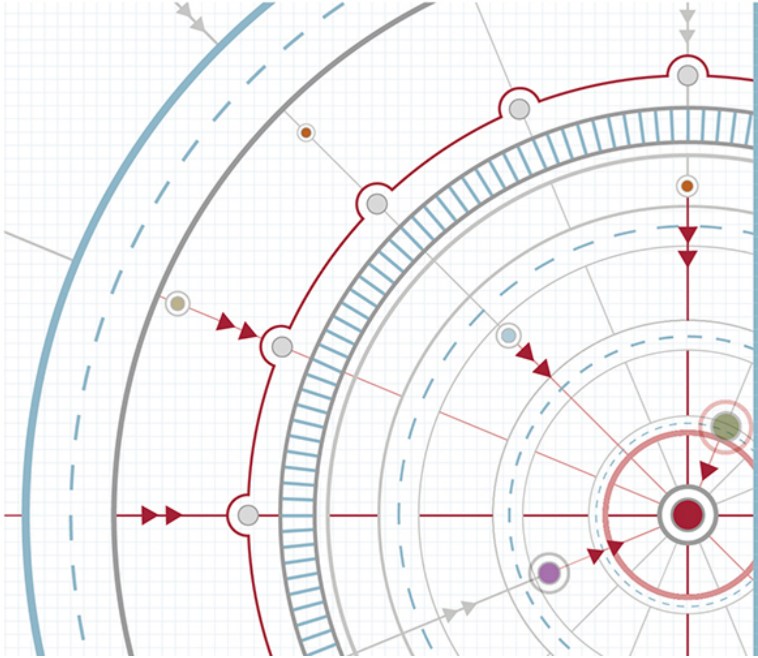

CMAC meeting, 21 March 2019
Agenda Paper 3

Overview of investors' feedback on Discussion Paper *Financial Instruments with Characteristics of Equity*

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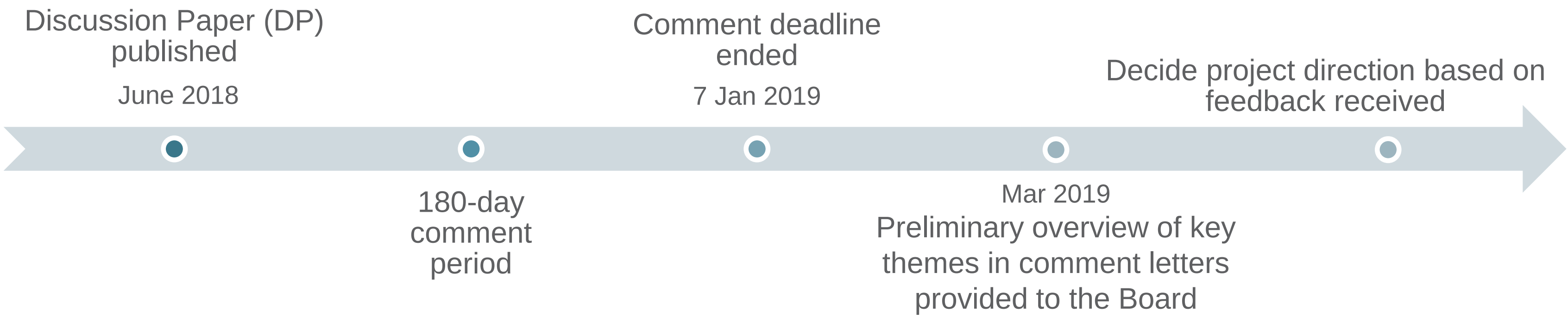
Purpose of this session

- To provide CMAC members with an overview of the feedback received from investors (users of financial statements) on the Discussion Paper (DP) and to ask for their views on:
  - the feedback received and whether they have additional feedback for the Board; and
  - what areas of the DP they think the Board should prioritise.
- These slides cover
  - background information on the project;
  - overview of investor feedback and profile of investor outreach;
  - recap of the sections in the DP that generated the largest volume of responses from investors;
  - summary of feedback received from investors;
  - an overview of other stakeholders' views about the proposals (see Appendix); and
  - questions for CMAC members.

Introduction

- The Financial Instruments with Characteristics of Equity (FICE) project is a Research project.
- Project objectives
  - improve the information that entities provide in their financial statements about financial instruments that they have issued
  - address challenges with applying IAS 32 *Financial Instruments: Presentation* in practice
- Currently processing the feedback and preparing for Board discussions.



More information can be found on the FICE project page on our website.
https://www.ifrs.org/projects/work-plan/financial-instruments-with-characteristics-of-equity/

High level overview of topics in the FICE DP

- Broadly speaking, the DP covered 3 topics:

Classification	•Still a single distinction (liability or equity) •Clarified principles •Limit classification changes that are well understood
Presentation	• Separate presentation for liabilities • Expanded statement of changes in equity
Disclosure	• Consider investor information needs re: dilution, liquidity, solvency, priority on liquidation, terms and conditions

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Summary of feedback from investors

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Overview of the investor feedback

- Investors were generally more interested in some topics—namely presentation and disclosure—than others. Not all investors provided comments on every area of the

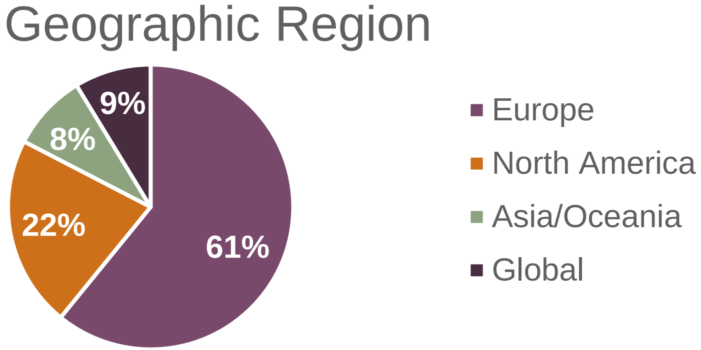
DP Proposals	Investor feedback
Separate presentation of financial liabilities with equity-like returns	General support—liabilities are sufficiently different in nature that separate presentation would result in useful information. Mixed views expressed on presenting returns in OCI or profit or loss.
Attribution requirements for equity instruments	Some investors found the objective of the attribution requirements useful, but said the resulting information as proposed in the DP would be a 'nice to have' rather than a necessity.
New disclosures for financial liabilities and equity instruments	General support from investors.

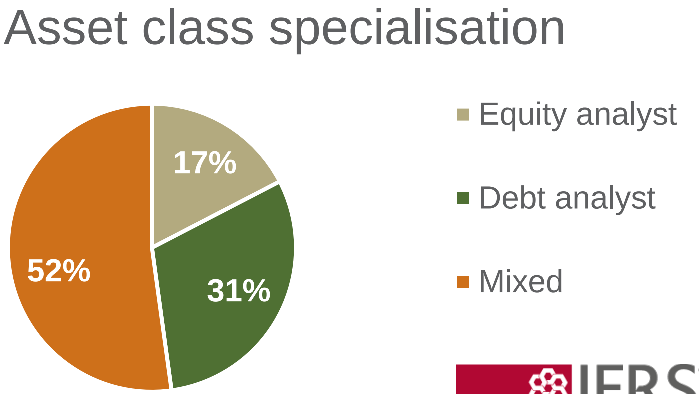
Overview of the investor feedback (cont.)

- Some investors acknowledged the trade-off between costs and benefits ie complexity vs transparency in making changes to IAS 32.
- Some investors questioned whether the presentation and disclosure proposals in the DP would apply to employee share-based compensation within the scope of IFRS 2.

Profile of investor outreach

- The Board and staff attended 18 outreach meetings/events with investors.
- 5 comment letters were received from investors.
- We also considered specific investor feedback gathered through outreach by a national standard setter.
- Meetings covered a wide variety of investors based in various geographical locations from those specialising in banking to others covering markets more generally.
- There was a mix of equity and credit-oriented investment professionals.





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Overview of feedback to DP’s proposals on Presentation

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Recap: DP proposals for presentation of equity instruments

Attribution within equity

- **For non-derivative equity instruments** present separately the amount of dividends paid/declared on ordinary shares and other equity instruments such as preference shares.

- **For derivative equity instruments** the Board considered more than one method to show value transfers between potential ordinary shareholders (ie own equity derivative holders) and ordinary shareholders, eg allocate income equal to changes in fair value of the derivatives.

  DP indicated that the Board has not formed a preliminary view on the preferred method.

Summary feedback—Presentation of equity instruments

Limited support for attribution. Some investors said it is a 'nice to have' rather than a necessity.

Some were in favour…

- Isolation of profits and OCI attributable to equity in aggregate and then attribution to each class of equity instruments was supported by equity investors.
- Information about potential shareholders (ie holders of unexercised options) would be useful for the convertible bond market.
- Attribution for non-derivative equity instruments, eg dividends paid to non-cumulative preference shares and ordinary shares, was supported by some investors.

Some expressed concerns…

- Not appropriate to allocate current period profit to future or potential shareholders that do not have the right to dividends or other returns.
- Fair values of derivatives on own equity are not so useful because many factors affect fair value including the use of management assumptions and valuation models—more interested in cash flows or the disposal values.

Recap: DP proposals for separate presentation of financial liabilities

Financial liabilities that have "equity-like" returns (ie amount that depends on the entity's available economic resources)

Statement of Financial Position

Separate line item in the statement of financial position

Statement of financial performance

Present in other comprehensive income (OCI) without recycling

Summary feedback—Presentation of financial liabilities

General support—financial liabilities with “equity-like” returns are sufficiently different in nature that separate presentation would result in useful information.

Mixed views on presenting returns (income and expenses) in OCI or profit or loss, and if OCI is to be used, on whether there should be subsequent recycling from OCI to profit or loss.

Some were in favour of OCI without recycling

- Do not consider such items of income/expenses as a measure of the issuer’s core operations.
- Presenting in OCI is consistent with presentation of own credit gains and losses.
- A non-recycling approach removes the profit or loss volatility in future periods.

Some would prefer…

- Presentation within profit or loss because OCI is perceived to lack transparency—many analysts currently do not focus on OCI.
- Presentation in OCI but with recycling because the timing of realisation should be very clear (ie upon settlement).

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Overview of feedback to DP's proposals on Disclosure

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Recap: DP proposals for disclosure

- The Discussion Paper explores possible requirements to disclose:

a) the priority of financial instruments on liquidation
b) the maximum dilution of ordinary shares
c) terms and conditions that are relevant to understanding of the timing or the amount feature

a) Summary feedback—Priority of claims on liquidation

Support from debt investors and debt analysts

Some were in favour…

- Disclosures of this information is useful in analysing which instruments of the capital structure have access to the operating cash flows of an entity.
- Despite the challenges listed on this slide, disclosure of priority of claims is better than users presuming priority based on limited information—“some information is better than none”.

Some highlighted challenges…

- In complex (international) group structures ranking financial liabilities and equity instruments is challenging.
- There may be structural subordination within the group structure that could be difficult to capture.
- Excluding non-financial liabilities could be misleading.
- Information on priority based only on contractual terms without considering laws and regulations may be incomplete.

b) Summary feedback—Maximum dilution of ordinary shares

General support from equity investors and equity analysts

- Very informative, provides more transparency.
- Helps investors assess the distribution of returns among equity instruments and how this may change in the future.

But some suggested…

- Disclosures be supplemented with scenario or sensitivity analysis eg if share price increases by x%, maximum dilution would be Y.

Although some preferred…

- Having sufficient information about the inputs to enable them to do their own analysis.

c) Summary feedback—Terms and conditions

Strong support from investors

- Source of information from which analysts can perform their own scenario analyses and potential lenders can perform their own fair value valuations.
- Financial statements do not currently provide comprehensive disclosure about terms and conditions for financial instruments.
- Some investors particularly mentioned that it would be useful to disclose particular terms and conditions affecting cash flows eg early redemption and step-up clauses and information about covenants associated with outstanding claims.

BUT investors generally suggested a balance between providing information that is sufficiently granular and disclosure overload

- Disclosures should provide a summary of key features and material information about the entity's capital or financing structure to avoid disclosure overload.
- Reference could be made to other documents for further information eg prospectuses.

Overview of feedback to DP’s proposals on Classification

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Classification: basic idea of the DP proposal is…

A financial instrument issued by an entity is a financial liability if the answer is yes to one or both of the following questions

Can the issuer be required to pay cash or to hand over another financial asset before liquidation?

Timing feature

Has the issuer promised a return to the instrument's holder regardless of the issuer's own performance or share price?

Amount feature

Otherwise, it is an equity instrument

High level classification impact of DP proposals

- Limited changes in classification for most simple instruments.
- The most prominent classification changes confirmed by feedback was for:
  - Cumulative perpetual instruments change from equity to financial liability (see slide 22).
  - FX rights issues (that meet exception under IAS 32) change from equity to financial liability.

Summary feedback—Concerns over changes in classification

Some investors were concerned about classification changes for particular financial instruments

- **Potential reclassification from equity to financial liability**—Some perpetual financial instruments with fixed cumulative returns would change from equity to liabilities applying the Board's preferred approach. This is because of the contractual obligation in these instruments to pay an "independent amount" on liquidation.
- **Concern about potential market disruption**—If the DP proposal results in IFRS amendments, some investors were concerned about potential market disruption from these instruments. This is because these instruments often contain accounting call options that allows the issuer to call the instruments at a fixed price in the event of a change in accounting classification.
- Other stakeholders expressed similar concerns.

Summary feedback—other classification matters

- Other comments on classification received from some investors:

In favour of classification principles that can be applied consistently.

Support retention of the 'puttables exception'.

Agree that economic compulsion and the effect of laws and regulations should not affect the classification and prefer disclosure of management's intentions and the effects of laws and regulations. Some highlighted the importance of "substance over form".

Financial analysis is done on the basis of a going concern assumption—they found the 'amount feature' to be inconsistent with that assumption.

Questions for CMAC members

- Do you have any particular views on the feedback summarised in this pack that you would like to share?
- Do you have any additional feedback you would like to bring to the Board’s attention?
- On the basis of the feedback summarised in this pack and your own experience, what areas (eg disclosure) do you think the Board should prioritise?

Next steps for the project

- Meetings with stakeholders at other IASB consultative group meetings (GPF, ASAF) during 2019.
- Continue re-deliberations with the Board during 2019—The Board will decide on project direction.

Appendix: feedback from other stakeholders

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Feedback: presentation of financial liabilities

Mixed views on separate presentation using OCI without recycling

- Some agree that particular types of financial liabilities are sufficiently different in nature that disaggregation would be useful, especially, in the statement of financial position.
- Some find the notion of separating financial liabilities and its scope to be complex.
- Some, without expressing their view on the separate presentation itself, raise concerns with expanding the use of OCI, which in their view, is inconsistent with the Conceptual Framework.
- Opponents of using OCI without recycling have split views between:
  - still using OCI but with recycling and
  - separate presentation within profit or loss.

Feedback: presentation of equity instruments

Broad disagreement with the proposed approach

- Significant concerns expressed on the proposed attribution, especially for derivatives—viewed as too complex and costly to be operational and useful to users of financial statements.
- Question the usefulness of information resulting from attribution of current period income and expenses to those who are not yet shareholders of the entity.
- Although not supporting the proposed attribution, general agreement that information provided in the financial statements with respect to equity instruments should be improved.

Feedback: disclosures

- General support observed for disclosure proposals.
- Suggestion that IAS 33 or other IFRS Standards have room for improvement to provide more useful information about equity instruments.

Priority on liquidation	• General agreement while acknowledging that **challenges** exist, for example, providing priority information is particularly challenging for **a group with multiple subsidiaries** in different jurisdictions.
Maximum dilution of ordinary shares	• General support, however, some highlighted **differences in scope** compared to IAS 33.
Contractual terms and conditions	• Broad agreement whilst recognising the **challenge** on **the level of aggregation and disclosure overload**, especially for entities with complex capital structures. • Some suggest **narrowing its scope**, for example, to only include issued financial instruments or financial instruments for which classification involves significant judgement. • Potential duplication highlighted, considering the information currently provided by certain industries (for example, Pillar 3 disclosure for banks).

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