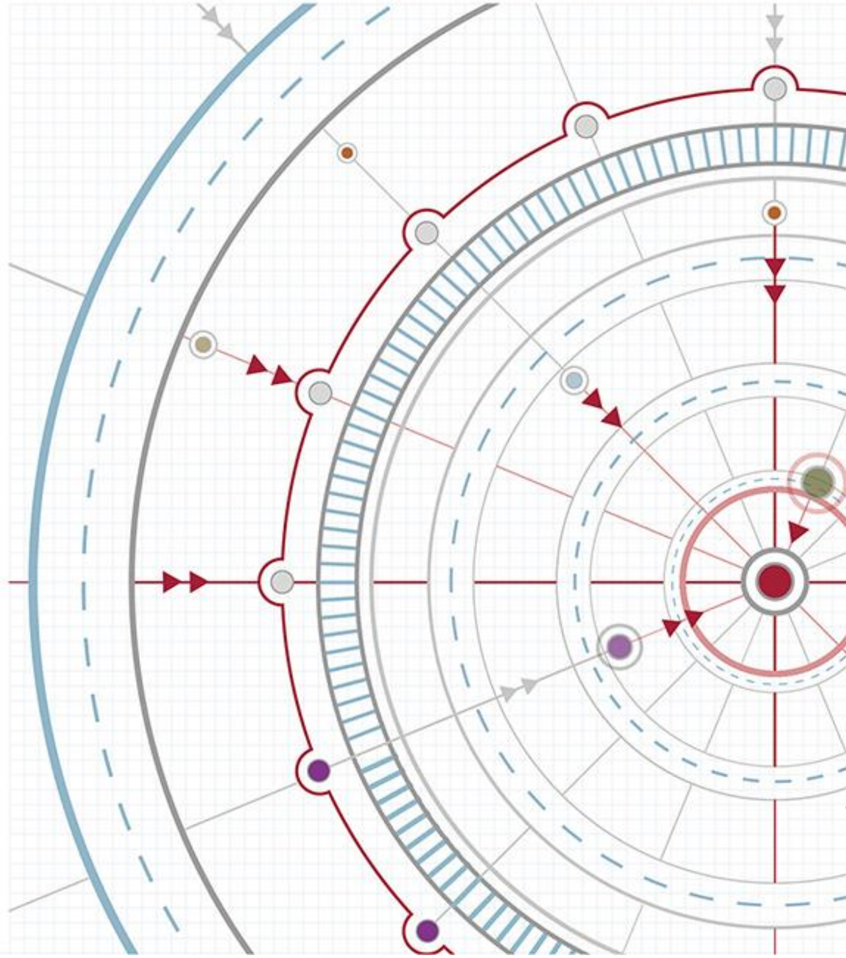

Financial Instruments with Characteristics of Equity

Key themes emerging from feedback

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Purpose of this presentation

- This presentation provides key themes emerging from feedback received on the Discussion Paper *Financial Instruments with Characteristics of Equity* through comment letters and outreach activities.
- At this session we are not asking the Board any question.
- The Staff plan to bring detailed comment letter analysis at future Board meetings.

Please note this presentation provides a high level summary of the comments received through comment letters and outreach activities—it is not an exhaustive analysis of all views expressed. This summary should be read as indicative only.

Structure of this presentation

- Key themes emerging from feedback (excluding feedback from investors[1])
  - Overview (slide 5)
  - Challenges identified by the Board and the Board's approach to address them (slides 7-11)
  - Classification (slides 12-19)
  - Presentation and disclosure (slides 20-25)
  - Contractual terms and interaction with other IFRS Standards (slides 26-29)
- Summary of feedback from investors (slides 30-41)
- Appendix 1 – Respondents' profile (42-48)

[1]Investors (ie users of financial statements)

IFRS

Key themes emerging from feedback (excluding feedback from investors)

Overview

- Wide acknowledgement of the importance of the subject.
- General support for retaining a binary distinction between liabilities and equity.
- The feedback suggests that the Discussion Paper is perceived as a fundamental change from IAS 32 for reasons including:
  - use of new terminologies that would require significant efforts to assess potential effects and to implement if they were to be finalised.
  - classification change for particular types of financial instruments (see slide 17).
- Suggestion that the articulation of the Board's preferred approach and the related notions be further clarified.

Structure of the following sections

- For ease of reference, we have included a summary of the Board’s preliminary views for each of the key sections of the Discussion Paper. These slides are titled “Recap”.
- The slides that summarise the feedback from respondents are titled “Feedback”.

Challenges identified by the Board and the Board's approach to address them

Key themes emerging from feedback

Recap: challenges and response

The Discussion Paper identified the following challenges

Conceptual challenges:

- A lack of clear basis/rationale for classification

Application challenges:
For example,

- Application of fixed-for-fixed requirements to derivatives on own equity
- Written puts on non-controlling interests
- Contingent convertibles

The Board's proposals in the Discussion Paper were to:

- Articulate the classification principles with a clear rationale
- Provide additional information through presentation and disclosure

The Discussion Paper asked whether respondents think standard-setting activity is required to address the challenges identified?

Feedback: how to address the challenges?

General support for standard-setting to address known practice issues <u>but</u> mixed views on how

Addressing application challenges with respect to complex financial instruments should be prioritised.

Some suggest a more fundamental review to address broader conceptual challenges either as a follow up or instead of a project focusing on addressing practice issues.

In addition, what did we learn from outreach activities and comment letters?

- When developing the Discussion Paper, the Board was aware that IAS 32 works well for **most** financial instruments but presents challenges for some **complex** financial instruments.
- Feedback received through comment letters and outreach activities:
  - **confirmed** that financial innovation has resulted in a large variety of financial instruments with characteristics of equity, some of which present **challenges when applying IAS 32**.
  - highlighted that accounting diversity in practice is **more significant and widespread than expected** by the Board. In particular, the interpretation of the fixed-for-fixed requirement in practice seems to be broader than anticipated.

Overview – feedback on the key components of the Board's preferred approach

Classification

- Timing feature
- Amount Feature
- Contractual terms

Presentation

- Separate presentation of financial liabilities
- Attribution within equity

Disclosure

- Priority on liquidation
- Maximum dilution of ordinary shares
- Terms and conditions

Key

- Green: Broadly agree with some limited qualification/question
- Amber: Partially agree with a number of concerns
- Red: Broadly disagree and a significant level of concerns raised

Classification

Key themes emerging from feedback

Recap: classification of non-derivative financial instruments

- Use the timing and the amount features to classify a non-derivative financial instrument, ie classify as a financial liability if it contains:
  - (a) an unavoidable contractual obligation to transfer economic resources at a specified time other than at liquidation (the ‘timing feature’); and/or
  - (b) an unavoidable contractual obligation for an amount independent of the entity’s available economic resources (the ‘amount feature’).
- This is because information about both of these features is relevant to assessments of (i) the entity’s funding liquidity and cash flows and (ii) the entity’s solvency and returns.
- Provide information about other features of a financial instrument through presentation and disclosure.

Recap: classification of derivatives on own equity

- Classify derivatives on own equity as follows:

  (a) a derivative on own equity would be classified **in its entirety** (ie the individual legs of the exchange would not be separately classified) **as an equity instrument, a financial asset or a financial liability**; and

  (b) a derivative on own equity is classified as a **financial asset** or a **financial liability** if:

  i. it is net-cash settled (the ‘timing feature’); and/or

  ii. the net amount of the derivative is affected by a variable that is independent of the entity’s available economic resources (the ‘amount feature’).

Classification – general themes emerging from feedback

Concerns expressed about the Board’s preferred approach to classification, in particular, regarding the amount feature.

Questions on the need for the new terminologies and clarity of some terms, for example, “independent amount” and “available economic resources”.

Agreement that information about features of financial instruments other than timing and the amount feature (for example, priority) should be provided through presentation and disclosure.

Feedback: amount and timing feature

Timing feature

General support for the timing feature

- Consistent with existing requirements in IAS 32
- Questions raised on the meaning of the term ‘liquidation’ because in the context of certain industries such as banks, a resolution will take place before or instead of liquidation.

Amount feature [2]

Concerns expressed about the amount feature

- Conceptual: inconsistent with the Conceptual Framework[3] (CF)
  - The amount feature that includes obligations only arising on liquidation is inconsistent with the ‘going concern’ principle in the CF.
  - The concept of ‘unavoidable obligation’ is inconsistent with ‘practical ability to avoid’ in the CF.
- Articulation: concerns on the clarity of how the amount feature and the related notions are articulated, for example, solvency assessment.

[2] We received a high number of comments on the amount feature. Those comments are nuanced and complex, consequently, we will provide the Board with further details of the feedback on the amount feature among others at future meetings through the detailed comment letter analysis.

[3] The Conceptual Framework for Financial Reporting. The Board issued the revised Conceptual Framework in May 2018.

Feedback: classification of non-derivative financial instruments

- Concerns raised with classification change from equity to liabilities for financial instruments that contain an obligation to pay an "**independent amount"** that can be deferred at the issuer's option **until liquidation** - many Additional Tier 1 capital instruments issued by banks and perpetual instruments issued by corporates contain this feature.

- Questions on whether contingent settlement outcomes should affect the classification or the measurement of a financial instrument.

- Support for retention of the puttables exception.

Feedback: classification of derivatives on own equity

Agreement that derivatives on own equity should continue to be classified in their entirety

Concerns expressed about the Board's preferred approach to classifying derivatives

- Acknowledgement that classification of derivatives on own equity gives rise to application challenges and therefore, guidance and/or clarification on the fixed-for-fixed requirements may be useful.
- However, applying the **amount feature** may not be significantly simpler than the current fixed-for-fixed requirements and new interpretative issues may arise.
- Questions on what is meant by the "net amount" or the "independent variables".
- Some expressed concerns on the removal of FX rights issue exception. In their view, the reasons that led to the FX rights issue exception still remain relevant.

Recap and Feedback: compound instruments and redemption obligation arrangements

- Recap: The Discussion Paper includes discussion on how an obligation to extinguish own equity instruments, for example, written put options on non-controlling interests (NCI puts), should be classified using the Board's preferred approach.

Mixed views on classification of redemption obligation arrangements, NCI puts in particular

- Broad agreement with recognising a liability for the obligation to redeem shares in NCI puts (consistent with IAS 32).
- Some highlight what they perceive as economic difference between a written put on own shares and a convertible bond.
- Some question the usefulness of information resulting from derecognising a NCI on which put options are written whilst the shares issued by the subsidiary to the NCI are still outstanding.
- Questions raised around the unit of account, in particular on what constitutes the package of contractual rights and obligations that need to be considered together for classification purposes.

Presentation and disclosure

Key themes emerging from feedback

Recap: 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

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 CF.
- Opponents of using OCI without recycling have split views between:
  - still using OCI but with recycling and
  - separate presentation within profit or loss.

Recap: presentation of equity instruments

- **For non-derivative equity instruments –** present on the face of the statement of financial performance the amount of dividends (ie the amount required to be adjusted for when calculating basic EPS in accordance with IAS 33 *Earnings Per Share*).

- **For derivative equity instruments –** the Board considered the following methods, without forming a preliminary view:
  (a) a full fair value approach (presenting changes in the fair value of derivatives as their share of income)
  (b) the average-of-period approach (apportioning the current period income using the ratio of average of period fair value of ordinary shares and derivatives)
  (c) the end-of-period approach (apportion the reporting date book value of equity using the fair value of ordinary shares and derivatives at that date)
  (d) not requiring attribution, but using disclosure.

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).

Contractual terms and interaction with other IFRS Standards

Key themes emerging from feedback

Recap: contractual terms

- Economic compulsion
  - When classifying a financial instrument issued, an entity **should not consider** economic incentives that might influence the entity's decision to exercise its rights.
  - The indirect obligation requirements in IAS 32 **should be retained**.

- Interaction with law
  - An entity should classify financial instruments based on the contractual terms (ie should **not consider** rights and obligations that are **not contractual**, eg law)—consistent with the existing scope of IAS 32.

Feedback: economic compulsion and interaction with law

Economic compulsion: general agreement with not considering economic compulsion in classifying financial instruments

- Agreement because considering economic incentives when classifying a financial instrument would require frequent reassessment, use of probability which would add judgement and complexity.
- Encouragement to consider improving clarity of the current requirements in areas such as determining whether a settlement option is substantive and the scope of indirect obligation.

Interaction with law: general agreement that classification should be based on contractual rights

- While agreeing with the Board's preliminary view, many consider that distinguishing contractual and legal/statutory obligations is not always clear, for example, what happens on liquidation may only be set out in statutes.
- Encouragement to consider providing guidance in this area.

Interaction with other IFRS Standards

- The interaction between the proposals in the Discussion Paper and existing requirements in IFRS Standards was highlighted. For example:

Interaction between the proposals in the Discussion Paper and **Conceptual Framework**

Interaction with measurement requirements in **IFRS 9**

Would presentation and disclosure proposals apply to **IFRS 2** instruments?

What are the implications of **IFRS 10** on accounting for NCI puts?

Consider improvements to **IAS 33**

Agree with retaining conclusions in **IFRIC 2**

Summary of feedback from investors

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 Discussion Paper.

Discussion Paper proposals	Investor feedback
Separate presentation of financial liabilities	General support – liabilities are sufficiently different in nature that separate presentation would result in useful information. Mixed views expressed on presenting income and expenses 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 Discussion Paper 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 acknowledge the trade-off between costs and benefits ie complexity vs transparency in making changes to IAS 32.
- Some investors question whether the presentation and disclosure proposals in the Discussion Paper would apply to employee share-based compensation within the scope of IFRS 2.
- Some investors welcome classification principles that can be applied consistently.

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Presentation

Summary of feedback from investors

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, for example 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.

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, 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).

Disclosure

Summary of feedback from investors

Priority of claims on liquidation

Support from debt investors and debt analysts

Some were in favour…

- Disclosure 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.

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 for example, 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.

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 for example, early redemption and step-up clauses and information about covenants associated with outstanding claims.

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

- Disclosure 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 for example, prospectuses.

Classification

Summary of feedback from investors

Feedback on classification proposals

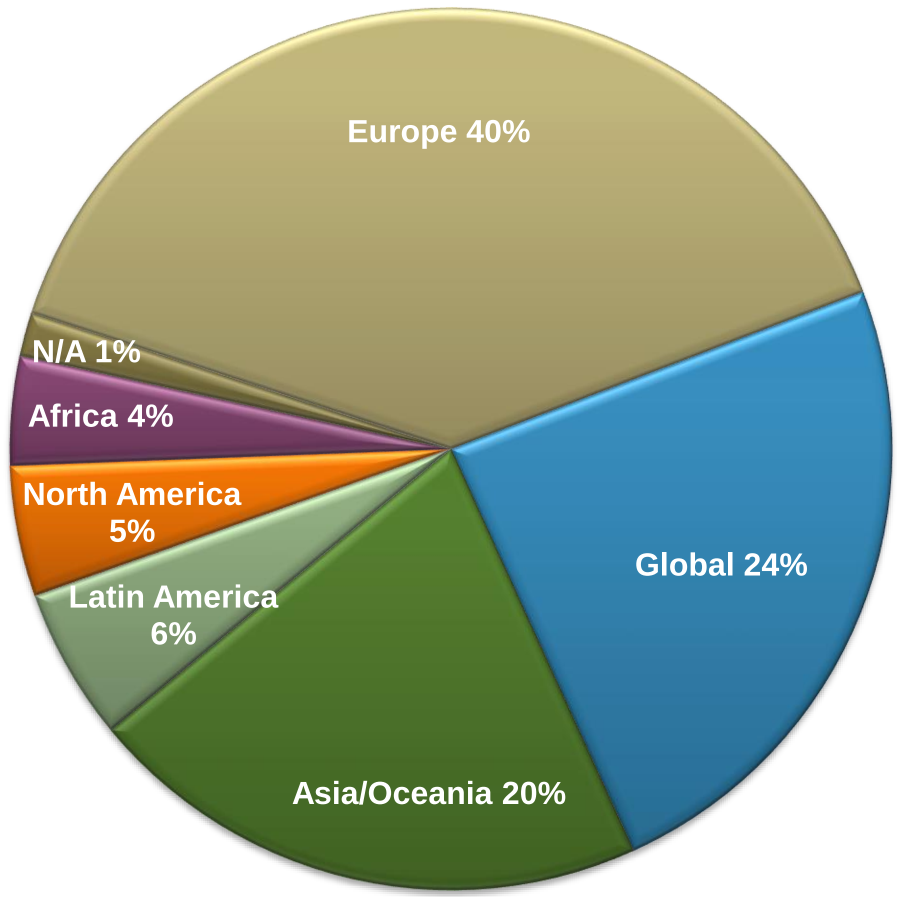
- Some investors were concerned about classification changes for particular financial instruments. For example, classification changes for some perpetual financial instruments with fixed cumulative returns as explained on slide 17.
- Some mentioned potential market disruption. This is because these instruments 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.
- The following comments were also provided:
  - Financial analysis is done on the basis of a going concern assumption and they found the “amount feature“ to be inconsistent with that assumption.
  - Support retention of the “puttables exception“.
  - Agree that economic compulsion and the effect of laws and regulations should not affect the classification decision and prefer disclosure of management’s intentions or expectations and how laws and regulations could affect settlement outcomes. At the same time, some highlighted the importance of “substance over form”.

Appendix 1 – Respondent’s profile

General respondents' profile

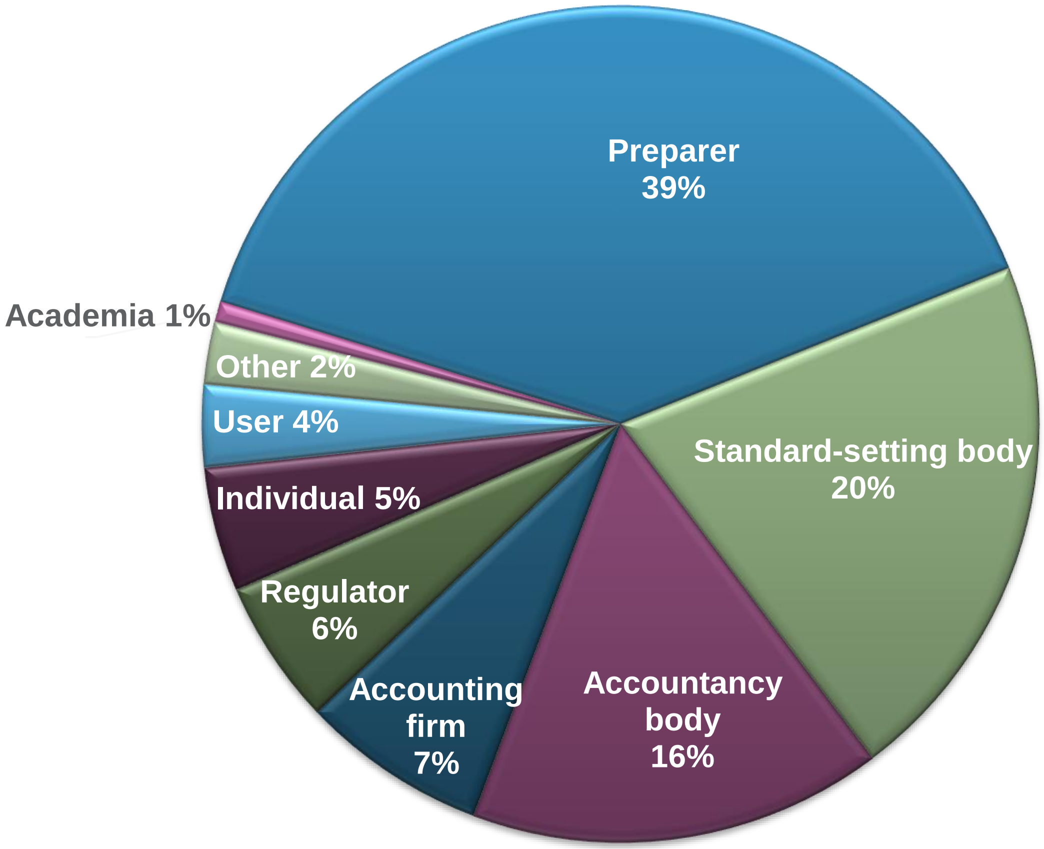
Respondent's profile – geographical region

- **126 Comment Letters received**



Respondent's profile – respondent type

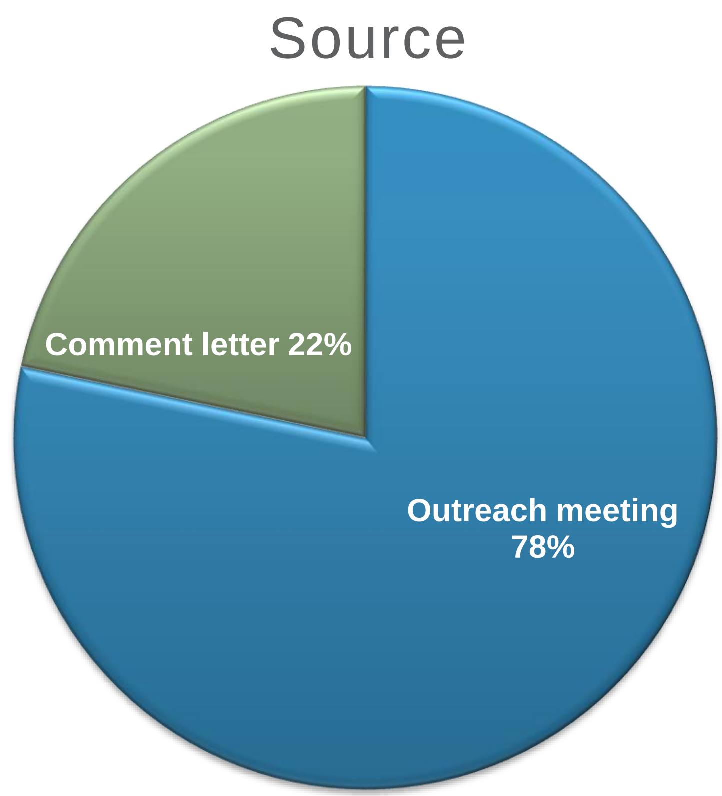
- **126 Comment Letters received**



Investors' profile

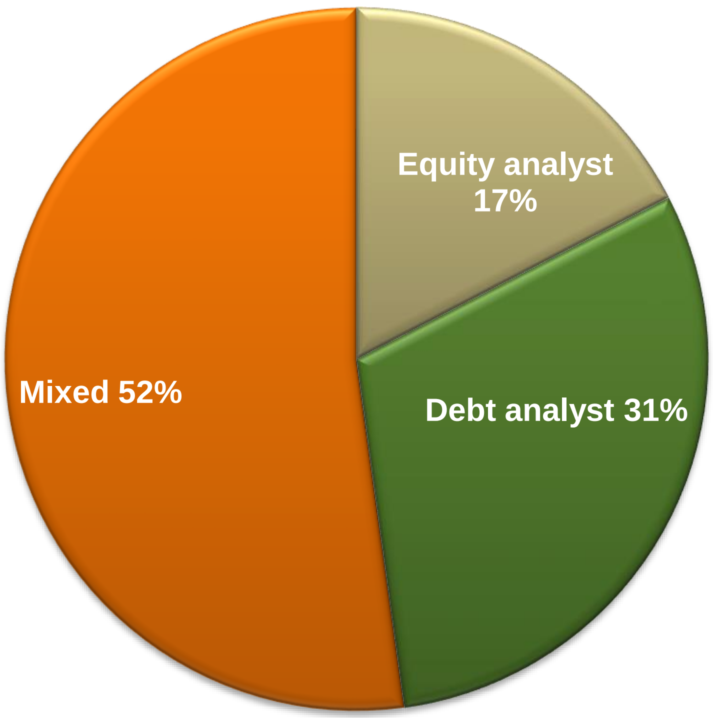
Source of feedback

- 18 Outreach meetings
- 5 Comment letters received

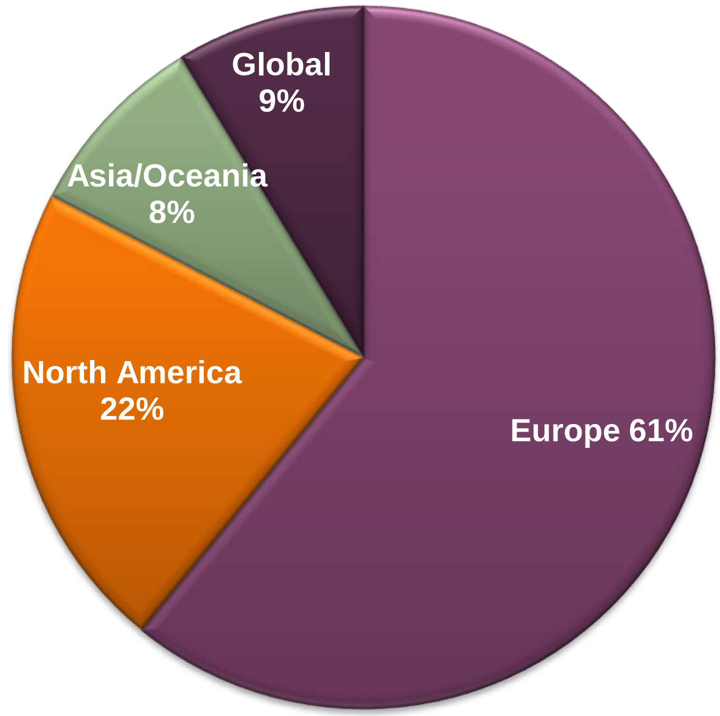


Profile of investor outreach

Asset class specialisation



Geographic Region[4]



[4] This chart provides a geographical representation of all investors that we spoke to based on their location. However, the market coverage of these investors could be wider than their geographic location.

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