Financial Instruments with Characteristics of Equity - Early stage impact assessment of the DP's proposals

Survey Questionnaire: Users of financial statements

Introduction

On 28 June 2018, the IASB published the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP) focused on proposals for changes to the classification, presentation and disclosure requirements of financial instruments with characteristics of equity. You can access background material on the IASB DP through this link (here).

On 28 August 2018, EFRAG issued its draft comment letter with a comment period deadline of 3 December 2018. During the consultation period, EFRAG is conducting an early stage impact assessment of the DP's proposals and the findings will be reflected in EFRAG's final comment letter.

This early stage impact assessment is intended to help EFRAG and its constituents understand the potential impact, expected benefits and costs of the proposed approach on classification and presentation of financial instruments. If you have any views on the DP's proposals, you are encouraged to provide such comments by responding to EFRAG's public consultation on the IASB's DP (here).

This survey, which is targeted at users of financial statements, is part of the impact assessment exercise. The related questionnaire includes background questions as well as questions on the potential impact including the expected costs and benefits of changes if the IASB DP proposals were to be adopted.

The survey should take approximately 30 minutes to complete. You can interrupt it at any time and come back to where you left, if needed. To do that, use "Save and continue later" menu available in the top right corner of the following pages.

The online response or completed questionnaire should be received by EFRAG before 26 November 2018.

Background information

Please provide the following information about your background.

(a) What is the most appropriate description of your role?*

- Portfolio Manager
- Analyst - Buy side
- Analyst - Sell Side
- Other

Please specify:

(b) Please indicate the asset class that you predominantly focus on- select all that apply:*

- Public Equity
- Private Equity
- Debt (bonds, loans)
- Hybrids (convertibles, bail-in instruments)
- Alternatives (real estate, commodities)
- Other

Please specify:

(c) How would you describe your sectoral coverage?*

- Generalist covering multiple sectors
- Specialist only covering a single sector

(d) If you are a specialist, what sector do you cover?*****

- Entities that predominantly focus on banking activities
- Entities that predominantly focus on insurance activities
- Other financial institutions
- Non-financial institutions

Please indicate the other type of financial institutions:

Please describe the non-financial institutions:

(e) Please specify whether the companies you cover apply IFRS.*****

- Yes
- No
- Apply both IFRS Standards and other GAAPs

(f) Do you cover companies in the European Economic Area (EU, Norway, Liechtenstein and Iceland)?*****

Yes

No

(g) Apart from the EEA, which other regions do you cover companies- select all that apply?

Other Europe

North America

Asia-Pacific

Other Markets (South and Central America, Middle East/Africa)

(h) May we contact you if we have questions about your response?**

No

Yes

If so, please provide your contact details:

Financial statements' analysis under current accounting requirements

How informative do you consider the distinction of liabilities versus equity within IFRS financial statements to be relative to this distinction by rating agencies methodologies?

More informative than rating agencies' frameworks

Equally informative to rating agencies' frameworks

Less informative than rating agencies' frameworks

No opinion

If applicable to the sectors you analyse, how informative do you consider the distinction of liabilities versus equity within IFRS financial statements to be relative to this distinction within regulatory reporting frameworks?

- More informative than regulatory reporting frameworks
- Equally informative to regulatory reporting frameworks
- Less informative than regulatory reporting frameworks
- No opinion/Not applicable

For the following aspects of analytical evaluation, please indicate how useful you find IFRS based financial statements information including the distinction made between liability and equity on the statement of financial position and related disclosures in the notes:

	Usefulness of IFRS based financial statement information			
	Not useful	**Partially useful**	**Useful**	**No opinion**
Assessment of liquidity and cash flows	( )	( )	( )	( )
Assessment of balance sheet solvency	( )	( )	( )	( )
Assessment of total returns on financial liabilities and equity instruments including periodic returns (dividends, interest), fair value changes	( )	( )	( )	( )

and gains/losses on disposal				
Assessment of priority of financial liabilities and equity instruments on liquidation or reorganisation	( )	( )	( )	( )
Assessment of participation in upside of returns	( )	( )	( )	( )
Assessment of potential dilution of Earnings Per Share (EPS) due to secondary equity claims	( )	( )	( )	( )

In your assessment of companies, do you rely on any Non-GAAP measures instead of, or in addition to, the liabilities and equity related line items presented on the income statement and balance sheet?

No

Yes

If so, please elaborate on the Non-GAAP measures that you rely on:

If applicable, please describe any other relevant information on financial liabilities and equity instruments but find such information to be either deficient or non-existent in the financial statements of IFRS reporting companies.

Please elaborate on your answer:

IASB DP Proposal for classification

The IASB DP articulates new classification principles by describing two features for defining a financial liability. A claim is a financial liability if either (or both) of the following apply:

(a) the timing feature, which defines a financial liability as a contractual obligation to transfer a financial asset (e.g. cash) at a specified time other than at liquidation. An example of the definition of a financial liability based on only the timing feature would be preference shares puttable at fair value. For this instrument, the issuer entity has an unavoidable contractual obligation to transfer cash at a specified time other than at liquidation.

(b) the amount feature, where the contractual settlement amounts are independent of an entity's available economic resources. An example of the definition of a financial liability based on only the amount feature would be an undated cumulative bond or non-redeemable cumulative preference share with a stated coupon or dividend amount that is specified rate of return or a specified amount of cash. The issuer entity can postpone the payment until liquidation but the entity still has to pay an amount (at liquidation or earlier) that does not change in response to the entity's available economic resources. Equity is a residual category (i.e. a claim is equity if it is not defined as a liability based on amount and timing features).

Instruments with expected changes in classification

Cumulative financial instruments, including perpetual cumulative hybrid securities are currently classified as equity in their entirety whenever the issuer has the unconditional right to defer payment of any coupons or principal.

Under the IASB DP proposals, the classification of undated or perpetual bonds (vanilla, convertible and contingent convertible) may change from equity to financial liability if such instruments have a payment deferral cumulative feature (e.g. issuer has the right to defer but not cancel the payment of interest).

Besides perpetual bonds, the proposals in the DP would impact the classification of:

(a) *Non-redeemable fixed-rate cumulative preference shares:* change from equity under IAS 32 to financial liabilities.

(b) *Derivatives on own equity that are settled in or have exposure to foreign currency and currently meet the foreign currency rights issue exception*: change from equity under IAS 32 to financial liabilities.

(c) *Net-share settled derivatives on own equity*: change from financial liabilities under IAS 32 to equity.

Questions - Potential effects of changes in classification:

Do you currently analyse entities that have undated or perpetual bonds with a payment deferral cumulative feature (e.g. the entity has the right to defer but not cancel the payment of interest)?

- ○ Yes
- ○ No
- ○ Do not know

If yes, what is your expectation of the impact on your perception of the effective leverage ratios if, as proposed by the IASB DP, undated or perpetual bonds that have a payment deferral cumulative feature (i.e. the entity has the right to defer the payment of interest but not to cancel them) were classified as liabilities instead of equity.

- ○ Insignificant
- ○ Significant
- ○ Very Significant
- ○ Difficult to assess

The IASB DP highlights that changes in classification will occur for net share settled derivatives on own equity, foreign currency rights issues, non-redeemable fixed rate cumulative preference shares. In your experience, are any of these financial instruments generally issued by the companies that you follow at such a level that a change in classification can materially impact your assessment of the leverage of these companies?

- Yes
- No
- Do not know

If yes, please explain which of these instruments can have a material impact on your assessment of the leverage of these companies:

In your experience, have you encountered any financial instruments where the classification between liability or equity is unclear?

- Yes
- No

If yes, please elaborate on the type of instruments you consider to have an unclear accounting classification:

IASB's proposals for presentation – financial liabilities

Statement of financial performance

The IASB DP proposes that financial instruments that will be classified as financial liabilities but have equity like returns (i.e. the amount of the liability depends on the entity's performance or value of its own shares) should have their changes in value presented in other comprehensive income (OCI) and that reclassification (recycling) from OCI to profit and loss is not allowed. For example, shares redeemable at fair value would be accounted for as liabilities with changes in fair value presented in OCI with no recycling.

See illustrative example of potential presentation of financial liabilities here.

Questions on presentation of financial liabilities on the statement of financial performance:

Please indicate the usefulness of the following aspects of the IASB DP proposals for the presentation of financial liabilities on the statement of financial performance:

	Your expectations on usefulness			
	Not useful	**Partially useful**	**Useful**	**No opinion**
Remeasurements of financial liabilities with equity like returns (such as shares redeemable at fair value) presented in OCI	( )	( )	( )	( )
Not allowing the reclassification (recycling) of OCI gains or losses to profit or loss	( )	( )	( )	( )

Statement of financial position (balance sheet)

The IASB DP proposes requirements for separate presentation of both derivative and non-derivative financial liabilities that have equity-like returns in the statement of financial position.

The IASB DP also proposes that financial liabilities be presented by order of priority in liquidation on the face of statement of financial position. Some companies present their balance sheet assets in order of liquidity.

See illustrative example of potential presentation of financial liabilities here.

Questions on presentation of financial liabilities on the statement of financial performance:

Please indicate the usefulness of proposed presentation changes to the statement of financial position (balance sheet).

	Your expectations on the usefulness			
	Not useful	**Partially useful**	**Useful**	**No opinion**
Disaggregation of statement of financial position (balance sheet) with separate presentation for financial liabilities that have equity-like returns	( )	( )	( )	( )
Presentation of financial liabilities by order of priority in liquidation on the face of statement of financial position (balance sheet). Currently some companies present their	( )	( )	( )	( )

balance sheet assets by order of liquidity				

IASB's proposals presentation - equity instruments

The IASB DP includes the idea of allocation of profit or loss and OCI to different classes of equity instruments in order to depict the wealth transfers across these instruments (i.e. attribution).

For equity instruments, the IASB DP proposes the following:

(a) currently companies separate the income statement between the group and non-controlling interests (NCI). The IASB proposes to extend this to require total comprehensive income (i.e. profit or loss and OCI for the reporting period) to equity instruments other than ordinary shares. For example, total comprehensive income would be allocated to preference shares, warrants and any derivatives of own equity that are classified as equity with the balance being allocated to ordinary shares; and

(b) update the carrying amount of equity instruments other than ordinary shares. The update would be based on the allocation described above. For example, the allocation would lead to an update of the carrying amount of preference shares, warrants. In other words, except for ordinary shares, which will always be at initial recognition value, all other equity claims will have their carrying value updated.

(c) In the IASB DP, there is a discussion of three different methods to allocate total comprehensive income to derivative equity instruments that the allocated/attributed amounts will affect the carrying values of equity securities statement of financial position and be reflected in the statement of changes in equity (please see illustrative examples in background material). The IASB also considers only disclosing the allocation/attribution instead of the presentation changes on the statement of financial position and statement of changes in equity.

See illustrative example of allocation of comprehensive income to derivatives on own equity here.

Questions on presentation of equity instruments:

For assessing how the entity's returns are distributed among different equity instruments, please indicate the expected usefulness of allocating total comprehensive income across different subclasses of equity.

- Not useful
- Partially useful
- Useful
- No opinion

For assessing wealth transfers across different holders of equity securities, please indicate the expected usefulness of updating the carrying amount of equity instruments other than ordinary shares in the statement of financial position and statement of changes in equity.

- Not useful
- Partially useful
- Useful
- No opinion

Which approach to allocation of comprehensive income to derivatives on own equity would provide the most useful information on the distribution of returns and wealth transfers across subclasses of equity. See example of possible approaches here.

- Updates to the statement of financial position and statement of changes in equity for the full fair value changes of derivatives on own equity.
- Updates to the statement of financial position and statement of changes in equity for the relative average of period fair value of derivatives on own equity.
- Updates to the statement of financial position and statement of changes in equity with end of period approach (i.e. update carrying amount for the derivatives on own equity with the net assets attributable based on relative end-of period fair values of derivatives on own equity and deduct it from the carrying amount of the derivatives at the beginning of the year).
- Only disclosure and improvements to EPS calculation requirements.
- None - Retention of current reporting requirements with no allocation of total comprehensive income to derivatives of own equity instruments
- Do not know

Please explain your choice or provide any alternative ideas:

IASB Proposals Disclosures

The IASB's DP explores requirements to disclose:

(a) The priority of claims on liquidation.
(b) The potential dilution of shares.
(c) Terms and conditions that are relevant to understanding the timing and amounts of claims on a reporting entity.

Please see illustrative examples in background material here.

Questions on disclosures:

Please indicate the usefulness of the following proposed disclosures:

	Your expectations on usefulness			
	Not useful	**Partially useful**	**Useful**	**Do not know**
The priority of claims on liquidation at consolidated entity level	( )	( )	( )	( )
Potential future dilution of shares at year end	( )	( )	( )	( )

Terms and conditions that are relevant to understanding the timing and amounts of a reporting entity's claims	( )	( )	( )	( )

Potential costs and benefits of the IASB proposals

What level of overall analytical benefits do you expect if the IASB DP proposals were to be adopted?

- None
- Insignificant
- Significant
- Very Significant
- Difficult to assess

What level of incremental analytical costs do you expect if the IASB DP proposals were to be adopted?

- None
- Insignificant
- Significant
- Very Significant
- Difficult to assess

To what extent would you expect the DP proposals to have an impact on your reliance on any Non-GAAP measures?

- Will reduce use

- Will have no impact on use
- Will increase use
- Difficult to assess
- Not applicable

To what extent would you expect the DP proposals will have an impact on the cost of capital of the companies you cover?

- Will likely decrease cost of capital
- Will likely have no impact on cost of capital
- May increase or decrease the cost of capital
- Will likely increase cost of capital
- Difficult to assess
- No opinion

How do you assess the potential trade-off between any incremental analytical costs and expected improvements in information resulting from the IASB DP proposals?

- Costs will outweigh benefits
- Costs will offset benefits
- Benefits will outweigh costs
- Difficult to assess

THANK YOU FOR YOUR PARTICPATION