DEBT OR EQUITY? HOW WOULD YOU DECIDE?

SUMMARY REPORT
LONDON 4 DECEMBER 2018



EFRAG
European Financial Reporting Advisory Group

FRC Financial Reporting Council

Photo by João Barbosa

This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by the speakers at the event.

Background

EFRAG and the Financial Reporting Council ('FRC') organised a joint outreach event with the title 'Debt or equity? How would you decide?' in London on 4 December 2018. This report has been prepared for the convenience of European constituents to summarise the event.

Participants and panellists were welcomed by the FRC Director, Accounting & Reporting Policy, Anthony Appleton.

Susanne Pust Shah, Project Director at the FRC introduced the Discussion Paper ('DP') on Financial Instruments with Characteristics of Equity ('FICE') which was then followed by the following presentations:

- Alan Chapman, Director, Grant Thornton provided 'A view from practice'
- Andrew Lennard, Research Director of the FRC discussed the 'Tentative FRC views'; and
- Andrew Watchman, EFRAG CEO and Chairman of EFRAG TEG provided an update of EFRAG's activities on the DP as well as the tentative views in its draft comment letter.

This was followed by a panel discussion and questions before the event was closed by Anthony Appleton.

Presentations by speakers

1. A view from practice

Alan Chapman said that based on his knowledge of and experience with IAS 32 *Financial Instruments: Presentation*, the key challenge with the DP would be the 'amount test' and that this has fueled significant debate in the discussions on the DP so far. He considered this to be a significant source of complexity and likened it to a risk/reward overlay on top of the 'timing test' which is similar to the requirements of IAS 32.

Alan then highlighted aspects of 'independent of economic resources' by citing examples in the DP and specifically the implications for measurement of an amount only payable on liquidation. Such an instrument may be a compound instrument with a negligible amount as liability at inception, but it may need to be remeasured to a more subjective amount if the going concern assumption comes into doubt. He thought the additional guidance in the DP for derivatives over own equity is important given the little guidance in IAS 32.

He pointed out that currently equity is the bucket at the end of the accounts with few disclosures and it is difficult to see claims on the residual. Attribution of comprehensive income may provide more information, but this would have to weighed against additional costs.

Alan expressed concern about consistency as the remeasurement of puttables (not classified as equity) is included in OCI under the proposals, but not where entity had an obligation to pay a dividend based on a specified percentage of profits. However, overall, he thought this avoids the effect sometimes called counter-intuitive, i.e. as the entity's performance improves, the profit and loss may decline due to recognition of these items in profit or loss. This is therefore a trade-off between counter-intuitive results or consistency.

He concluded that whilst the proposals codify the approach for derivatives on own equity and written puts over non-controlling interests, other areas are not addressed such as contingent settlement obligations and payments under the ultimate discretion of the shareholders such as dividends.

2. Tentative FRC views

Andrew Lennard introduced the discussion with points of agreement with the IASB's DP. These include that a binary distinction between liabilities and 'something else' should be maintained, but that such binary distinction is not sufficient and supplementary disclosures are required. He pointed out that the distinction is relative, e.g. an ordinary shareholder would consider preference shares as debt, but that would be different for a bank providing lending. Furthermore, he considered the basic ideas as evidenced by 'timing' and 'amount' features as appropriate.

However, on scope of the DP the FRC's tentative view is that a fundamental review would be welcome especially given the new terminology and complexity the DP introduces. He pointed out that it is easy to consider that the existing requirements are working well given how few instruments causes problems. Furthermore, he is not convinced that a fundamental review would require excessive changes – and how would it be possible to judge beforehand? Alternatively, the FRC would support a project focusing on disclosure and presentation as the disclosure on equity specifically, is lacking and needs to be improved.

The amount and timing tests seem to aim to reduce the claims that are classified as equity – Andrew queried whether this should be the objective given that the amount test contradicts the conceptual framework as there is no present obligation to transfer an economic resource. This is important as the amount test is the source of much complexity and so the FRC is considering whether the amount test should rather be relevant for disclosure or presentation rather than classification.

On claims that will be settled by variable number of shares, he questioned whether this is really a liability. Any change to definitions to include the issue or transfer of shares would challenge the long-standing view that own equity is not an economic resource and would result in any derivative on own shares being classified as financial assets or liabilities (i.e. not equity). Another alternative would be to focus on claims existing at balance sheet date which would mean the method of settlement would not be determinative and would be consistent with performance obligations per IFRS 15 *Revenue from Contracts with Customers*. This, however, may result in some claims being classified as equity.

Andrew asked what resulting numbers under the proposals on attribution of comprehensive income to classes of equity mean and if a share of 'performance' is to the benefit of warrant holders, is this necessarily at the expense or ordinary shareholders?

3. EFRAG tentative views

Andrew Watchman introduced his section by discussing the various interactions by EFRAG on the DP which included outreach events, bulletins, a webinar and an early stage impact analysis. He observed that when some commentators say that IAS 32 is 'broken', it is not always obvious whether the answer under IAS 32 is unclear or whether said person disagrees with the outcome.

Andrew re-iterated the concerns others mentioned about the reassessment and new uncertainties and issues that the new wording may bring which may overshadow the clearer articulation of concepts in the DP. He also explained that hybrid bonds will be classified under the DP as liabilities compared to equity generally under IAS 32. He described hybrid bonds as follows: generally perpetual with a stated rate of discretionary interest and an issuer call with periodic interest reset dates and the amount outstanding becomes payable on liquidation. Therefore, one can argue that these often act like liabilities on a going concern basis, even if some argue that they are equity on a liquidation basis.

On the proposals for presentation of liabilities, he remarked that different people have different views on whether the current presentation of liability changes dependent on the resources of the entity is counter-intuitive or not. He also observed that profit participating loans, which some would argue may create the same counter-intuitive accounting effect, would not be in scope.

Andrew remarked that current dilution disclosures required under IAS 33 *Earnings per Share* disclosures are incomplete as these do not capture instruments currently out of the money. With respect to the proposals on the presentation of equity instruments, he commented that it is not clear whether these disclosures focus on period-by-period attribution or on a cumulative basis.

The EFRAG preliminary agreement with the proposals that classification should focus on the contract rather that legal framework or economic incentives is for pragmatic reasons given the unintended consequences of a change in this regard according to Andrew. The EFRAG draft comment letter mentions that some practical issues may arise in distinguishing what is the effect of the contract and what is the effect of legislation, e.g. for 'bail-in' instruments.

Discussion

The discussion started with a question to the audience:

Do you agree that a claim should be classified as a liability if it meets either of the 'timing' or 'amount' tests?

Yes, but the amount test should exclude amounts payable only on liquidation	57%
No, classification should depend only on the timing test	29%
Yes	14%

Some in the audience thought that whilst the amount and timing features are good ideas, these need further development as the fundamental question as to what a liability is has not been answered. For example, a cumulative preference share cannot force an entity into liquidation, so a liability classification does not seem appropriate. However, delivery of shares to a certain value does 'feel' like a liability but the reason for this is harder to explain.

If one ignores the part on payment on liquidation for the amount feature, the two features are very similar, but would still make a difference when considering the classification of derivatives over own shares. There were comments that pointed to the attraction of what is known and the 'stickiness' of the IAS 32 outcomes.

The result of the poll may indicate that there is not a desire to set the bar for equity classification as high as possible. Some indicated that insurers prefer equity classification from a 'permanence' and capital perspective although some banks have indicated during outreach that liability classification may mean the ability to apply hedge accounting.

It was suggested that own shares could be considered an own resource. This avoids the need for the amount feature, but then all derivatives on own equity and all non-derivative obligations to issues own share would be classified as liabilities (i.e. not as equity). Whilst one may feel a share option "deprives" shareholders from a residual, one also has to consider that shareholders have been compensated by the receipt of the value of such option. Therefore, even if the option holder benefits the option contract means that there was an agreement to share the outcomes.

The discussion turned to economic compulsion and whether the amount feature is intended to address the most egregious cases of economic compulsion e.g. hybrid bonds. An alternative could be to include an economic compulsion concept within the basic principles rather than referring to liquidation. However, this would need to avoid the inclusion of market expectations around dividends which could result in ordinary shares being classified as a liability – such a distinction may also be difficult. There was a suggestion that concepts such as 'escalating returns' or 'value of the instrument' (i.e. deeply in the money derivatives) could help in these scenarios. The consensus was that given the lack of an underlying principle on economic compulsion, the amount feature does not solve related issues.

On possible proposals for disclosures, there was a suggestion that where the amount of a liability depends on future performance, disclosures of those terms and conditions would be useful. For equity instruments, a principle to consider would be an explanation of the type of equities in place to enable a user to understand allocation of performance. There was a caution against information or disclosure overload and that this information may be already available. It was also suggested that a disclosure objective may be useful to fill the economic compulsion gap that exists currently.

There seemed to be a consensus that whilst this was a good piece of research, to find a solution that applies to all instruments in all sectors globally is very difficult. However, as neither the FASB 2008 DP issued with an IASB wrap-around, which proposed a narrow approach to equity among other alternatives, nor the EFRAG loss-absorption model proved popular, it may not be possible to start from first principles.

Attribution of comprehensive income to equity instruments other than ordinary shares was not supported by participants. It was mentioned that as private entities are exempt from IAS 33, consideration should be given to whether they should be out of scope if these proposals are carried forward. There was also a thought that the DP provides a clearer basis for classification of derivatives over own equity is due to the guidance provided on issues such as anti-dilution provisions or foreign currency, rather than by the amount feature itself. A quick fix would be to include similar guidance in IAS 32.

Anthony Appleton thanked presenters and panellists and closed the meeting.