MEETING SUMMARY OF HKICPA ROUNDTABLE DISCUSSION WITH INVESTORS AND OTHER USERS OF FINANCIAL REPORTS

IASB Discussion Paper on Financial Instruments with Characteristics of Equity

Date: 1 November 2018

Time: 4:00 pm – 5:40 pm

Venue: HKICPA Boardroom, 37/F Wu Chung House, Wanchai

Summary of observations

Challenges of getting information about claims

- Participants generally considered that there is only limited information about the claims in the financial statements. For example, bond issuers generally do not disclose information about loan covenants in the financial statements.
- Participants cannot get a full picture about the claims, and hence understand the economic consequences of the claims on the issuers' financial position and performance.

IASB's preferred classification approach

- One participant considered that irredeemable fixed rate cumulative preference shares are equity in nature because the issuer is only required to pay cash or transfer financial assets at liquidation. Other than its priority, such claim does not have more rights than ordinary shareholders at liquidation. Therefore, it is not appropriate to change its existing classification from equity to debt. In her view, the amount feature, by itself, should not be a factor that distinguishes a claim as debt or equity.
- On the other hand, another participant considered that irredeemable fixed rate cumulative preference shares and perpetual instruments with similar contract terms should be classified as debt because the issuer has to pay a fixed amount of cash to settle the claims eventually at liquidation. This participant currently treats these claims as debt when analysing the financial statements, even though they are classified as equity under IAS 32.
- Some participants considered that given the rapid financial innovation, it is difficult to predict what new claims would appear and how they should be classified. Therefore, it would be important and useful to disclose more information about the claims in the financial statements.

Economic compulsion / Interaction between contracts and laws

- Participants generally agreed that economic incentives and the effect of laws and regulations should not be considered when classifying a claim as debt or equity. However, they requested for disclosures about whether and how economic incentives and laws and regulations could affect the settlement outcomes, e.g. likelihood of conversion into shares and expected cash payment based on the conditions as at year end. They considered that companies should also disclose management assumptions and observable data when assessing the potential settlement outcomes.

Separate presentation of debt with equity-like returns

- Two participants agreed with the IASB's proposal of separately presenting income and expenses arising from debt with equity-like returns into other comprehensive income (OCI) without subsequent recycling. They considered that such income and expenses are not related to the core operation of the issuer and therefore, should not affect profit or loss. In addition, they considered that income and expenses recognised in OCI should not be subsequently recycled to profit or loss so as to avoid potential manipulation of earnings.
- One participant considered that if the term of the debt is less than 1 year, then it would be more appropriate to present its income and expense in the profit or loss because such debt is more of trading in nature. If the term of the debt is more than 1 year, then its income and expenses should be presented in the OCI so as to minimise the volatility of the profit or loss over the term of the debt.

Attribution of total comprehensive income to equity instruments

- Some participants expressed the concern about the reliability of the fair value of derivative equity instruments because measuring the fair value of such instruments involves the use of management assumptions and valuation models. Therefore, they doubted about the usefulness of information provided by attributing the total comprehensive income based on those fair value.
- Participants generally preferred the approach of disclosing the fair value of the equity instruments.

New disclosures

- Participants generally welcome the proposed new disclosures.
- In respect of the priority of claims on liquidation, some participants expressed the following views:
  - Issuers may have to incur significant costs, including legal cost, in preparing the list, especially for multinational groups. It is questionable whether the

benefits of information provided by the list could outweigh the costs of preparing it.

  - The list would only be useful when the issuer has a going concern issue.
  - The increased transparency of the priority of claims could lead to an increase in an issuer's cost of funding as credit investors may demand better returns if the relative ranking of the claim in the list is low.
  - Issuers should also disclose the terms and conditions that may affect the priority of claims on liquidation and the use of management assumptions when preparing the list.

- Some participants requested for information about the voting rights of the equity instruments.