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7 January 2019,

Dear Mr Hoogervorst,

Dear Mr Gauzès,

Re: KBC comment letter on IASB Discussion Paper “Financial Instruments with Characteristics of Equity” (DP/2018/1)

On behalf of KBC Group (KBC), we are pleased to send a comment letter on the issued Discussion Paper (DP) with regard to Financial Instruments with Characteristics of Equity “FICE”.

KBC welcomes the IASB’s DP on this difficult topic and is pleased to see some evolution on how to account for FICE. Below we summarise our main remarks and in the annex we include the detail comments on your questions.

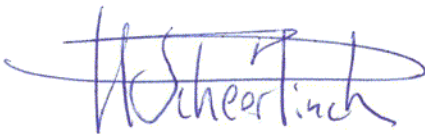
Our key notes are:

- *KBC is not convinced that there is an immediate need to change the current IAS 32, especially with the current proposal. The main definitions and concepts used in IAS 32 are well understood by our stakeholders, therefore we don’t currently see a need to revise IAS 32. We therefore suggest that the Board addresses specific issues by targeted improvements to either IAS 32 or another standard (e.g. IAS 33).*
- *We also note that any efforts to bringing a new standard should be well supported by a need for doing so. Bringing a new standard, results in using new terminology which would most certainly create new interpretation issues. In our view the trade-off between a clearer articulation of concepts in IAS 32 does not outweigh cost of implementation and the potential risk of new issues and uncertainties.*
- *If the board were to proceed with the current proposal, we would encourage the board to address the ‘amount feature’ primarily by enhancing the presentation and disclosure requirements. IAS 33 can accommodate a solution.*
- *We do not support the proposal where changes in a liability instrument dependent on own economic resources would be presented in OCI; despite some conceptual argument to the contrary. Looking at the complexity in the OCI, the lack of clarity in its use and the potential issues that might arise (e.g. question the non-recyclability), we would suggest to drop this proposal .*
- *We strongly disagree with the proposal of profit attribution as it creates unnecessary complexity without evidence of added value.*

- *Finally we raise some concerns on the disclosure requirements. While we acknowledge that there might be a need to enhance the disclosure requirements, references to e.g. "terms and conditions" (7.27(a) of the DP) can be seen as too vague and difficult to be implemented. We would encourage the Board to consider a referencing regime similar to IFRS 7, where IFRS disclosure requirements can be fulfilled by explicit references to existing reports outside of the financial statements.*

For further information on this letter, please contact Toon Clercx, IFRS expert at KBC Group at toon.clercx@kbc.be

Yours sincerely,



Hendrik Scheerlinck,
CFO KBC Group

Question 1

Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.

- a. Do you agree with this description of the problems and their causes? Why or why not? Do you think there are other factors contributing to the challenges?
- b. Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

- 1) *KBC currently sees no big issues with the application of IAS 32. The main definitions and concepts used in IAS 32 such as e.g. the 'fixed-for-fixed' rule which is required for equity classification of certain convertible instruments are well understood by internal and external stakeholders. Hence KBC is not convinced that there is an immediate need for the changes, especially as proposed in the DP.*
- 2) *We understand that financial engineering has resulted in a some isolated issues in applying IAS 32 but we would ask the board to address these specific issues by targeted improvements and by providing specific solutions and clarifications. We disagree that an entire standard setting program is required to tackle the few issues that IAS 32 has created and we note that using new terminology would most certainly create new interpretation issues. We believe that the trade-off between a clearer articulation of concepts in IAS 32 does not outweigh the risk of new issues and uncertainties.*
- 3) *Finally someone can argue that a proposal (like the Board' preferred approach) that needs exceptions even before being implemented, that it doesn't solve the issues with IAS 32; or at least to an extent that any costs arising can be supported.*

Question 2

The IASB's preferred approach to classification would classify a claim as a liability if it contains:

- a. an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or
- b. an unavoidable obligation for an amount independent of the entity's available economic resources.

This is because information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarized in paragraph 2.50 of the DP.

The IASB's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

- 4) *KBC agrees to the binary split of equity versus liability under the current IAS 32 standard. We believe that both the timing and amount features are relevant for classification, however we note that most of the isolated issues in the interpretation of IAS 32 come from the 'amount' feature (e.g. settlement in shares for which the value depends on both dependent and independent features). The 'timing' feature generally doesn't create any issues and additionally we believe that remaining unclarities, if any, have to be tackled by the IFRS 7 Disclosure requirements on liquidity.*
- 5) *If the board were to proceed with the IAS32 DP, we encourage that the board tackles the amount feature by enhancing the presentation and disclosure requirements. More specifically, we believe that IAS 33 can provide a solution. The amount feature in our view is more relevant in the assessment of returns to the shareholders and not necessarily*

depicting the availability of resources to the entity. Given the importance of this information KBC believes that further improvements should be considered in this area, but we are not convinced that these improvements should come via the presentation of equity and debt, but we suggest that the IASB makes some targeted improvements in IAS 33 – Earnings per Share, to tackle specific issues on the ‘amount’ feature.

Question 3

The IASB’s preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

- a. an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or
- b. an unavoidable contractual obligation for an amount independent of the entity’s available economic resources.

This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability.

- 6) *We refer to the answer on question 2. We agree with the binary split, but there are some conceptual issues by creating new language around the ‘amount’ feature. Further inconsistencies by this new terminology is elaborated in question 5.*

Question 4

The IASB’s preliminary view is that the puttable exception would continue to be required under the IASB’s preferred approach. Do you agree? Why, or why not?

- 7) *KBC is in favor to retain the puttable exception. We note that some of those instruments lead to practical issues in terms of IFRS 9 presentation of shares with finite lifetime from an investor perspective (Those instruments are classified as debt failing the SPPI-test under IFRS 9)*

Question 5

The IASB’s preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity’s own equity instruments—are as follows:

- a. a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; 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 derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or
 - ii. the net amount of the derivative is affected by a variable that is independent of the entity’s available economic resources.

Do you agree? Why, or why not?

- 8) *For KBC the main principle of a financial liability remains key: a financial instrument is a liability if it result in a settlement in cash or another financial asset (or exchange of asset/liabilities with unfavorable terms) which cannot be avoided by the issuer of the instrument. Any other variations to financial instruments (e.g. share settled instruments or*

instruments which can be settled at the discretion of the issuer) do not meet the liability definition.

- 9) KBC would like to stress that the new discussion paper creates issues by introducing new terminology. For example, we would ask the board to clarify the concept of what is considered to be 'an amount independent of an entity's economic resources'. Especially the concept of 'economic resources' is too much open for interpretation. Payments related to EBITDA are not independent payments in KBC's view. This is because the EBITDA measure can be considered as quite a good proxy of an entities available economic resources. This is evidenced by valuation analyses of entities which is often based on (multiples on) EBITDA. Note that many companies are not listed, so that the EBITDA is often the only relevant parameter to make an assessment of an entities economic resources. Also the EBITDA measure is rather pure in terms of recurrent cash flows and is not so much distorted by one-off events. (as compared to the share price)
- 10) Also this new terminology creates inconsistencies in e.g. the definition of a derivative under IFRS 9 versus IAS 32. The inconsistency arises from the first leg of the derivative definition under IFRS 9 whereby there is a requirement of a derivative to have payments which are not specific to a party to the contract. Payments based on EBITDA are generally considered as payments which are specific to a party in the contract and therefore they would not meet the definition of a derivative. Following the IAS 32 DP, payments based on EBITDA would trigger a (derivative) liability classification since EBITDA is considered to be an independent variable. We would encourage the board to be careful when introducing new terminology and avoid inconsistencies such as the derivative definition under IFRS 9 versus IAS 32.

Question 6

Do you agree with the IASB's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the IASB considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

- a. Do you think the IASB should seek to address the issue? Why, or why not?
- b. If so which approach do you think would be most effective in providing the information, and why?

- 11) KBC agrees with the EFRAG statement that accounting for a written put option on own shares that is issued together with ordinary shares is not the same as accounting for a convertible bond. For KBC, there is a contractual obligation if KBC has no other practical ability to avoid a settlement in cash. We would follow the IASBs approach if there are alternative settlement outcomes which are at the discretion of the issuer so that the issuer can avoid payments in cash, the entire instrument could be classified as an equity instrument.
- 12) We would agree with the board's preferred approach whereby the concept of economic compulsion is disregarded from the classification requirements. Inputting the concept of economic compulsion would create too much practical and pragmatic issues, even if from a conceptual point of view one could argue that economic compulsion could be regarded. e.g. would ordinary shares need to be classified as debt if there is a strong economic compulsion by the issuer to pay dividends? It would be difficult to draw the line when economic compulsion would be taken into account.

Question 7

Do you agree with the IASB's preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The IASB also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

- 13) KBC refers back to the inconsistency issue between IFRS 9 and IAS 32 in terms of derivatives. Where the fair value of the derivative changes as a result of features dependent on the entities performance, it would not meet the definition of a derivative under IFRS 9 (as the fair value change is specific to a party in the contract).
- 14) The only consistency that KBC sees is with regard to the application of 'changes in own credit risk', which is also to be recorded in OCI on financial instruments issued. Here IFRS 9 responded to the counter-intuitive effects that an entity's worsening performance would result in a gain (in P&L) on its own issuances. In IAS 32, changes in fair value attributable to credit risk could be booked in OCI, but as further elaborated in question 8, we do not support any allocation approach whereby changes from dependent feature would be recorded in OCI and changes from independent features in P&L.
- 15) On presentation requirements, KBC believes in general that the principle is clear that when an instrument is classified as equity or liability, all subsequent changes such as payments follow the classification, i.e. the changes will be booked in performance. This rule is generally well known with internal and external stakeholders. KBC would therefore not support the board's preferred approach whereby changes in a liability instrument which value is dependent on the issuer, would be presented in OCI instead of P&L. We note that the OCI statement is already a fairly complex line of which the underlying principles are yet again discussed in the new Conceptual Framework. Also the concept of recyclability of OCI reserves still raises discussion. Adding another line item in OCI would therefore not be supported by KBC.

Question 8

The IASB's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

- 16) KBC does not support any proposal to split returns from equity instruments due to its high level of complexity, operational challenges and its relevance. Costs of preparing would exceed the benefits significantly.

Question 9

The IASB's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial statements:

- a. information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).

- b. information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).
- c. information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the IASB's preliminary view? Why or why not?

How would you improve the IASB's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the IASB's should consider when developing its preliminary views on disclosures?

- 17) *KBC supports more disclosure requirements only if they can address specific issues and if they bring more relevant information to the users of the Financial statements.*
- 18) *With regard to liquidation disclosures, we do not believe that additional information upon liquidation would provide relevant information. Upon liquidation, all claims will be settled in order of seniority, independent of whether an instrument is classified as equity or debt for accounting purposes. Therefore we don't believe that extra disclosures on liability features at liquidation will create valuable information. The measurement of the liability feature will be insignificant anyway, since liquidation is considered to be remote in a going-concern environment. Besides, we would like to note that for financial institutions, resolution comes before liquidation and this is often the trigger for some conversions to occur. The conversion mechanisms and the seniority of claims coming from this conversion is firmly regulated in applicable CRR/CRD legislation. We don't believe that for financial institutions, additional disclosures on resolution/liquidation would provide more relevant information as this is often already disclosed in Basel Pillar III reports. Also the regulatory treatment of these instruments is completely disconnected from the accounting classification. I.e. an instrument can equally qualify for Tier 1 Capital qualification when it is classified as equity just as well as debt. Primary focus for financial institutions is to comply with the regulatory requirements, secondly the accounting treatment will be looked at. To this extent KBC would very much welcome a "referencing regime" similar to IFRS 7, that would allow that an entity can make references to existing public information for fulfilling the IFRS disclosure requirements*
- 19) *Any effects of potential dilution (e.g. due to a variable amount of shares that might be issued) are relevant for IAS 33 requirements. Any additional disclosure needs would need to be tackled by IAS 33 (Earnings per share).*
- 20) *Finally we do not believe that including a requirement to disclose "terms & conditions" of financial instruments provides useful and relevant information since it would present overload information which is already presented in the prospectus of these instruments. We propose that detailed information remains in the prospectus and should not be duplicated in the financial statements. Hence, should the Board feels strongly that this information belongs in the financial statements, then KBC suggests to investigate the possibility of a referencing regime (like IFRS 7) where information outside of the financial statements can be used to fulfill IFRS disclosure requirements.*

Question 10

Do you agree with the IASB's preliminary view that:

a. economic incentives that might influence the issuer's decision to exercise its rights *should* not be considered when classifying a financial instrument as a financial liability or an equity instrument?

b. the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

21) *We refer to the answer on question 6 where we support the board approach to not take economic incentives into account.*

Question 11

The IASB's preliminary view is that an entity shall apply the IASB's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, why not?

22) *KBC supports EFRAG's opinions that the focus should be on the substance of the contractual arrangement in a financial instrument rather than the regulatory and legal requirements.*