

**Organismo Italiano di Contabilità – OIC  
(The Italian Standard Setter)**

Italy, 00187 Roma, Via Poli 29  
Tel. +39 06 6976681 fax +39 06 69766830  
E-mail: presidenza@fondazioneoic.it

EFRAG  
35 Square de Meeûs  
B-1000 Brussels  
BELGIUM  
commentletter@efrag.org

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**Re: EFRAG CL on the IASB Discussion Paper Financial Instruments with Characteristics of Equity**

Dear Jean-Paul,

We are pleased to have the opportunity to provide our comments in order to contribute to the EFRAG comment letter on the IASB Discussion Paper *Financial Instruments with Characteristics of Equity* (the DP in the letter).

We support the IASB's decision to reactivate the debate on the distinction between equity and liability and we appreciate the IASB's efforts to develop a general underlying rationale applicable to the classification of all types of financial instruments issued.

We broadly agree with most of the IASB's proposals; however, we believe that before developing a new standard the IASB should make sure that the new proposals does not have any unintended consequences. Therefore, we are convinced that for this project an effect analysis is critical. The approach proposed by the IASB should be therefore tested especially because the timing and amount feature may be differently interpreted.

We support a principle-based approach to classify consistently all financial instruments, including derivatives, as financial liabilities or equity instruments. However applying the principle of the DP to compound instruments may require additional guidance especially for the written put options on non-controlling interests, including the recognition and measurement in separate financial statements.

Regarding presentation, although we support the separate presentation in OCI of the fair value changes of equity linked financial instruments, we suggest the IASB to evaluate to allow the recycling of income and expenses arising from these financial instruments. In relation to the attribution mechanisms for equity instruments other than ordinary shares, we suggest reviewing IAS 33 and providing information about dilution through disclosures, rather than introducing specific presentation requirements in equity.

Finally, we strongly support the IASB's decision to retain the puttable exception.

Our detailed comments are set out below.

Should you need any further information, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò  
(Chairman)

## **Appendix A**

### **Section 1: Scope, Challenges and Objective**

#### **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 challenges 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?*

We support the IASB's decision to reactivate the debate on the distinction between equity and liability, because financial innovation is increasing the types and the complexity of financial instruments.

We appreciate the IASB's efforts to develop a general and robust underlying rationale for the distinction between equity and liability applicable to all types of financial instruments reducing the use of specific rules and/or exemption.

In theory, in our view, this process should lead to the development of a new standard. However, most classification outcomes arising from the application of IAS 32 has not been criticised. Consequently, before developing a new standard the IASB should make sure that the new proposals should not lead to any unnecessary disruption in the classification outcomes. If the IASB found out that the new proposals would have unintended consequences, then it would be better to adopt a fine-tuning approach addressing only the specific challenges identified.

### **Section 2: Board's preferred approach**

#### **QUESTION 2:**

*The Board'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, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance as summarised in paragraph 2.50 of the DP.*

*The Board'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?*

We appreciate the IASB's efforts to enhance the classification requirements of IAS 32 explaining the current guidance and providing new guidance in order to reduce divergence in practice.

The classification principles proposed by the IASB could improve the consistency and the clarity of the classification requirements. Nonetheless, the IASB's preferred approach uses a completely new terminology that could cause unintended consequences and new issues could arise in practice.

In our view, one of the main difficulty in applying IAS 32 refers to the classification of financial instruments settled in the entity's own equity instruments.

In our understanding, the classification requirements of the DP confirms the point of view of the investor as IAS 32. Indeed, the *amount feature* leads to assess whether the position of the holder of the financial instrument is closer to a creditor (i.e. has the right to obtain a number of shares for an amount independent of the entity's available economic resources) or to a shareholder (i.e. has the right to receive shares for an amount not independent of entity's available resources).

We understand that DP, like IAS 32, adopts the point of view of the investor. However, we suggest that the IASB should investigate the consistency between this approach and other Standards, for example, we note that IFRS 2 seems to adopt a different approach distinguishing classification based on the method of payment (cash or equity instruments).

Moreover it could be evaluated the possibility to always classify as equity instruments that are offered pro-rata to all the entity's shareholders independently by the fact that the amount feature is independent or not of the entity's resources.

With specific reference to the IASB preferred approach, it is necessary a careful assessment of the potential effects of the new classification principles. In particular, we observe that the DP does not define the term "liquidation". As this term is a legal term it could have different meaning in different jurisdictions, thus we suggest defining this term (or using a different term) to avoid different interpretations. In addition, we observe that in the bank industry the EU regulation refers to the term "resolution" rather than "liquidation".

With reference to the *amount feature* we have the following comments:

- The notion of "an amount independent of the entity's available economic resources" is difficult to apply and not intuitive. Therefore, we suggest clarifying the meaning of "independent" and "not independent". In particular, we suggest:
  - o clarifying whether a correlation, albeit minimal, between the amount of the obligation and the value of the issuer means that the instrument is "not independent" of the entity's available economic resources;
  - o providing more guidance and less straight-forward illustrative examples on this topic;
  - o explain the relationship between the notion of "dependence" and the risks that bears the investor. In particular, the IASB should clarify that if the amount of the obligation depends on the performance of the issuer, the risks and benefits of the investor are identical to those of an existing shareholder.
- it is important to clarify:
  - o the meaning of the concept of "available economic resources"; and
  - o whether the share price could be considered as a reasonable proxy of the entity's available economic resources.

### **Section 3: Non derivative Classification**

#### ***QUESTION 3:***

***The Board'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.***

***Do you agree? Why, or why not?***

With regard to application of the Board's preferred approach on non-derivative financial instruments, please refer to our comments to Question 2.

Regarding the effects of the DP proposals on the classification of non-derivative financial instruments, we understand that the classification of cumulative preference shares would change. However, this should not be a significant issue for our stakeholders.

Savings shares may also change classification according to the proposal of the DP; these type of shares generally grant a greater dividend and have a lower seniority on liquidation than ordinary shares. Applying the criteria of the DP, saving shares may be compound instruments, because these instruments may require a fixed amount to be paid on liquidation. In this case, as explained in the DP, there is no need to recognise a financial liability because, even if the fixed amount payable on liquidation is independent from the entity's available economic resources, on a going concern basis the present value of this fixed amount would be not material. It could be argued whether this result would change when a substantial doubt about the entity's ability to continue as a going concern arises. We think that this instrument remains an equity instrument, because the classification of the financial instrument is made on initial recognition. However, we think that the IASB should confirm this view.

**QUESTION 4 del DP:**

***The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?***

We support the IASB's decision to retain the puttable exception. This exception is even more important, because we understand that under the Board's preferred approach a greater number of puttable instruments would be classified as liabilities. For example, shares that are redeemable at their nominal amount and whose payment may be deferred until liquidation would be classified as liability, because meets the amount feature of the DP (i.e. the nominal amount is independent of the entity's resources). According to IAS 32, these instruments are equity instruments, without using the puttable exception.

**QUESTION 5:**

***The Board'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?***

We welcomes the DP's proposal to classify, consistently with IAS 32, derivatives on own equity in their entirety. We support a principle-based approach to classify consistently all financial instruments, including derivatives, instead of having specific rules, as the *fixed for fixed* condition, that apply only to derivatives.

## Section 5: Compound Instruments and Redemption Obligation Arrangements

### **QUESTION 6:**

*Do you agree with the Board'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 Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.*

*(a) Do you think the Board should seek to address the issue? Why, or why not?*

*(b) If so what approach do you think would be most effective in providing the information, and why?*

We support the IASB proposals to improve the existing guidance on derivatives addressed in Section 5, ie derivatives that include an obligation to extinguish own equity instruments (e.g. written put options, purchased call option or forward contracts to buy own equity instruments) and embedded derivatives in compound instruments (e.g. convertible bonds).

In particular, we agree that a redemption obligation arrangement (e.g. a written put option on own shares that is issued together with ordinary shares) and a compound instrument (e.g. a convertible bond) have similar contractual rights and obligations and thus they should be accounted for consistently.

However, we suggest furthering investigating:

- the accounting of written put option on non-controlling interests (NCI) in separate financial statements; and
- some application issues that could lead to uncertainty in the consolidated financial statements, such as the profit allocation to NCI once the NCI have been derecognised.

## Section 6: Presentation

### **QUESTION 7:**

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

*The Board 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?*

We see merits in presenting in OCI the fair value changes of financial instruments that do not contain an obligation for an amount independent of the entity's available economic resources. This, in our view, is consistent with the presentation of the gains and losses arising from changes in own credit risk of financial liabilities designated as measured at fair value through profit or loss under IFRS 9.

However, we have some concerns on the proposal to not allow the recycling of income and expenses arising from these financial instruments. In particular, in our view, it is not clear why the fair value changes of these instruments is not relevant to assess the performance of the issuer.

In addition, we observe an increase of the use of OCI in the statement of financial performance and we suggest to clearly identify all the financial instruments, which currently lead to counter-intuitive accounting under IFRS Standards and further investigate the scope of the separate presentation requirements for financial liabilities.

Lastly, we support the DP's proposal to apply the presentation requirements to the total income and expenses arising from a partly independent derivative, instead of splitting the different components, (e.g. foreign currency and share price) even if this represents an exemption to the general presentation principle. We think that this proposal has the merit to reduce the implementation costs.

**QUESTION 8:**

*The Board'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?*

*The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?*

*The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:*

- (a) a full fair value approach (paragraphs 6.74–6.78);*
- (b) the average-of-period approach (paragraphs 6.79–6.82);*
- (c) the end-of-period approach (paragraphs 6.83–6.86); and*
- (d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25.*

*Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?*

We acknowledge that it is useful for investors having information about the distribution of returns among the different types of classes of equity. However, we question whether the proposed attribution approaches (i.e. attributing total comprehensive income to equity instruments other than ordinary shares and updating the carrying amounts of those equity instruments based on that attribution) are the best way in order to provide this information. We think that the proposed attribution mechanisms are too complex and costly, because they require determining the fair value of the derivative equity instruments, even if they are not observable.

In addition, the attribution requirements would not necessarily reflect the entire effect of the transfer of wealth between existing shareholders and potential shareholders. This is because there are financial instruments that are settled with own equity but are accounted for as liabilities in their entirety, as, for instance, financial instruments settled in a variable number of shares. In this case, the transfer of wealth would not be seen so clearly within equity, because gains or losses that arise from such instruments would be presented in profit or loss.

Consequently, we suggest, as an alternative to the attribution approaches, providing information about dilution through disclosures and improvements to IAS 33.

**Section 7: Disclosure**

## **QUESTION 9**

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

*(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 Board's preliminary view? Why, or why not?*

*How would you improve the Board'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 Board should consider when developing its preliminary views on disclosures?*

In general, we see merits in the DP's proposal of providing through disclosures the following information:

- The priority of claims on liquidation
- Potential dilution of ordinary shares arising from the exercising of other instruments (e.g warrant)
- Terms and conditions of claims that affect the timing and amount of cash flows

Nonetheless, we think that providing information about priority of claims on liquidation for consolidated financial statements can be a challenging exercise as, in most jurisdictions, it is the legal entity that is responsible for enter into agreements or contracts, assuming obligations, etc.

## **Section 8: Contractual Terms**

### **QUESTION 10:**

*Do you agree with the Board'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?*

*Why, or why not?*

We support the IASB's preliminary decision to clarify that economic incentives that might influence the issuer's decision to exercise its rights should not affect the classification of a financial instrument, because considering economic incentives for classification purposes may raise several questions and uncertainties.

In addition, we think that the IASB should explain whether a constructive obligation, which leads to a provision according to IAS 37, does not lead to a financial liability.

### **QUESTION 11:**

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

We support the Board preliminary view on considering just the contractual terms of a financial instrument in the assessment of its classification; however, we highlight that there are significant challenges in distinguishing between rights and obligations that arise from contractual terms and those that arise from law.

Nevertheless, we deem important to maintain consistency between the classification of financial liabilities and financial assets. In this regard, we note that under IFRS 9 the effect of a regulation, which may modify the contractual cash flows of a financial asset, shall not be considered in performing the SPPI test. The IASB should maintain this consistent approach also for the classification of financial liabilities.