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1 February 2019

Dear Mr Hoogervorst,

Re: Discussion Paper Financial Instruments with Characteristics of Equity

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* ('FICE'), issued by the IASB on 28 June 2018 (the DP).

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

General

EFRAG acknowledges the various challenges that arise from the application of IAS 32 *Financial Instruments: Presentation*, including the risk of inconsistent application in some areas and the limitations in the information provided to users of financial statements. In its comment letter to the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* EFRAG recommended that the IASB should undertake a comprehensive discussion on how to distinguish financial liabilities from equity instruments, from both conceptual and practical perspectives, including what this distinction means and is attempting to portray. In that comment letter, EFRAG more specifically asked the IASB to:

- retain the binary split between liabilities and equity and define equity as the residual that is not directly measured;
- address issues that arise in practice such as the accounting for non-controlling interest written put options ('NCI puts'), the application of the fixed-for-fixed condition, the role of economic compulsion when the entity has alternative settlement options, the counter-intuitive accounting that arises with financial instruments for which the amount depends on the entity's own performance and implementation issues with paragraphs 16A to 16F of IAS 32; and
- provide more information about different classes of equity and potential dilution.

EFRAG therefore appreciates the IASB's efforts to address the identified challenges by developing proposals relating to classification, presentation and disclosure.

Summary of EFRAG's views on the DP

Classification

EFRAG welcomes the fact that the IASB's preferred approach to classification would retain the use of a binary split between liabilities and equity and would continue to define equity as 'the residual interest in the assets of the entity after deducting all of its liabilities'. However, EFRAG does not support the IASB's preferred approach to classification as a way forward to address the identified challenges. In summary, EFRAG is concerned that the IASB's preferred approach:

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- introduces completely new terminology which is likely to cause some disruption, create additional costs for preparers and risks the emergence of new issues and uncertainties, particularly for instruments with contingent settlement provisions and entities that apply IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*;
- bases the distinction between debt and equity on the notion of an 'amount independent of the entity's available economic resources' ('the amount feature') on liquidation, which is inconsistent with the going concern assumption in the Conceptual Framework, paragraph BC18 of Basis of Conclusions of IAS 32 and would represent a fundamental change to IAS 32; and
- does not solve the existing conceptual issues such as removing the need for exceptions and creating alignment with the Conceptual Framework.

Overall, EFRAG considers any benefits of the IASB's preferred approach to classification are unlikely to outweigh the associated costs. For example, the preferred approach is likely to require preparers and auditors to review all existing contracts and reconsider a wide range of past classification decisions, and would require entities to measure the fair value of derivatives on own equity for presentation purposes.

Although EFRAG does not support the IASB's preferred approach to classification in general, EFRAG suggests that some of the proposed supporting guidance could usefully be incorporated into IAS 32. EFRAG considers that this approach could help address challenges identified in the application of IAS 32 in areas such as the fixed-for-fixed condition and the role of economic compulsion when the entity has alternative settlement options without replacing IAS 32 or introducing completely new terminology.

Presentation and disclosure

EFRAG acknowledges the inherent limitations of any binary debt-equity split and therefore welcomes the IASB's efforts to improve the presentation and disclosure requirements to provide additional information to users.

EFRAG's specific comments on the disclosures proposed in the DP are set out in paragraph 151 onwards of the Appendix to this letter.

In relation to presentation, EFRAG welcomes the IASB's efforts to address the concerns of some stakeholders that the current accounting requirements lead to counterintuitive outcomes when applied to liabilities with an equity-like return. However EFRAG is not convinced that expanding the use of Other Comprehensive Income ('OCI') is the most appropriate way to address those concerns and suggests that the IASB instead considers enhanced disclosures. If the IASB does however pursue the OCI approach, EFRAG considers that its scope needs further development and that the question of recycling should be discussed further.

EFRAG does not support the proposed attribution of total comprehensive income to subclasses of equity and suggests that the IASB instead considers targeted improvements to IAS 33 *Earnings per Share*.

Suggested way forward

At this stage, EFRAG suggests that the IASB focuses on targeted improvements to current requirements in IAS 32 and other standards (including IAS 33). In particular, EFRAG suggests that the IASB pursues improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions, including those that are mandatorily convertible or written down on a 'non-viability' event. EFRAG notes that the DP already identifies some solutions to the issues that arise in practice with IAS 32 which could be a good basis for further discussions. For example, the IASB could draw on the work in developing the DP and consider improving IAS 32 by:

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- improving disclosure requirements for equity instruments, particularly those with contingent settlement provisions;
- incorporating some of the detailed guidance in paragraphs 4.45 to 4.66 of the DP focused on variables that have resulted in questions and difficulties when applying the fixed-for-fixed condition (e.g. reference point to determine whether the transaction involves foreign currency, anti-dilution provisions and time value of money);
- improving the requirements for indirect obligations in paragraph 20 of IAS 32;
- incorporating some of the IFRS Interpretations Committee ('IFRS IC') Agenda Decisions that include an analysis of IAS 32, particularly on instruments with contingent settlement provisions;
- incorporating IFRIC 2 into IAS 32; and
- considering further the accounting for written put options over non-controlling interests.

EFRAG acknowledges that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity. However, at this stage EFRAG has not identified any consensus among those constituents on how to achieve this in a reasonable timeframe. Therefore, developing a more conceptual and less rule-based approach is going to be very challenging and any alternative that results in widespread classification changes is likely to prove controversial (as with previous approaches discussed by the IASB and EFRAG).

Accordingly, if the IASB pursues targeted improvements to IAS 32 in the shorter term, EFRAG suggests that the IASB then reconsiders whether to continue a more comprehensive FICE project in the longer term. The next IASB agenda consultation could be an opportunity to seek input from constituents on this.

EFRAG's detailed comments and responses to the questions in the DP are set out in the Appendix of this letter.

If you would like to discuss our comments further, please do not hesitate to contact Filipe Camilo Alves or me.

Yours sincerely,



Jean-Paul Gauzès
President of the EFRAG Board

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Appendix - EFRAG's responses to the questions raised in the DP

Section 1 - Objective, scope and challenges

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?

EFRAG's response

EFRAG acknowledges the various challenges that arise from the application of IAS 32 and appreciates the IASB's efforts to address the current application issues and diversity in practice.

EFRAG notes that currently there is no consensus on what the right approach is for the distinction between debt and equity and that this a significant factor for the existing challenges in IAS 32 and a cause for diversity in practice when IAS 32 is unclear or lacks guidance.

As further explained in section 2, EFRAG does not support the IASB's preferred approach as a way forward to address the identified challenges, particularly on the classification and presentation of financial instruments. Nonetheless, EFRAG considers that there is room to improve IAS 32 to provide better information for users and that improvements to presentation and disclosures constitute a significant part, or even the most important part, of this project.

Introduction

- 1 EFRAG acknowledges the various challenges that arise from the application of IAS 32 and appreciates the IASB's efforts to address the current application issues and diversity in practice. EFRAG has highlighted many times the importance of this project, particularly for users of financial statements.
- 2 Any errors in classification of financial instruments under IAS 32 can have a significant impact on the *Statement of Financial Position* (the classification of financial instruments as equity or liability have a significant impact on gearing, liquidity and solvency ratios, which may result in a breach of debt covenants or maintaining a certain level of equity) and the *Statement of Financial Performance* (the classification of financial instruments will determine whether interest, dividends, losses and gains on financial instruments are recognised in equity or included in profit for the year).

Objective of the project

- 3 EFRAG considers that notwithstanding the challenges identified, particularly on derivatives on own equity, IAS 32 has worked well in practice for the majority of liabilities and equity. We recall that many respondents to and participants in the outreach meetings on the EFRAG Discussion Paper *Classification of Claims*, published in 2014, considered that IAS 32 is not fundamentally broken and that the IASB should not start from a blank sheet of paper.

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- 4 To address the issues that currently arise in practice, EFRAG considers that the IASB should, as in 2003, take the opportunity to make improvements to IAS 32 to clarify existing guidance, reduce complexity, eliminate internal inconsistencies to the extent possible, improve presentation and disclosure requirements, incorporate previous agenda decisions from the IFRS IC and incorporate elements of existing Interpretations. EFRAG considers that this is possible without fundamentally changing the existing principles, terminology and classification outcomes of IAS 32. This would have the overall impact of increasing comparability and providing better information for users.

Scope of the project

- 5 EFRAG welcomes that the DP focuses not only on classification but also on potential improvements to presentation and disclosure of financial instruments with characteristics of equity.
- 6 Improvements to presentation and disclosure requirements are needed and constitute a significant part, or even the most important part, of this project. For example, EFRAG notes that ESMA¹ has recently called for more transparency on the disclosures of fundamental characteristics of complex instruments such as puttable instruments, compound instruments and derivatives on own equity.
- 7 However, EFRAG has some reservations on the scope of this project:
 - (a) EFRAG considers that the scope of the project and the DP's proposals are very ambitious, particularly on presentation of equity instruments (e.g. the attribution mechanism described in section 6). In EFRAG's view, the implementation of the IASB's preferred approach would require the publication of a new IFRS Standard that would replace IAS 32, which is not aligned with the idea that IAS 32 is not broken. In addition, the DP's proposals would or could affect several other IFRS Standards such as IAS 1 *Presentation of Financial Statements*, IAS 33, IFRS 2 *Shared-based Payment*, IFRS 9 *Financial Instruments*, IFRS 10 *Consolidated Financial Statements* and possibly the Conceptual Framework. In some cases the effects on other IFRS Standards could go beyond purely consequential amendments and require additional standards-level projects (e.g. IAS 33); and
 - (b) in EFRAG's consultation, constituents identified a number of other challenges in the application of IAS 32 which have not been discussed by the IASB and remain unresolved under the IASB's preferred approach. For example, whether a financial instrument in the form of a preference share that includes a contractual obligation to deliver cash is a financial liability or equity, if the payment is at the ultimate discretion of the issuer's shareholders (discussed by the IFRS IC in March 2010); and how to account for discretionary interest payments of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event (discussed by the IFRS IC in 2014).

¹ ESMA Report – Enforcement and Regulatory Activities of Accounting Enforcers in 2017

Section 2 - The IASB's preferred approach

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 summarised 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?

EFRAG's response

EFRAG appreciates the IASB's efforts to improve IAS 32's requirements on classification of financial instruments as a way to address the lack of clarity in the existing guidance and the absence of guidance in some areas that leads to diversity in practice.

However, EFRAG is concerned that the IASB's preferred approach introduces completely new terminology, uses an amount feature on liquidation for classification purposes and is likely to result in considerable implementation costs for preparers and disruption in the market due to reclassification changes, particularly for entities with complex financing and capital structures such as financial institutions. Accordingly, EFRAG does not support the IASB's preferred approach.

At this stage, EFRAG suggests the IASB to focus on targeted improvements to IAS 32 and other standards (e.g. IAS 33 *Earnings per Share*), particularly on improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions. EFRAG notes that the DP already identifies some practical solutions to the issues that arise in practice with IAS 32 which could be a good basis for further discussions

EFRAG acknowledges that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity. However, at this stage EFRAG has not identified any consensus among those constituents on how to achieve this. Therefore, developing a more conceptual and less rule-based approach is going to be very challenging and any alternative that results in widespread classification changes is likely to prove controversial (as previous approaches discussed by the IASB and EFRAG).

Accordingly, EFRAG suggests that the IASB reconsiders whether to continue a comprehensive FICE project (e.g. as part of its next agenda consultation).

The IASB's approach to improvements to classification

- 8 EFRAG appreciates the IASB's efforts to improve IAS 32's requirements on classification of financial instruments as a way to address the lack of clarity in the existing guidance and the absence of guidance in some areas that leads to diversity in practice.

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- 9 EFRAG acknowledges that the ‘timing’ feature used in the DP for classification purposes, which reflects the idea that claims classified as equity should not have a maturity or require ongoing payments, is essentially consistent with IAS 32. EFRAG also acknowledges that the ‘amount’ used in the DP is to some extent in line with a ‘loss absorption’ approach described in the 2008 EFRAG Discussion Paper *Distinguishing Between Liabilities and Equity* (in that an amount that depends on the entity’s available economic resources implies that the holder participates in losses).
- 10 EFRAG nonetheless has several concerns in relation the IASB’s preferred approach to the classification of financial instruments. Specifically, EFRAG is concerned that:
- (a) the DP introduces completely new terminology. EFRAG understands that a better articulation of IAS 32’s underlying principles could be an effective way to improve the consistency, clarity and completeness of the requirements and would require new terminology. However, new terminology would also require preparers and auditors to reconsider some past classification decisions. Accordingly, this approach, while addressing various interpretive issues, will also cause some disruption and risks the emergence of new issues and uncertainties, particularly for instruments with contingent settlement provisions and entities that apply IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments*.
 - (b) the distinction between debt and equity is based on the notion of an ‘amount independent of the entity’s available economic resources, particularly on liquidation (i.e. **amount feature on liquidation**). This is because the notion ‘an amount independent of the entity’s available economic resources’ and ‘an amount that could exceed the entity’s available economic resources’ has been raising a lot of debate, particularly when considering that this new concept encompasses ‘unrecognised assets of an entity’ and that financial instruments that are settled only on liquidation can be classified as liabilities. More details on the specific challenges brought by the notion of an ‘amount independent of the entity’s available economic resources’ are further described in section 3.
 - (c) the articulation of the timing feature focuses on ‘liquidation’ when companies prepare financial statements on a going concern basis and real-life situations can be more complex than simply liquidation. For example, if an entity fails to satisfy debt holders’ claims, debt holders may prefer to take control of the entity for restructuring rather than enter into liquidation; similarly, for regulated financial entities, the issue can be more related to a ‘resolution’ than to ‘liquidation’ and this would bring complexity to the distinction between debt and equity, as many instruments would be, on the trigger event for resolution, converted into shares or even written down before actual liquidation;
 - (d) the IASB’s preferred approach does not solve the existing conceptual issues such as removing the need for exceptions and alignment with the Conceptual Framework;
 - (e) overall benefits are not likely to outweigh the costs associated with the implementation of the IASB’s preferred approach. For example, the IASB’s preferred approach is likely to require preparers and auditors to review all existing contracts and reconsider a wide range of past classification decisions even if classification outcomes are likely to remain the same. In addition, it would require entities to measure the fair value of derivatives on own equity for presentation purposes; and
 - (f) the IASB has not yet provided a comprehensive analysis of the impact of its proposals, in particular on undated or perpetual hybrid securities such as additional tier 1 (‘AT1’) instruments. In its early-stage impact analysis, EFRAG notes that the many respondents to the survey either had no opinion or found

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it difficult to assess the impact of the IASB's preferred approach on financial reporting and financing (e.g. cost of capital, covenants and compensation contracts) reflecting a general difficulty in anticipating the overall marginal effect of a new accounting standard.

- 11 Overall, for these reasons EFRAG does not support the IASB's preferred approach as a way forward to address the challenges that currently arise in practice and at this stage suggests that the IASB focuses on targeted improvements to current requirements in IAS 32 and other standards (e.g. IAS 33 *Earnings per Share*), particularly on improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions.
- 12 EFRAG notes that the DP already identifies some solutions to the issues that arise in practice with IAS 32 which could be a good basis for further discussions. For example, the IASB could consider improving IAS 32 through targeted improvements such as:
 - (a) improving disclosures for equity instruments, particularly those instruments with contingent settlement provisions. In EFRAG's view, improvements to disclosures are currently needed and constitute a significant part, or even the most important part, of this project;
 - (b) incorporating some of the detailed guidance in paragraphs 4.45 to 4.66 of the DP focused on variables that have resulted in questions and difficulties when applying the fixed-for-fixed condition in IAS 32 (e.g. reference point to determine whether the transaction involves a foreign currency, anti-dilution provisions and time value of money). Such an approach should be built as much as possible on the notions already existing in IAS 32 to avoid unnecessary complexity;
 - (c) improving the requirements in paragraph 20 of IAS 32 for indirect obligations (as further described in section 8);
 - (d) incorporating some of the IFRS IC Agenda Decisions that include an analysis of IAS 32, particularly on instruments with contingent settlement provisions;
 - (e) incorporating some of the guidance on whether the liability component should include the effect of any conditionality (paragraphs 5.20 to 5.26 of the DP) for instruments with contingent settlement options;
 - (f) requiring further disaggregation of equity on the face of the statement of financial position to clearly identify and differentiate different subclasses of equity (e.g. ordinary shares and financial instruments that could be settled by issuing ordinary shares); and
 - (g) incorporating IFRIC 2 into IAS 32.
- 13 EFRAG considers that some of these targeted improvements could be done together with the *Primary Financial Statements* project.
- 14 EFRAG acknowledges that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity. However, at this stage EFRAG has not identified any consensus among those constituents on how to achieve this in a reasonable timeframe. Therefore, developing a more conceptual and less rule-based approach is going to be very challenging and any alternative that results in widespread classification changes is likely to prove controversial (as with previous approaches discussed by the IASB and EFRAG).
- 15 Accordingly, EFRAG suggests that the IASB reconsiders whether to continue a comprehensive FICE project (e.g. as part of its next agenda consultation).
- 16 If the IASB decides to continue a comprehensive FICE project, the IASB could further consider different approaches raised by EFRAG's constituents such as:

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- (a) an approach based on the timing feature only;
- (b) an approach based on the assumption that own shares are economic resources;
- (c) an approach based on the timing and amount feature without considering liquidation;
- (d) an approach that could be applied to all financial instruments, regardless of whether they are in the scope of IAS 32, IFRS 2 or IAS 32 *Provisions, Contingent Liabilities and Contingent Assets*;
- (e) the role of entity perspective and 'proprietary perspective' in the classification of financial instruments; and
- (f) whether the accounting for financial instruments with contingencies should be different from other instruments.

Section 3A - Classification of non-derivative financial instruments

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.

Do you agree? Why, or why not?

EFRAG's response

EFRAG highlights that, although under the IASB's preferred approach the classification outcomes would largely be the same as IAS 32, the classification outcomes for some instruments would change (e.g. cumulative preference shares, cumulative undated bonds). These changes would arise from the proposed clarifications of IAS 32's underlying rationale, particularly in relation to the amount feature.

EFRAG is not convinced that the identified changes in classification outcomes relate to areas of IAS 32 that are problematic and is concerned about the potential impact that these changes in classification will bring to the market.

Finally, EFRAG has significant concerns on the use of a completely new terminology for the classification of non-derivatives, particularly on the notion of 'an amount independent of the entity's available economic resources' and the fact that some financial instruments would be classified as liabilities even if they are only settled on liquidation (e.g. cumulative preference shares) as such an outcome would be inconsistent with the Conceptual Framework and its going concern principle.

Classification of non-derivative financial instruments

- 17 EFRAG's overall views on the IASB's preferred approach to classification are set out in our response to Question 2. The following comments relate more specifically to the IASB's preferred approach as it would apply to non-derivative instruments.

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- 18 EFRAG notes that the classification of non-derivative financial instruments would, in most cases, be the same as IAS 32. However, EFRAG also notes that the classification of some instruments would change, particularly due to the articulation of the amount feature. This feature will affect the classification of instruments that do not require the transfer of economic resources before liquidation but the claim (including the claim on liquidation) is for a fixed amount that is independent of the entity's available economic resources. For example, the following instruments that are classified as equity in accordance with IAS 32 would be reclassified as liabilities:
- (a) non-redeemable cumulative preference shares; and
 - (b) undated or perpetual cumulative hybrid securities that currently are classified as equity (vanilla, convertible and contingent convertible bonds) in their entirety where the issuer has the unconditional right to defer payment of any coupons or principal.
- 19 In these cases, EFRAG considers that:
- (a) such classification outcome is inconsistent with the Conceptual Framework and its going concern principle;
 - (b) the IASB does not clearly explain why this is a better accounting outcome; and
 - (c) the identified changes in classification outcomes are not related to areas of IAS 32 that are problematic.
- 20 EFRAG is also concerned about the impact that these classification changes will bring to the market as some entities would no longer be able to account for their hybrid capital (or part of it) as equity. Some constituents have highlighted that the classification of subordinated hybrid capital as debt could, for entities that hold such instruments, significantly reduce solvency ratios and lead to higher cost of capital either due to higher interest rates on debt in general or due to higher coupon rates on the hybrids when refinanced into hybrid structures to make it compliant with the new equity classification requirements. Furthermore, the classification of the hybrid capital as debt could trigger (by the issuer) the accounting call feature contained in hybrid structures, thereby potentially inflicting losses to investors.
- 21 Therefore, EFRAG is not convinced that classification outcomes for non-derivatives under the IASB's preferred approach represents a significant improvement when compared to IAS 32.

Non-derivative financial instruments with alternative settlement outcomes

- 22 In section 5, EFRAG provides its comments in regard to financial instruments in which the issuer has the option for a liability or equity settlement and related discussions on whether the IASB should enhance the embedded derivative requirements and separate embedded derivatives or use of the attribution requirements to help in providing information about these types of instruments. Such comments also apply to non-derivative financial instruments.

Further guidance on an amount independent of the entity's available economic resources

- 23 Paragraphs 3.17 to 3.24 of the DP propose additional guidance on the meaning of an amount independent of the entity's available economic resources. As already mentioned in section 2, EFRAG has some specific concerns on the new terminology in the DP, particularly on the use of the amount feature ('amount independent of the entity's available economic resources') for classification purposes.
- 24 EFRAG considers that the notion of 'an amount independent of the entity's available economic resources' is difficult to apply, very judgemental and not intuitive, particularly when considering non-listed companies and financial institutions that

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issue complex instruments with many different variables. For example, in the DP the IASB refers to the entity's own share price as a reference. Nonetheless, the fair value of shares (e.g. listed shares) does not necessarily correlate with the entity's available economic resources within one or even multiple periods.

- 25 EFRAG understands that the notion of 'an amount independent of the entity's available economic resources' would encompass fixed monetary amounts or amounts that vary in response to something other than the fair value of the entity's shares. However, EFRAG notes that financial instruments for which the amount is partly independent of the entity's available economic resources can also be classified as liabilities (e.g. foreign currency written call options).
- 26 Furthermore, when the DP refers to equity, it states that equity claims could not contain either of the features that lead to a liability classification. That is, the amount cannot be 'independent of the entity's available economic resources'. EFRAG considers that this could create confusion because if a claim is partly independent of the entity's available economic resources (e.g. redeemable shares or puttable shares at fair value in a foreign currency or indexed to a commodity), then one may argue that the amount of the claim is not independent of the entity's available economic resources and classify the claim as equity (particularly when dealing with derivatives which the net amount partly depends on the entity's available economic resources).
- 27 Finally, EFRAG is particularly concerned about the use of the amount feature on liquidation for classification purposes as it would mean that some instruments would be classified as liabilities even though there is no obligation to transfer economic resources other than at liquidation.
- 28 This would be inconsistent with the Conceptual Framework and its going concern principle. The going concern assumption has already been considered by the IASB when developing IAS 32, as explained in paragraph BC18 of the Basis for Conclusions. It would also raise measurement questions, particularly when liquidation becomes more likely.

Other potential improvements

- 29 EFRAG considers that the IASB could discuss alternative approaches for the subclasses of equity, as described below in section 6. For example, the IASB could consider whether the classification, presentation and disclosure requirements could be improved based on whether financial instruments will or may be settled in the issuer's own equity instruments (i.e. existing and potential shareholders).

Section 3B - Puttable exception

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?

EFRAG's response

EFRAG considers that the accounting treatment provided by paragraphs 16A to 16D of IAS 32 should be retained until the IASB is able to find another solution that addresses the issues that gave rise to the exception.

EFRAG considers that the IASB could take the opportunity to understand the extent to which the exception is used in practice, the application challenges that are currently arising from it and whether potential improvements can be identified.

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- 30 In its endorsement advice issued in May 2008, EFRAG supported the amendment to IAS 32 to provide a limited exception to the existing requirements as a short-term solution pending the outcome of its longer-term projects. EFRAG considered that such an approach was reasonable in the circumstances. In the endorsement advice, EFRAG noted that IAS 32 already included some exceptions to the Conceptual Framework definitions of equity and liabilities in order to try to keep up with the increasing sophistication of financial instruments.
- 31 EFRAG still considers that the accounting treatment provided by paragraphs 16A to 16D of IAS 32 is relevant and should be retained unless the IASB is able to find another solution that addresses the issues that gave rise to the exception.
- 32 Nonetheless, this should not prevent the IASB from exploring improvements to the existing guidance in paragraphs 16A to 16D of IAS 32 and related disclosures. The requirements of paragraphs 16A to 16F of IAS 32 have led to implementation issues and confusion, as evidenced by requests to the IFRS IC. In particular, this relates to practical difficulties in identifying the most residual instrument.
- 33 EFRAG also notes that being equity classified, puttable instruments are not measured at fair value, as would be the case under liability classification. As a result, users may not have sufficient information to understand the economic effect of these claims. EFRAG acknowledges that for puttable instruments which meet the conditions, this problem is mitigated by the current disclosure requirements in paragraph 136A of IAS 1. EFRAG considers that these disclosure requirements provide useful information for users about expected future cash flows from such claims (assuming that such instruments would be measured at fair value). Thus, EFRAG suggests that the disclosure requirements in paragraph 136 of IAS 1 should not only be retained but also clearly state that it applies to instruments as described in paragraphs 16C and 16D of IAS 32.
- 34 Finally, EFRAG considers that the IASB should take the opportunity to better understand how widely the exception is being applied in practice and how it can be improved. For example, whether the wording of the exception is currently too narrow and how to address the challenges that arise when all an entity's claims meet the definition of a liability and no claim qualifies for classification as equity.

Section 4 - Classification of derivative financial instruments

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?

EFrag's response

EFrag appreciates the IASB's efforts to improve IAS 32's requirements on classification of derivatives with the objective of addressing the issues identified by the IFRS IC.

However, EFRAG is concerned that the proposed guidance under the IASB's preferred approach differs significantly from current guidance, particularly in terms of terminology (e.g. the identification of different types of derivatives such as asset/equity and liability/equity exchanges), which would have a significant impact on the existing application guidance and introduce new uncertainties. In addition, EFRAG is not convinced that the identified changes in classification outcomes relate to areas of IAS 32 that are problematic and is concerned about the potential impact that these changes in classification will bring to the market

Nonetheless, EFRAG notes that the DP identifies some solutions to the issues that arise in practice with derivatives on own equity which could be a good basis for further discussions on targeted improvements to IAS 32. For example, the IASB could consider incorporating some of the detailed guidance in paragraphs 4.45 to 4.66 of the DP focused on the difficulties related to the fixed-for-fixed condition (e.g. reference point to determine whether the transaction involves foreign currency, anti-dilution provisions and time value of money).

Different alternatives on accounting for standalone derivatives on own equity

35 EFRAG's overall views on the IASB's preferred approach to classification are set out in our response to Question 2. The following comments relate more specifically to the preferred approach as it would apply to derivative instruments.

Accounting for all derivatives on own equity as derivative assets or liabilities

36 When discussing the accounting for derivatives on own equity, the IASB considered the possibility of scoping out derivatives on own equity from IAS 32 and classifying all derivatives on own equity as derivative assets or liabilities under the scope of IFRS 9.

37 Such an approach would have the benefit of simplifying considerably the requirements in IAS 32 and would be in line with the view of many users of financial statements who argue that there are many complex instruments that attempt to

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qualify as equity but are not common shares. Such an approach would also be in line with the view that derivatives are executory contracts and that entities often buy their own shares in the market to settle the instrument, making it more similar to a cash-settled instrument. In addition, some holding this view also highlighted that existing requirements for derivatives (i.e. fixed-for-fixed condition) increased structuring opportunities from preparers that want to avoid fair value changes of derivatives on own equity being reflected in profit or loss.

- 38 EFRAG acknowledges that such an approach, which would mean that all standalone and embedded derivatives that are currently classified as equity would be reclassified as liabilities and accounted for at fair value through profit or loss in accordance with IFRS 9, would be a fundamental change to IAS 32 and would not be aligned with the objective of limiting unnecessary changes to classification outcomes of IAS 32 that are already well understood and considered to provide useful information.

Separate and classify separately the legs of the derivative

- 39 EFRAG agrees with the IASB's analysis in paragraph 4.20 of the DP that a detailed componentisation of all derivatives on own equity would create many conceptual and operational challenges. It would also be a significant change to current requirements.

Classification of derivatives on own equity under the IASB's preferred approach

- 40 Although EFRAG appreciates the IASB's efforts to improve IAS 32's requirements on classification of derivatives with the objective of addressing the issues identified by the IFRS IC, EFRAG expresses the following concerns:
- (a) the IASB's preferred approach for the classification of derivatives on own equity will not fundamentally change the classification outcome, however the proposed terminology differs significantly from current requirements in IAS 32. For instance, the IASB uses a completely new terminology when referring to the classification of different types of derivatives (e.g. asset/equity exchanges, liability/equity exchanges, 'net amount of a derivative'). EFRAG is concerned that the introduction of such terminology will introduce cost to preparers, complexity to existing requirements and significantly impact the existing application guidance which would have to be updated to reflect the new concepts and wording;
 - (b) even if the new terminology leads to accounting outcomes being broadly similar to the requirements in IAS 32, the IASB's preferred approach affects the accounting for some financial instruments that currently, to EFRAG's knowledge, do not raise concerns in practice (e.g. net-share settled derivative instruments). If any new approach brings about such changes this should be justified by a clear explanation of why it leads to a better accounting outcome;
 - (c) for liability/equity exchanges, it is hard to envisage an example of a basic (as opposed to highly bespoke), stand-alone derivative to extinguish a financial liability in exchange for delivering own equity instruments. In the context of embedded derivatives, the example of a convertible bond is easy to understand. It is not clear why this distinction is considered necessary or useful, except to place the current grossing up of certain derivatives under IAS 32 paragraph 23 on a more principle-based footing. However, this adds an unnecessary layer of complexity and creates an artificial distinction that inevitably fails in the case of purchased put contracts which are not grossed up as the entity can avoid payment;
 - (d) the judgement in determining the impact of these may not be significantly simpler than the current fixed-for-fixed requirements; and

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- (e) share price is considered to be a variable dependent on the entity's available economic resources, but other items (e.g. EBITDA that in many cases are used as proxies for share price when shares are not actively traded) are considered to be independent variables.

41 Therefore, EFRAG proposes targeted improvements to current classification requirements in IAS 32, particularly improvements to the guidance on whether an instrument meets the fixed-for-fixed condition. EFRAG considers that the guidance suggested in the DP (the detailed guidance in paragraphs 4.45 to 4.66 focused on variables that have resulted in questions and difficulties when applying the fixed-for-fixed condition in IAS 32) could be a good basis for further discussions on targeted improvements to IAS 32.

Foreign currency rights exception

42 The DP's proposals on foreign currency would impact the classification of financial instruments that currently meet the foreign currency rights exception in paragraph 16 of IAS 32. This guidance addresses the accounting for rights, options and warrants to acquire a fixed number of additional shares pro rata to all existing shareholders of a class of non-derivative equity instruments in which entities fix the exercise price of the rights in currencies other than their functional currency. These rights are commonly described as 'rights issues'.

43 Currently, rights issues offered for a fixed amount of foreign currency are classified as equity if such rights are issued pro-rata to all of an entity's existing shareholders in the same class for a fixed amount of currency, regardless of the currency in which the exercise price is denominated.

44 In accordance with the IASB's preferred approach, such instruments would be classified as a derivative liability with related returns presented in OCI if certain criteria are met. The reason offered is the inconsistency with similar embedded contracts such as foreign currency convertible bonds which do not qualify for equity classification under IAS 32 as it does not meet the fixed-for-fixed requirements.

45 Applying such an approach to financial instruments that currently meet the foreign currency rights exception in paragraph 16 of IAS 32 would have the conceptual benefit of removing exceptions to the fixed-for-fixed condition in IAS 32 and presenting within comprehensive income the changes in the foreign currency and fair value of the shares to be deliverable. Presenting separately the income and expenses that arise from such liabilities in OCI would also alleviate the tension on the impact of fair value changes in profit or loss and related volatility. However, EFRAG:

- (a) is not convinced that such an approach would solve the concerns that led to the amendments published in 2009;
- (b) is not aware of any issues with the application of such an exception;
- (c) considers that with the criteria in its preferred approach the IASB would be replacing the existing classification exception by a presentation exception; this is because such an approach represents an exception to the IASB's principle that the income and expenses that arise from liabilities that depend on the entity's available economic resources should be separately presented in OCI;
- (d) considers that the proposal would significantly increase the complexity of the requirements in IAS 32 if separate presentation requirements only applied to the portion of income and expenses that depends on the entity's available economic resources (disaggregation approach) as the entity would have to make the split between the changes in the foreign currency and value of the shares to be deliverable;

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- (e) considers that the DP's proposals would lead to an additional item presented in OCI and would create further discussion as to whether there should be subsequent reclassification to profit or loss ('recycling');
 - (f) disagrees with the IASB's conclusion that such transactions are transactions with owners in their capacity as owners which should be recognised in the statement of changes in equity rather than in the statement of comprehensive income in accordance with IAS 1; and
 - (g) contradicts another IASB conclusion that classifying rights as derivative liabilities is not consistent with the substance of the transaction (paragraph BC4F of IAS 32).
- 46 Therefore, EFRAG considers that the foreign currency rights issue is still relevant and should be retained until the IASB is able to find a solution that addresses the issues that gave rise to the amendments in 2009.

Net-share settled derivatives

- 47 Currently, net-share settled derivatives are classified as liabilities and measured at fair value through profit or loss. Under the IASB's preferred approach, net-share settled derivatives to deliver a fixed number of own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount are classified as equity. Considering the DP's attribution proposals, this would mean that the carrying amount of the derivative would have to be subsequently updated.
- 48 EFRAG notes that this classification change is a consequence of updating the IAS 32 requirements and is not meant to address any specific concern that arises in practice. Although EFRAG understands that most derivatives are physically gross settled or net-cash settled, we consider that the IASB has not clearly explained the benefits of such classification, in terms of relevance. This is especially relevant if the IASB decides to have an attribution approach other than full fair value to update the carrying amount of the derivative.
- 49 EFRAG also notes that liability/equity exchange contracts that are net-share settled fall under section 5 and therefore will require grossing up similarly to the gross share-settled forward contracts to buy and written puts over own equity. This is not clear from the DP and could benefit from a better description as well as examples. EFRAG also notes that with such an approach, the financial statements would imply that the entity has to purchase own shares when this is not the case.
- 50 Therefore, EFRAG is not convinced that classification outcomes for net-share settled derivatives under the IASB's preferred approach represents a significant improvement when compared to IAS 32
- 51 If the IASB decides to proceed with targeted improvements to IAS 32, EFRAG considers that there is no need to amend the existing requirements to the accounting for net-share settled derivatives.

Additional specific guidance on variables that affect the net amount (i.e. fixed-for-fixed condition)

- 52 Paragraph 4.45 to 4.66 of the DP proposes guidance on whether a specific variable that affects the net amount of the derivative precludes equity classification. This proposed guidance aims to clarify whether a derivative can be classified as equity if its net amount is affected by variables such as foreign currency, time value of money, anti-dilution provisions and contingencies (i.e. whether a derivative meets the fixed-for-fixed condition).
- 53 EFRAG notes that a number of the submissions to the IFRS IC on IAS 32 were related to the fixed-for-fixed condition. When analysing the issues, the IFRS IC also identified that there was diversity in practice in many issues related to the application

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of the fixed-for-fixed condition. This is due to the fact that currently IAS 32 provides limited guidance on how to interpret the fixed-for-fixed condition. As a result, the IFRS IC either reported the issues to the IASB and/or requested the IASB to better explain the requirements in IAS 32.

- 54 EFRAG considers that the DP identifies some solutions to the issues that arise in practice with the fixed-for-fixed condition which could be a good basis for further discussions on targeted improvements to IAS 32. Therefore, EFRAG suggests the IASB to consider incorporating some of the detailed guidance in paragraphs 4.45 to 4.66 of the DP focused on difficulties related to the fixed-for-fixed condition (e.g. reference point to determine whether the transaction involves foreign currency, anti-dilution provisions and time value of money).
- 55 If the IASB decides to proceed with its preferred approach, EFRAG raises a number of specific issues below and considers that it would be important to have a clear implementation guidance, particularly on foreign currency, which would help entities to apply the principles described in the DP.

Foreign currency²

- 56 This section is focused on whether the net amount of a derivative is impacted by foreign currency, resulting in a financial liability classification, similarly to the position under IAS 32.
- 57 EFRAG considers that the issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency is very important. Entities often issue financial instruments that are denominated in a currency other than its functional currency. A common example is the issuance of convertible bonds by a parent or subsidiary which are denominated in a currency other than its functional currency for ease of access to investors. EFRAG welcomes guidance on this topic.
- 58 EFRAG agrees with the principle included in paragraph 4.50 of the DP as the relevant determination for the separate financial statements. Challenges arise when considering consolidated financial statements, including situations where an entity issues derivatives over equity instruments of another entity within the group. Considering the notions of 'reporting entity' and 'functional currency' that exist in IFRS Standards, ideally the principle in paragraph 4.50 of the DP should also apply to consolidated financial statements (as a single entity). However, we acknowledge that a group does not have a functional currency and such discussion is beyond the scope of this project. Therefore, we agree with the outcome proposed.
- 59 However, EFRAG considers that, if the IASB were to proceed with this proposal, it should consider developing illustrative examples of derivative contracts on equity instruments of another entity within the same group to better explain how these principles would apply in practice considering different perspectives. For example, the classification in the separate financial statements of the subsidiary and parent and the consolidated financial statements of the group. Including examples where the shares of the subsidiary are denominated in a different currency (e.g. US Dollars) when compared to the currency used to settle the derivative and subsidiary's functional currency (e.g. Euros).
- 60 EFRAG also notes that the foreign currency variable is important for the separate presentation requirements of derivatives that have been classified as liabilities. More specifically, it affects the assessment of whether income and expenses that

² referred to as 'Currency or fixed units of financial assets in the DP'

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arise from partly independent derivatives should be recognised in OCI (e.g. foreign currency denominated written put option).

Dependency on the entity's economic resources before deducting all other claims

- 61 Paragraph 4.52 of the DP clearly considers that a derivative contract gross or net-share settled based on EBIT is different in nature than a contract based on the fair value of shares settled in shares. The DP seems to suggest that as interest and tax are excluded, EBIT only reflects changes in assets; however this would not be a problem where the entity has low debt. Furthermore, earnings include capitalised interest in some cases as well as other working capital type liabilities.
- 62 Some would argue that in many cases EBIT or a multiple thereof (or other similar metrics) are considered to be proxies for the fair value of the entity's economic resources and that for purposes of consistency, these should also be classified as equity. The example in paragraph 4.52 of the DP is not clear whether the derivative is gross or net-settled in shares or whether it is cash-settled. Where EBIT is used as a proxy for the fair value of shares (e.g. in the case of unlisted shares), it is not clear why equity classification is not considered to be appropriate. Therefore, we consider that the IASB should consider this aspect in more depth and provide further explanations as to the rationale for the final approach taken. EFRAG considers that whilst the guidance may be clear and simple to apply in practice, the scope of instruments to be classified as equity could be narrower than economic reality would suggest.

Time value of money

- 63 EFRAG notes that the impact of time value of money and the potential impact on the amount feature could pose interpretation problems and therefore welcomes the additional guidance. EFRAG agrees with the basic consideration that time value of money impacts all financial instruments whether it be directly or indirectly. Any final definitions and guidance on this topic need to be consistent as far as possible to the explanation and guidance in IFRS 9.
- 64 EFRAG notes that the additional guidance creates the scope for more uncertainty and judgement as time value of money can be both a dependent and independent variable. EFRAG considers that further guidance is required to assist preparers and advisors in the exercise of judgement in this area. For example, what is considered to be 'leveraged', i.e. does this mean anything other than a one-to-one relationship? In the example provided in paragraph 4.54 of the DP, both instruments seem to qualify for equity treatment, but it is not clear whether the strike price is comparable irrespective of the method used. Further examples of when the time value of money is an independent variable would support practical application.
- 65 Considering the discussion above on the use of different currencies, EFRAG considers that additional guidance on the notion of 'benchmark interest rate of an unrelated currency' would be welcomed. For example, when an entity issues a foreign currency Bermuda option for NCI, it is possible that entities that belong to the group have different functional currencies and work in different markets. Therefore, it would be important to link this guidance to paragraph 4.50 of the DP.
- 66 EFRAG considers that the DP does not provide sufficient guidance or examples to conclude that this should solve most practical application problems, especially as time value of money can be both a dependent and independent variable.

Dilution and distributions to holders of equity instruments

- 67 Given that in practice clauses related to dilution and distribution to holders of equity instruments give rise to considerable efforts to determine whether fixed-for-fixed requirements have been met, additional guidance is welcome and the examples in

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paragraph 4.58 even more so. EFRAG considers that the guidance provided will go a long way towards solving most problems around practical application in this area.

Non-controlling interests

- 68 EFRAG welcomes that the DP confirms the principles in IAS 1 on NCI when considering derivatives over own shares.
- 69 However, for the avoidance of doubt, the examples should clarify who are the parties to the contract (parent, subsidiary and/or other parties); explain the treatment in the accounts of the parent and/or subsidiary and then conclude on the position on consolidation. Currently, the guidance is not always clear whether the contract meets equity classification in the financial statements of the subsidiary and/or parent before concluding on the treatment in the consolidated financial statements.

Contingencies

- 70 Examples of contingencies outside of the control of both parties and currently included in various contracts include:
- (a) changes in indices (stock markets or consumer price);
 - (b) changes in other financial variables such as interest or exchange rates;
 - (c) changes in tax laws or other regulatory requirements such as capital requirements;
 - (d) changes in key performance indicators such as turnover, net income or leverage ratio;
 - (e) changes in control;
 - (f) changes in listing status (such as successfully completing an IPO); and
 - (g) cross-default settlement clauses.
- 71 EFRAG agrees with the basic principle that contingent settlement features for which the contingency is outside the control of the entity are considered unavoidable and therefore preclude equity classification. The example in paragraph 4.66 of the DP explains when such an event does not impact either the timing or amount features, but more examples showing where either is impacted may also be useful.
- 72 EFRAG also suggests that the IASB should consider developing further guidance on what is in the control of the entity which can be complex in practice. For instance, when determining whether shareholders are making decisions as 'part of the entity' (as members of the entity's corporate governance structure), or whether they are distinct from the entity itself when making these decisions (as holders of a particular instrument). This is also relevant for interpretation of clauses relating to initiation of IPOs or successful completion of IPOs etc.

Section 5 - Compound instruments and redemption obligation arrangements

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?

EFRAG's response

EFRAG supports the requirements in paragraph 23 of IAS 32 and therefore welcomes the DP's proposal to retain gross liability accounting for redemption obligation requirements. However, EFRAG is not convinced that the accounting within equity for a written put option on own shares together with the previously issued ordinary shares should be the same as for a convertible bond.

For financial instruments contingent on an uncertain event, EFRAG is concerned that, due to the complexity of the IASB's preferred approach (particularly the amount feature on liquidation), the uncertainty and diversity in practice that exists today on the classification of instruments such as financial instruments mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event would remain.

For financial instruments with alternative settlement outcomes that are controlled by the entity, EFRAG considers that information about the variability resulting from the different features included in these types of instruments could be provided through a better breakdown of equity components on the face of statement of financial position, together with improved disclosures on the terms and conditions of such financial instruments. EFRAG also considers that improvements to the requirements for indirect obligations as described in section 8 could also improve the classification in specific cases.

Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)

Compound instruments

- 73 EFRAG considers the current approach under IAS 32 to be well understood and giving rise to few problems in practice. However, EFRAG considers that it would be useful to require separate presentation in the statement of financial position of the equity components of compound instruments and derivatives on own equity (e.g. within a subclass) to help users better understand where the different components of complex financial instruments are presented.

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Redemption obligation requirements

- 74 EFRAG supports the requirements in paragraph 23 of IAS 32 to recognise a 'gross' liability for instruments that contain an obligation for an entity to purchase its own equity instruments for cash or another financial asset. EFRAG therefore welcomes the DP's proposal to retain gross liability accounting for redemption obligations.

Accounting within equity for written put options

- 75 EFRAG agrees in principle that instruments with the same economic substance but different structures should be accounted for in the same way. However, EFRAG is not convinced that a written put option on own shares combined with the previously issued ordinary shares has the same economic substance as a convertible bond.
- 76 The suggested similarity between the economic substance of a written put and a convertible bond seems partly to be a consequence of the IASB's decision to recognise a gross liability for the pay leg of the written put.
- 77 In EFRAG's view, there are also important differences between the two instruments: in one case the entity has issued shares and might be required to repurchase them; in the other case an entity might be required to issue shares in the future to settle the claim. The similarity between a convertible bond and a written put from the perspective of the holder assumes that the holder of the put also holds the underlying shares which is not necessarily the case.
- 78 In particular, EFRAG is concerned that the accounting for the equity component of a written put option would reflect a written call or conversion option in a convertible bond. Such an outcome is complex for users and preparers to understand and does not reflect the substance of the instruments. Therefore, this treatment is unlikely to provide useful information to users, regardless of whether changes in the carrying amount of the liability is affected by an attribution requirement. EFRAG considers that this accounting becomes even less meaningful for any attribution method other than at fair value.
- 79 EFRAG notes that the DP introduces a new concept as derecognition of equity does not reflect extinguishment of the equity but a reflection of the change in characteristics of equity instruments. It is not clear what this means and what, if any, practical implications of such a new category of derecognition could be. Furthermore, the DP indicates that equity is the residual of the amounts recognised for the liability, the conversion option and cash received, however, it is not clear whether this includes the impact of valuation adjustments such as credit or debit valuation adjustments or funding valuation adjustments.
- 80 In summary, EFRAG considers that the DP's proposals for the accounting within equity:
- (a) will increase significantly the complexity of the requirements on date of recognition as the equity component is changed from a written put to a written call or a conversion option in a convertible bond. EFRAG also considers that it will be difficult for users to understand the outcome of such accounting treatment;
 - (b) will be difficult for users to understand the outcome of the attribution proposals even if the attribution is at full fair value. If the IASB decides to use another attribution mechanism, EFRAG considers that users will not be able to understand the final outcome;
 - (c) may increase confusion due to the new concept that equity is derecognised when equity has not been extinguished and the implications thereof; and
 - (d) the principles stated in paragraph 5.8 of the DP will be difficult to incorporate in IAS 32 or a new IFRS Standard as it would need detailed guidance and

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examples, as EFRAG does not consider that it is intuitive that a written put option with the related shares (and other similar derivatives) should be analysed from classification purposes in a similar way as a compound instrument.

- 81 Therefore, EFRAG considers that there is no need to amend the existing requirements in IAS 32 for written put options.

Accounting for NCI puts

- 82 In the consolidated financial statements, written put options over NCI are accounted for in accordance with paragraph 23 of IAS 32. The issues relating to paragraph 23 to obligations to repurchase own entity's equity instruments therefore apply equally to written puts over NCI, including:

- (a) the accounting within equity; and
- (b) the presentation of the subsequent remeasurement of the redemption amount.

- 83 Regarding the derecognition of the NCI on which put options are written, EFRAG notes that current practice is mixed as some consider it logical to derecognise the NCI while others consider such derecognition as inappropriate. This could be the case when a put option is not at a fixed price which some interpret as that the NCI continue to have equity-type exposure and that the NCI should continue to be recognised. Neither approach is currently forbidden by paragraph 23 of IAS 32. Nonetheless, EFRAG expresses the same concerns as in paragraph 78 above in regard to recognising an equity component that represents an implicit call option as compared to the put option.

- 84 Whilst the DP clarifies that the component of equity (whether shares issued or NCI) is derecognised, it does not deal with certain conceptual issues that have been raised in the past or certain related application issues. For example:

- (a) why changes to the redemption amount (especially for written puts at fair value) should fall under the principles in IFRS 9 around recognition in profit or loss rather than those in IFRS 10 and IAS 1 around transactions between equity holders;
- (b) the treatment of profit allocation and dividends paid to NCI under IFRS 10 when the NCI have been derecognised;
- (c) the impact of the changes on other topics such as earnings per share, i.e. derecognised shares means that subsidiary's income is fully included, but derecognised shares may need to be considered for fully diluted EPS. This may be different from the current situation;
- (d) whether the accounting should differ based on whether the written put forms part of a business combination or whether it was entered separately; and
- (e) the treatment when there is uncertainty around how many shareholders would exercise a cash option in allocation rights as per ESMA's enforcement decision EECS/0214-03.

- 85 Therefore, EFRAG concludes that there are various conflicts that have to be resolved on the basis of derecognition of the equity component. In addition, EFRAG has concerns about the recognition of a conversion option in a NCI put that reflects a call option of a convertible bond (see paragraph 78 above). EFRAG's comments on the DP's proposals on separate presentation of liabilities with equity-like returns are set out in section 6.

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Financial instruments with alternative settlement outcomes that are contingent on uncertain event

- 86 EFRAG understands that the suggestions included in the DP for contingencies, such as mandatorily convertible bonds with a cap that is triggered automatically, would not change current requirements significantly and would be aligned to the IFRS IC decisions up to date. Some of the IASB's suggestions would also have the benefit of bringing more clarity on whether measurement of the liability should reflect the probability-weighting of the liability component based on the likelihood of the liability settlement outcome occurring. Such guidance is particularly important for clarifying the accounting for financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event, which have been raising concerns around the measurement of the liability component³.
- 87 Nonetheless, due to the complexity of the IASB's preferred approach, particularly the amount feature on liquidation, EFRAG considers that the uncertainty and diversity in practice that exists today on the classification of instruments such as financial instruments mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event would remain with the IASB's approach. For example, with the IASB's preferred approach, uncertainty and diversity in practice would continue to arise:
- (a) on whether AT1 instruments with discretionary coupons/dividends should be treated from an accounting perspective as compound instruments and how the presentation and recognition of the coupons/dividends should be done (an issue that already exists and has not been addressed by the IASB); and
 - (b) on the impact of the amount feature on instruments that can be mandatorily converted into own shares or written down, whether the measurement of the liability component (i.e. present value) that equals to zero on a going concern basis would become an issue if the probability of a non-viability event or the call of an instrument increases.

Financial instruments with alternative settlement outcomes that are controlled by the entity

- 88 EFRAG notes that, under IAS 32, if an entity has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of equity. Therefore, requiring separation of an embedded derivative would be a significant change.
- 89 In addition, questions could arise on how instruments should be split. For example, a reverse convertible bond could be considered:
- (a) an equity component that represents the obligation to deliver a fixed number of shares and a derivative component that represent the issuer's right to choose cash payment instead of the fixed number of shares if it is a cheaper alternative; or
 - (b) an instrument that includes an unconditional right of the entity to settle a claim either by transferring a fixed number of equity instruments (which would be an equity settlement) or a specified amount of cash (which would be a liability settlement). That is, it would include a liability host and an embedded derivative (i.e. purchased put option on own equity).
- 90 Further, EFRAG notes that these instruments are often affected by multiple variables (e.g. foreign currency, market price of the shares, etc.) and it will be difficult

³ EFRAG notes that according to the IASB's approach, the liability component must be measured at the full amount that the issuer could be required to pay immediately

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to provide information about all those different features through separation of embedded derivatives and recognition of fair value changes in profit or loss. In addition, such requirements will be costly for preparers. Finally, EFRAG notes that adding attribution requirements to help in providing information about financial instruments with alternative outcomes at the entity's option would also add costs and complexity to current requirements (as further detailed in section 6).

- 91 EFRAG acknowledges that classifying these instruments as equity in their entirety provides no information about the alternative settlement outcomes (e.g. information about the variability resulting from the different features included in these types of instruments). EFRAG considers that additional information could be provided through a better breakdown of different categories of equity and improved disclosures on the terms and conditions of such financial instruments, especially where economic compulsion may play a role in the entity's exercise of its discretion.
- 92 EFRAG also considers that improvements to the requirements for indirect obligations as described in section 8 could aid the classification in specific cases (e.g. where an option does not have commercial substance). Also, the issues related to economic compulsion are addressed in section 8.

Section 6 - Presentation

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?

EFRAF's response

EFRAF considers that information about financial liabilities that provide equity-like returns or are indexed to equity can be relevant for users of financial statements to assess the entity's performance.

However, considering the challenges that would arise in practice from separately presenting such liabilities on the face of the primary financial statements, EFRAG is not convinced that expanding the use of OCI is the most appropriate way to address the concerns related to counter-intuitive accounting.

Instead, EFRAG would recommend the IASB to consider the possibility of providing such information within disclosures. More specifically, providing disclosures on liabilities, derivatives and embedded derivatives that are solely dependent on entity's available economic resources. Similarly, they should only apply to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, are solely depend on the entity's available economic resources. If the IASB does however pursue the OCI approach, EFRAG considers that its scope needs further development and the question of recycling should be considered further.

Separate presentation of financial liabilities in the balance sheet and income and expenses in OCI

- 93 EFRAG welcomes the DP's discussion on providing additional information to users, particularly about liabilities that have equity-like returns. We consider that

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improvements to presentation are important even if stakeholders disagree on the best classification approach.

- 94 EFRAG notes that the DP's proposal, when considered as a whole (i.e. creation of subclasses of liabilities, separate presentation requirements within the statement of financial position and statement of financial performance and arranging claims by priority), would imply significant changes to IAS 1 and IFRS 9 and current practice, particularly for entities with complex financing and capital structures.
- 95 In particular, EFRAG highlights that the DP's proposals would:
- (a) give rise to separate presentation requirements for three classes of financial liabilities which would affect both the statement of financial position and statement of financial performance:
 - (i) financial liabilities and derivatives for an (net) amount that is dependent on the entity's available economic resources;
 - (ii) financial liabilities and derivatives for a (net) amount that is independent of the entity's available economic resources; and
 - (iii) partly independent derivatives for which the net amount that is neither completely independent nor solely dependent on entity's available economic resources.
 - (b) increase the use of OCI in the statement of financial performance; and
 - (c) if the IASB requires entities to present financial liabilities and equity in order of priority on liquidation on the face of the statement of financial position, it is unclear whether this would over-ride the existing requirements in IAS 1.
- 96 Considering that challenges that would arise in practice from separately presenting such liabilities on the face of the primary financial statements, EFRAG would recommend, as further described below, the IASB to consider the possibility of providing such information within disclosures.

Statement of financial performance

- 97 EFRAG notes that separate presentation in OCI is one way to provide additional information about financial liabilities that provide equity-like returns, but is not the only one. For example, alternative approaches to enhance the information provided could include using a separate line item within profit or loss or through disclosures.
- 98 EFRAG can see arguments both in favour and against presenting income and expenses in OCI that arise from financial liabilities and derivative financial assets and liabilities that depend on the entity's available economic resources.
- 99 On the one hand, EFRAG acknowledges some of the similarities between this issue and the 'own credit risk' amendments to IFRS 9 as described in paragraph 6.48 of the DP. In addition, EFRAG considers that the IASB proposals have the benefit of providing a conceptual solution to what some see as counter-intuitive accounting for puttable shares and derivatives over own equity (including NCI puts).
- 100 On the other hand, EFRAG notes that the own credit risk issue only arises in the context of financial liabilities designated under the IFRS 9 fair value option and that when the amendment was issued, own credit risk was considered a temporary change in measurement until maturity and considered difficult to realise.
- 101 In addition, EFRAG notes that many consider that there are cases where an increase (decrease) in a financial liability should be, from a conceptual point of view, reflected as performance and not in OCI, even if its amount depends on the entity's available economic resources. For example, obligations for a cash-settled share-based payment and net-cash settled purchased call options (when an entity performs well, it realises a gain). In addition to this:

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- (a) in accordance with the revised *Conceptual Framework for Financial Reporting* the use of OCI is appropriate only if it enhances the relevance of profit or loss. EFRAG notes that if the IASB decides to expand the use of OCI, there is likely to be a call for further debate on the notion of performance and for the IASB to further clarify the dividing line between profit or loss and OCI;
 - (b) under the IASB's preferred approach, gains and losses would not be recycled to profit or loss, because the nature of these income and expenses will not change and will therefore not be relevant to assessments of performance at a future date. EFRAG considers that there are strong arguments in favour of requiring recycling on settlement date, when the gain or loss is realised. However, if, the gains and losses were to be reported in OCI and not recycled, then EFRAG considers that it would be useful to require disclosures of the amounts recognised in OCI and the movements within equity when the instrument is settled (e.g. how much would have been reclassified if the IASB had required reclassification upon derecognition);
 - (c) the DP is silent on whether an entity would be required to present the amounts recognised in OCI as a separate component within equity in the statement of financial position and whether there should be a subsequent transfer within equity. Current requirements in IFRS 9 do not permit an entity to recycle the amounts in OCI that are related to changes in the entity's own credit risk. However, IFRS 9 permits their subsequent transfer within equity;
 - (d) the existing requirements in IFRS 9 would be impacted not only in terms of OCI but also on separation of hybrids⁴. EFRAG would recommend the IASB to assess the impact of its proposed changes to IFRS 9 before proceeding; and
 - (e) entities may try to structure claims to meet the description of this new class in order to avoid reporting changes in the carrying amount of claims within profit or loss.
- 102 On balance, EFRAG considers that information about financial liabilities that provide equity-like returns or are indexed to equity is relevant for users of financial statements. However, considering the challenges that would arise in practice from separately presenting such liabilities on the face of the primary financial statements, EFRAG would recommend the IASB to further consider the possibility of providing such information within disclosures.
- 103 If the IASB does however pursue the OCI approach, EFRAG considers that:
- (a) its scope needs further development (e.g. whether it should only apply to the instruments described in paragraph 6.20 of the DP or to a wider range of instruments for which the amount is linked to the issuer's performance); and
 - (b) the question of recycling should be discussed further.

Partly independent derivatives

- 104 Although EFRAG is not convinced that expanding the use of OCI is the most appropriate way to address the concerns identified, EFRAG has considered the advantages and disadvantages of the different approaches described in the DP and sets out its comments below.
- 105 If a liability or derivative is partially independent of the entity's available economic resources and the IASB's preferred approach is to be applied, EFRAG agrees that the most conceptually sound approach would be the **disaggregation approach**.

⁴ EFRAG expresses below a number of concerns with the IASB's approach for hybrids and partly independent derivatives

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This is because splitting the different components would provide a better reflection of the effect of the entity's own performance in comprehensive income.

- 106 However, EFRAG considers that such a model would increase significantly the complexity of the requirements in IAS 32, would be costly to apply and would always generate an artificial split as preparers will not be able to eliminate the effects of the interrelation between the different variables such as share price and foreign currency changes. This approach would also widen the use of OCI.
- 107 EFRAG acknowledges that the **criteria-based approach** would address the cost issue of the disaggregation approach. However, EFRAG considers that the criteria-based approach:
- (a) constitutes an exception to the principle that only gains or losses that arise from liabilities and derivatives that depend on the entity's available economic resources should be presented in OCI. This would result in variables that are independent of the entity's available economic resources being reflected in OCI, even if restricted to a number of instruments;
 - (b) would increase complexity in terms of presentation in the statement of financial position as the IASB would need to identify separately within profit or loss and OCI those liabilities that are fully dependent, those that are partially dependent and those that are not;
 - (c) would involve judgement about the facts and circumstances when applying the criteria, particularly when assessing whether the 'foreign currency is imposed by an external factor' as in paragraph 6.34(d) of the DP (e.g. use of the wording 'practically possible');
 - (d) would lead to dissimilar accounting for derivatives and non-derivatives. This is because non-derivative financial liabilities would only be separately presented if the amount of the claim is solely dependent on the entity's available economic resources (e.g. shares redeemable at fair value). It is not clear whether the separate presentation requirements are also applied to non-derivatives that are partly dependent on the entity's available economic resources (e.g. shares redeemable at fair value in a foreign currency); and
 - (e) would widen the use of OCI.
- 108 Overall, EFRAG also does not support the DP's proposal to present separately in the statement of financial performance (in OCI) derivatives, embedded derivatives and hybrids which the net amount is affected by variables that are both independent and dependent on the entity's available economic resources.
- 109 EFRAG considers that if the IASB decides to further explore the requirements for separate presentation of financial liabilities in OCI, then they should be applied only to financial liabilities and derivatives for which the amount is solely dependent on or affected by the entity's own performance.
- 110 Nonetheless, EFRAG would prefer that such information would be provided within disclosures and apply only to liabilities, derivatives and embedded derivatives that are solely dependent on entity's available economic resources.

Separate presentation requirements for all embedded derivatives in hybrid instruments

- 111 EFRAG acknowledges that separate presentation of all embedded derivatives in hybrid instruments would, under the IASB's preferred approach, maximise the benefits of the separate presentation requirements. However, EFRAG is concerned about the costs and complexity of always requiring the split of hybrid instruments just for the purpose of using OCI.
- 112 If the IASB decides to proceed, EFRAG would then recommend that the IASB assess the impact of such proposals and limit them to embedded derivatives that

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are separated from the host (separation at the option of the entity and not a requirement) and hybrid instruments that, as a whole, are solely dependent on the entity's available economic resources (e.g. shares redeemable at fair value). EFRAG would then suggest that the IASB considers whether such information should be provided within the notes.

Statement of financial position

- 113 In regard to the statement of financial position, the DP proposes the use of additional line items or sub-classifications for the presentation of liabilities and derivatives for which the (net) amount fully or partly depends on the entity's own performance (e.g. share price).
- 114 EFRAG notes that the IASB would need to consider how these presentation requirements will interact with the existing requirements in IAS 1 (e.g. in terms of minimum line items). More specifically, whether the separate presentation requirements will be reflected as simply a separate line item, a new subtotal or a separate category.
- 115 The presentation may also depend on the IASB's final decision on disaggregation and criteria-based approach. If the disaggregation approach is used, only two subclasses of instrument will exist (solely dependent or not dependent). If the IASB opts for the criteria-based approach, then the IASB will need to develop three categories (solely dependent, partially dependent and not dependent).
- 116 Considering this, EFRAG would suggest the IASB to consider whether such detailed information could be presented within the notes of the financial statements, linking directly the changes in liabilities with the gains or losses recognised in OCI and the movements within equity.
- 117 In regard to the DP's discussion on arranging claims by priority on liquidation, EFRAG notes that currently most non-financial entities make the distinction between current and non-current assets/liabilities and organise the line items within each category typically by liquidity.
- 118 EFRAG also notes that currently many financial institutions use the exception described in paragraph 60 of IAS 1 which states that an entity shall present all assets and liabilities in order of liquidity when a presentation based on liquidity provides information that is reliable and more relevant than separately presenting current and non-current assets, and current and non-current liabilities.
- 119 Considering this, EFRAG considers that requiring entities to arrange the claims by priority on liquidation on the face of the statement of financial position would:
- (a) be inconsistent with current practice and would introduce a different organisation between assets (liquidity) and liabilities (priority);
 - (b) raise questions on how to arrange liabilities that have a high priority on liquidation but have to be liquidated in the short term, particularly for consolidated financial statements;
 - (c) raise questions on how to arrange claims for financial institutions as 'resolution' could bring complexity to such presentation, particularly when considering that many instruments would, on the trigger event, be converted into shares or even written down, with a different order of liquidation;
 - (d) mean that users could face additional difficulties in determining the working capital of an entity; and
 - (e) raise the same issues described in paragraph 162 below (i.e. defining priority within consolidated financial statements can be challenging).

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- 120 EFRAG would prefer to have information related to priority on liquidation reflected in the disclosures (please see section 7). Such an approach would be less disruptive than presentation on the face of the statement of financial position, while providing the same information.

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?

The IASB'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 IASB did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the IASB 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?

EFRAG's response

EFRAG acknowledges that the attribution approach has some benefits, such as providing information about distribution of returns among the different types of classes of equity and reflecting similar information as the 'narrow equity' approach. However, EFRAG considers that the costs of the information provided by the 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 likely to exceed the related benefits.

Instead, EFRAG recommends the IASB to consider improvements to existing presentation requirements without the attribution mechanism (i.e. more disaggregation of equity components on the face of the financial statements to help users to, for example, distinguish existing shareholders from potential shareholders) and provide information about dilution through improvements to IAS 33 and disclosures. If attribution is retained, EFRAG recommends the IASB to use the method that is similar to that currently used for NCI in IAS 33, based on the relative position of existing and potential shareholders at the year end.

Information on subclasses of equity

- 121 EFRAG notes that the identification of subclasses of equity is not an entirely new concept. As in previous versions, the Conceptual Framework mentions that equity may be sub-classified in the statement of financial position and that such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity.

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- 122 EFRAG also notes that many entities, particularly financial institutions, already show different sub-classifications of equity. For example:
- (a) issued capital/called up share capital that includes for example ordinary shares and preference shares;
 - (b) other equity instruments such as perpetual bonds, equity components of compound instruments and derivatives on own equity;
 - (c) reserves;
 - (d) retained earnings; and
 - (e) non-controlling interest.
- 123 The use of subclasses of equity is also aligned with EFRAG's views included in the EFRAG comment letter on the IASB DP *Conceptual Framework for Financial Reporting*, where EFRAG considered that primary and secondary equity claims are fundamentally different and that IFRS Standards should reflect those differences.

Overall assessment of the attribution requirement proposals

- 124 EFRAG considers that attributing total comprehensive income to some equity instruments other than ordinary shares and using such an attribution mechanism to update the carrying amounts of some equity instruments has some potential benefits:
- (a) showing the 'wealth transfer' or 'distribution of returns' among the different types of equity instruments;
 - (b) reflecting similar information as the 'narrow equity' approach (with the narrow equity approach, changes in value of the financial instruments with characteristics of equity classified as liability would impact retained earnings. With the IASB's preferred approach the carrying amount of equity instruments other than ordinary shares would also be updated against retained earnings); and
 - (c) limiting the accounting differences between liability and equity treatments, thereby limiting the incentives to structure instruments to achieve a particular accounting outcome.
- 125 However, EFRAG also has the following concerns relating to the attribution proposals in the DP:
- (a) EFRAG is concerned about the increased complexity and costs, particularly when considering that the IASB would require entities to update the carrying amount of their derivatives on own equity, which may be challenging if those fair values are not observable. EFRAG notes that entities will have to, even if not listed, determine the fair value of their equity instruments other than ordinary shares, compute an attribution method for derivatives and non-derivatives, present the results in the statement of financial position and statement of financial performance and keep track of these movements in the statement of changes in equity;
 - (b) EFRAG has heard mixed views on the usefulness of expanding the attribution requirements to ordinary shares and equity instruments other than ordinary shareholders, particularly when considering that potential shareholders do not have the right to dividends and other returns from entities;
 - (c) EFRAG notes that the DP does not specifically mention the impact of the introduction of subclasses of equity on the presentation requirements in the statement of financial position and statement of financial performance. That is, the DP does not specify whether equity instruments other than ordinary shares represent a new category, subtotal, one line item within equity or many

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new line items (e.g. split between derivatives and non-derivatives or by key classes of instruments such as options, forwards, etc.);

- (d) EFRAG considers that it will be difficult to obtain a relevant attribution requirement for equity instruments other than ordinary shares in the statement of financial performance while, at the same time, reaching a meaningful update of the carrying amount within equity, particularly when considering that different elements of equity instruments other than ordinary shares may have different attribution methods;
- (e) EFRAG considers that it is difficult to assess what would have to be changed in IAS 32, and other standards to encompass the proposed guidance on the attribution of comprehensive income in the statement of financial performance and statement of financial position. It is EFRAG's understanding that the IASB would have at least to consider amendments to the requirements in IAS 1, IAS 32 and IAS 33;
- (f) expanding the attribution requirements and updating the carrying amount of equity instruments other than ordinary shares would not, by itself, reflect the entire effect of the wealth transfer between existing shareholders and potential shares. This is because there are financial instruments that are settled with own equity but are accounted for as liabilities in their entirety. Such wealth transfer would not be seen so clearly within equity as gains or losses that arise from such instruments go through comprehensive income;
- (g) the IASB would have to evaluate whether an attribution method can be applied to partnerships, cooperatives and organisational structures other than corporates. In particular, EFRAG considers that the IASB should make clear that financial instruments that meet the puttable exception would be classified as ordinary shares;
- (h) currently the scope of IAS 33 is applicable only to listed companies (parent or consolidated). If the scope of any new attribution requirements is wider than the scope of IAS 33, subsidiaries would have to apply concepts from IAS 33 even if they are scoped out of IAS 33.
- (i) it is not clear whether the DP's attribution proposal would encompass changes to the existing attribution requirements on profit or loss in paragraph 81B(a) of IAS 1. If the attribution mechanism is also to be applied to profit or loss, EFRAG considers that such a split would affect the calculation of basic EPS, as currently the starting point for the numerator of the EPS is profit or loss related to the owners of the parent company (subject to adjustments), ignoring income and expenses included in OCI. This would mean, that Basic EPS would also ignore the financial liabilities for which the amount depends on the entity's available economic resources;
- (j) in practice, preparers use several equity components (issued capital, other equity instruments, reserves, retained earnings, OCI, etc.) which would increase the complexity in terms of attribution when compared to NCI. For example, entities would have to analyse how the allocation of comprehensive income to ordinary shares and equity instruments other than ordinary shares would affect the allocation of comprehensive income to reserves, retained earnings and particularly to separate components of OCI; and
- (k) EFRAG would expect that any amount recognised as an equity instrument other than ordinary shares would not be subsequently derecognised when the instrument is exercised. Therefore, when presenting equity instruments other than ordinary shares, the carrying amounts on the face of the statement of financial position would reflect both instruments that have been already settled and instruments that will be settled in the future.

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- 126 Overall, EFRAG is concerned that the introduction of subclasses of equity and attribution mechanism will introduce significant complexity and increase costs for preparers. EFRAG also considers that the costs of the information provided by the attribution approaches (i.e. attributing total income and expense to equity instruments other than ordinary shares and updating the carrying amounts of those equity instruments based on that attribution) are likely to exceed the related costs.

Statement of changes in equity

- 127 EFRAG is also concerned that an attribution approach would significantly increase the complexity and movements within the statement of changes in equity, blurring its usefulness.

Attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33

- 128 The fact that the IASB is discussing different attribution methods for different equity instruments other than ordinary shares indicates that it will be difficult to achieve a meaningful result for both the statement of financial performance and statement of financial position.
- 129 EFRAG is concerned that the result of using different methods may lead to an artificial allocation of total comprehensive income to different subclasses of equity, without adding significant value to users.
- 130 EFRAG considers that if the IASB uses different methods to update the carrying amount of equity instruments other than ordinary shares and NCI, then users will have difficulties in understanding how each component has been updated, which could lead to the misinterpretation of the resulting information.
- 131 Finally, although EFRAG is not in favour of an attribution mechanism:
- (a) EFRAG considers that an attribution based on the existing requirements of IAS 33 for non-derivative equity instruments could be applied in practice. We note, however, that the scope of the attribution requirements is wider than the scope of IAS 33 and that entities that are not currently applying the concepts of IAS 33 would be required to use the Standard for attribution purposes; and
 - (b) EFRAG would welcome more examples of non-derivatives instruments that would be considered other than ordinary shares and subject to attribution requirements.

Attribution approach for derivative equity instruments

- 132 Although EFRAG is not in favour of an attribution mechanism, between the three attribution approaches provided for derivatives, EFRAG prefers the IASB's full fair value approach for relevance and cost-benefit purposes. EFRAG considers that the use of the full fair value approach could result in an understandable 'measurement' basis for the carrying amount of equity instruments other than ordinary shares (particularly, for equity components of convertible bonds and derivatives on own equity) and that such information would be particularly useful if it reflected the full fair value changes of each individual equity instrument (not grouped by type or other). Such an approach would also have the benefit of aligning the 'measurement' basis for derivatives on own equity that have been classified as financial liabilities. The full fair value approach would also produce information that would be similar to the information that would result as if only ordinary shares were considered as equity instruments (depending on how non-derivative, non-ordinary share equity instruments would be accounted for if they were to be considered as liabilities).
- 133 However, EFRAG is concerned that this may result in ordinary shares or equity subclasses other than ordinary shares having a deficit balance and is concerned about directly updating/measuring components of equity. Instead, EFRAG

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considers that the IASB should focus on providing better information about different components or subclasses of equity through disclosures rather than implementing an attribution mechanism.

- 134 In regard to the remaining attribution approaches described in the DP, EFRAG considers that the average-of-period and end-of-period approaches would be complex and costly to apply as the entity would have, for example, to calculate the relative fair value of its own equity instruments. It is also difficult for EFRAG to see the relevance of the information provided by these methods for the purposes of updating the carrying amount of equity instruments other than ordinary shares, particularly when updating the carrying amount of each individual equity component of convertible bonds and options.

Definition and scope of each subclass of equity

- 135 EFRAG considers that if the IASB is going to proceed with its preferred approach and differentiate a subclass of *equity instruments other than ordinary shares*, then there is a need for the IASB to provide additional guidance on:
- (a) the classification of the many different types of ordinary shares with different rights, while determining the most residual class of financial instrument, as this has proven to be difficult in the past, particularly with the application of the puttable exception. In its letter to the IASB DP *Conceptual Framework for Financial Reporting*, EFRAG identified a number of challenges related to an approach based on the most residual instrument;
 - (b) how the IASB's preferred approach would fit in non-corporate structures, such as partnerships and cooperatives;
 - (c) whether perpetual bonds⁵ would be considered as *equity instruments other than ordinary shares*, even if they share similar characteristics to ordinary shares, and how the attribution would be made to such instruments. EFRAG notes that such instruments will not be converted into ordinary shares;
 - (d) how this definition would deal with financial instruments which can be written-down. That is, these financial instruments could be seen as the most subordinated instruments, more than ordinary shares⁶, in case of resolution (for more details on AT1 convertible bonds please see paragraph 189 below);
 - (e) the interaction between IAS 1 and IAS 33 in terms of definitions of 'ordinary equity shareholders' and 'potential equity shareholders'; and
 - (f) whether equity-settled share-based payments would be within the scope of the attribution requirements.

Disclosure-only approach

- 136 In paragraph 6.87 of the DP the IASB acknowledges the costs and complexity of any approach to attribute total comprehensive income to equity derivatives and discusses a 'disclosure only' approach as a way to provide information about the effect of derivative equity instruments on ordinary shares.
- 137 Such an approach would encompass additional disclosures about potential dilution (section 7) and extending the existing disclosure requirements related to the fair value of financial liabilities in IFRS 7 to equity instruments other than ordinary shares. The IASB argues that this would result in similar information being provided

⁵ A perpetual bond is a non-redeemable bond with no maturity which pays a stream of interest indefinitely

⁶ AT1 instruments that have a trigger that kicks-in before resolution can absorb losses before equity

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about derivatives on own equity regardless of whether they are classified as financial assets, financial liabilities or equity instruments.

- 138 EFRAG welcomes the DP's proposal to provide more information about the effect of derivative equity instruments on ordinary shares through diluted earnings per share and other disclosures. However, EFRAG is concerned about the related costs of extending the existing disclosure requirements related to the fair value of financial liabilities in IFRS 7 to equity instruments other than ordinary shares, particularly if Level 1 inputs (i.e. quoted prices in active markets) are not available.
- 139 Alternatively, EFRAG considers that the IASB could consider a number of additional improvements other than simply additional disclosures. This is discussed in the section below.

EFRAG's alternative approach

- 140 To provide more information about the effect of equity instruments other than ordinary shares, EFRAG considers that the IASB could combine a number of different improvements:
- (a) improve presentation by requiring further disaggregation of equity on the face of the statement of financial position and disclosures related to the different components/classes of equity;
 - (b) improve current requirements in IAS 33 based on the shortcomings that the IASB identified in the DP; and/or
 - (c) improve current disclosures in IAS 33 on dilution, including the distribution of returns when there is full dilution (section 7).
- 141 Finally, if expanding the attribution requirements to equity instruments other than ordinary shares is deemed necessary and retained, EFRAG recommends the use of the method that is currently used for NCI and IAS 33, based on the relative position of existing and potential shareholders, but without updating the carrying amounts within equity.

Improvements to presentation within equity

- 142 Currently, IAS 1 only requires the presentation of 'issued capital and reserves attributable to owners of the parent' and 'non-controlling interests'. From its initial research, EFRAG observed that when entities present their equity within the statement of financial position, there is often a lack of disaggregation and consistency on the presentation of categories, subtotals and lines items.
- 143 Therefore, EFRAG considers that the IASB could consider potential improvements to the content and structure of the statement of financial position within equity. For example, currently financial institutions often refer to 'issued capital' and 'other equity instruments' within the equity section of the statement of financial position. Thus, the IASB could consider the introduction of additional line items, subtotals and categories to separately present, for example, financial instruments that will or may be settled in the issuer's own equity instruments (distinguishing existing vs potential shareholders).

Improvements to current requirements in IAS 33

- 144 The DP acknowledges shortcomings in IAS 33 requirements including the exclusion of out-of-the money financial instruments that could have dilutive impacts at future dates. Having developed principles for identifying liabilities and equity, it is timely for the IASB to, in parallel, consider how to enhance IAS 33. For example, to help users to better assess the allocation of returns amongst different classes of equity, the IASB could start by improving IAS 33 by addressing the shortcomings identified in the DP, aligning the requirements in IAS 33 with the requirements in IAS 32 and IAS 1 (e.g. definitions) and addressing the issues that arise in practice (e.g. lack of

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transparency around the calculation of the weighted average number of ordinary shares).

- 145 EFRAG's support for updating IAS 33 is consistent with its response to the 2008 IASB Exposure Draft *Simplifying Earnings per Share* which reflected feedback from stakeholders, including users of financial statements, on some of the principles that could be adopted to enhance the calculation of both the basic and diluted EPS.
- 146 One of the 2008 ED proposals was that, for instruments that are remeasured at fair value through profit or loss, the related potential ordinary shares should not be included in the EPS calculations (this was then described as the 'fair value method'). EFRAG supported the 'fair value method' alongside the need for additional disclosures that could inform users on future potential dilution effects related to instruments that were recognised at fair value through profit or loss.
- 147 The DP proposes to align the attribution to non-derivative equity instruments other than ordinary shares to the requirements in IAS 33. At the same time, the attribution to classes of derivative equity instruments aims to enhance the information available for users beyond that provided by IAS 33. The ideas within the attribution approaches are aligned with some of the ideas for improving the EPS calculation that were made in the 2008 ED proposals. For instance, in the arguments for the full fair value attribution approach, paragraph 6.75(b) of the DP observes that, unlike IAS 33, where dilution is based on the intrinsic value, an attribution approach that is based on the fair value of an option contract reflects the probability that the ordinary shares will be issued.
- 148 However, as noted in various places in this comment letter, there is a concern about the complexity and costs associated with any of the three attribution approaches. Hence, as an alternative to the attribution approaches, EFRAG proposes the revision of IAS 33 requirements together with the enhancement of disclosures of equity instruments.
- 149 EFRAG acknowledges that the review of IAS 33 is considered to be challenging; however, EFRAG considers that the challenges that will arise with the attribution mechanism will be greater than reviewing IAS 33. The existing shortcomings could be addressed more efficiently through disclosure of potential dilution instead of an attribution system of equity claims. However, using an enhanced IAS 33 approach instead of attribution raises the question as to whether IAS 33 should be extended to all entities or whether attribution should be limited to the scope of IAS 33.

Alternative attribution mechanism with updating carrying amounts

- 150 If the IASB decides to proceed with an attribution approach, EFRAG considers that the IASB could consider the possibility of an attribution approach that would take into account the relative position of existing shareholders and possible exercise or conversion of potential ordinary shares (similar to IAS 33 approach).

Section 7 - Disclosure

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?

EFRAG's response

EFRAG considers that disclosures are a key part of the project and welcome the IASB's discussions. We acknowledge that the proposed disclosures, as a whole, would represent a significant extension of disclosures on financial instruments on own equity. However, they would provide a greater level of detail about financial instruments classified as equity, making the level of disclosure more similar to financial instruments that are classified as liabilities.

In regard to disclosures on priority on liquidation, EFRAG notes that some considerations would have to be taken into account in terms of the reporting entity which is being considered. In regard to disclosures on potential dilution, EFRAG recommends the IASB to further consider the scope of such disclosures. Finally, EFRAG provides a number of suggestions to improve current disclosures without creating disclosure overload.

151 EFRAG generally welcomes the DP's proposed disclosures about the priority of claims on liquidation, potential dilution and information about terms and conditions. EFRAG considers that improvements to existing disclosures is a key part of this project, not only for the consolidated financial statements of a group but also to the separate financial statements of the entities within a group.

152 Currently, IFRS Standards require some disclosures about the entity's capital structure, potential dilution and terms and conditions of financial instruments. However, there are a number of limitations. In particular, EFRAG agrees with the IASB's assessment that there is a significant difference between the information provided for items classified as equity compared with those classified as liabilities and that more information is needed about financial instruments classified as equity.

153 EFRAG consulted users of financial statements to understand their needs in terms of information about an entity's claims. Users considered that:

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- (a) the classification needs to be supported by suitable disclosures about the contractual terms and conditions;
 - (b) entities should provide better disclosures about potential dilution. They wanted more information that would help them in assessing the effects of dilution resulting from instruments settled with own equity; and
 - (c) entities should provide better disclosures on the 'waterfall'. They considered that information about priority of claims was useful to them, although some considerations would have to be taken into account in terms of the reporting entity which is being considered.
- 154 Therefore, EFRAG agrees that the DP's proposals on disclosures will help investors better understand the entity's capital structure and the impact of financial instruments with characteristics of equity.
- 155 EFRAG acknowledges that the proposed disclosures, as a whole, would represent a significant extension of disclosures on financial instruments on own equity. However, they would provide a greater level of detail about financial instruments classified as equity, making the level of disclosure more similar to those that are classified as liabilities. This may be particularly true for financial institutions that issue complex financial instruments in response to regulatory requirements and other entities with complex capital structures.
- 156 In addition, in its early-stage impact analysis EFRAG highlights that the user survey feedback provides support for enhancing current disclosure requirements on priority of financial claims (financial liabilities and equity), participation in upside of returns and potential dilution of earnings per share.

Disclosure on priority of financial liabilities and equity instruments on liquidation

- 157 Currently, entities (and especially financial institutions) have a variety of debt and equity instruments with different levels of seniority and subordination, with each instrument having their own rights, benefits, costs and risk.
- 158 IFRS Standards already require some disclosures about the entity's capital structure, however, there are a number of limitations:
- (a) IFRS 7 requires some specific disclosures about financial liabilities, however it does not have similar requirements for equity instruments; and
 - (b) IAS 1 requires a company to disclose information in the financial statements to evaluate a company's objectives, policies and processes for managing capital. These disclosures are more oriented to issued capital and not debt instruments classified as equity. The outcome is often boilerplate disclosures about the goal of optimising the weighted average cost of capital without providing the details to support or to evaluate such statements.
- 159 EFRAG considers that detailed information about an entity's capital structure, including how it changes over time, is fundamental to users as they need information about:
- (a) management making capital structure decisions in terms of the mix between equity and debt and the relative costs of each;
 - (b) the relative returns to each holder and the implications on the company's liquidity and solvency;
 - (c) the priority of claims in the event of liquidation; and
 - (d) the position of their investments in the capital structure, if they are investors in the entity.

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- 160 In addition, in its early-stage impact analysis, EFRAG noticed that many considered useful to have information about priority of claims on liquidation. Therefore, EFRAG supports the DP's proposal to improve disclosures on priority of financial liabilities and equity instruments on liquidation.
- 161 Nonetheless, EFRAG notes that some considerations would have to be taken into account in terms of the reporting entity which is being considered. EFRAG notes that, in most jurisdictions, it is the legal entity that has the capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and is ultimately held responsible for its actions.
- 162 Therefore, providing information about priority of claims on liquidation for consolidated financial statements can be a challenging exercise and may be inconsistent with the individual entities of the group. Considering this, EFRAG recommends the IASB to continue to develop proposals to improve disclosures on priority of claims on liquidation both on separate and, if practicable, consolidated financial statements and any interactions between the two.
- 163 Finally, EFRAG considers that such disclosures should reflect the carrying amounts presented in the statement of financial position and not the fair value amounts required by IFRS 7. This is because it would require entities to calculate the fair value of their instruments on own equity and would break the link to the statement of financial position. In addition, EFRAG notes that fair value amounts would even be more onerous for non-listed entities.

Disclosures about potential dilution

- 164 Currently, entities have a variety of liability and equity instruments that give the right or the option to the holder to acquire or settle the claim with ordinary shares in the future, particularly financial institutions. IFRS Standards already require some disclosures on potential dilution. More specifically, IAS 33 already requires disclosure of:
- (a) the amounts used as the numerators in calculating diluted EPS and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period;
 - (b) the weighted average number of ordinary shares used as the denominator in calculating diluted EPS and a reconciliation of these denominators to each other;
 - (c) instruments that could potentially dilute basic EPS in the future, but were not included in the calculation of diluted EPS because they are antidilutive for the period(s) presented;
 - (d) a description of those ordinary, or potential ordinary, share transactions that occur after the balance sheet date and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.
- 165 Paragraphs 7.13–7.15 of the DP identify a number of limitations regarding information provided by IAS 33. These limitations mean that users of financial statements have difficulties to determine the full impact that derivatives on own equity and other financial instruments may have on their position. In addition, EFRAG highlights that the diluted EPS is seen as a historical measure and not a predictor of dilution or a forward-looking number.
- 166 Therefore, EFRAG supports the DP's proposal to improve disclosures on dilution, particularly disclosures around the total number of ordinary shares outstanding or potentially outstanding at the end of the period and their effects.

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- 167 EFRAG considers that providing the users with the information about sources of potential dilution of the capital would increase the quality of the information provided in the financial statements and will help users to make the informed decisions. In EFRAG's view, the additional information about potential dilution can be provided through the notes to the financial statements and should not impose excessive additional costs to the preparers.
- 168 In its comment letter to the IASB Discussion Paper *Conceptual Framework for Financial Reporting*, EFRAG identified potential ways to disclose dilutive effects:
- (a) scenario analysis, depicting the instruments in issue and their rights and/or payoffs in various material scenarios; and/or
 - (b) the provision by the entity of financial models showing the rights holders of various instruments have on net cash inflows, and how the number and types of these instruments may change.
- 169 However, EFRAG notes that currently IAS 33 applies only to entities whose ordinary shares or potential shares are publicly traded. Considering this, EFRAG recommends the IASB to further consider the scope of such disclosures. That is, whether such disclosures would only apply to listed entities and whether they should apply to both separate and consolidated financial statements.

Information about terms and conditions

- 170 EFRAG highlights the importance of improving the disclosure requirements for financial instruments with characteristics of equity. Even though IFRS 7 requires the key terms and conditions of financial instruments to be disclosed, it is not always clear how the instruments are classified and why an instrument had been classified as equity or as liability.
- 171 ESMA has recently published a report, *Enforcement and Regulatory Activities of Accounting Enforcers in 2017*, which identified a number of deficiencies on disclosures related to financial instruments classified as equity. In particular, EFRAG notes that for financial instruments that have many features, it is often difficult to understand what the key features are that lead to the classification of equity or liability. In its early-stage impact analysis, EFRAG noticed that many users referred to instruments where classification is currently unclear.
- 172 Therefore, considering the lack of requirements in regard to disclosures on the terms and conditions of financial instruments, particularly for financial instruments with characteristics of equity, EFRAG considers that the IASB should give high priority to additional disclosures on the terms and conditions of financial instruments with characteristics of equity.
- 173 For example, if the Common Equity Tier 1 ratio of a bank falls below 5.125%, AT1 instruments may automatically be converted into Common Equity Tier 1 instruments or written down. The specific mechanism may be specified in the contractual conditions.
- 174 Some points to consider are:
- (a) how to disclose the information about write downs;
 - (b) key features that lead to the classification as equity or liability and how judgement has been applied;
 - (c) information about early redemptions and incentives to pay; and
 - (d) equity and liability characteristics within an instrument, regardless the classification, and related risks.

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175 EFRAG would support the IASB providing guidance on how to structure such information in order to avoid disclosure overload.

Other potential improvements

Potential improvements to disclosures in IAS 1 on restrictions to transfer cash

176 Many users have mentioned in the past that they often look for information about the nature and extent of any significant restrictions of the entity's ability to transfer funds to its shareholders in the form of cash dividends or any significant restrictions of the entity's ability to repay debt. To address user's needs, IAS 1 could require additional disclosures about the impact of externally imposed capital requirements (e.g. those resulting from borrowing arrangements, legal/regulatory requirements or contractual arrangements) or the existence of any other significant restriction (e.g. solvency test, cash flow test, non-distributable reserves) on the entity's ability to transfer, in practice, funds to its shareholders and creditors.

Section 8 - Contractual terms

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?

Why, or why not?

EFRAG's response

EFRAG welcomes the IASB's discussion on the role of economic incentives for classification purposes and agrees that 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 equity instrument. This is because EFRAG considers that considering economic incentives for classification purposes may raise more questions than answers.

EFRAG also considers that improving the requirements for indirect obligations in paragraph 20(b) of IAS 32 may alleviate some of the issues related to economic compulsion (to consider for example whether an entity is legally prohibited from exercising one of the settlement alternatives). Accordingly, EFRAG suggests improvements to current requirements.

Economic incentives that might influence the issuer's decision to exercise its rights

177 In accordance with paragraph 15 of IAS 32, financial instruments are classified in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. However, IAS 32 is silent on the role of economic compulsion and incentives.

178 As highlighted in paragraph 8.6 of the DP, the IFRS IC has discussed the role of contractual obligations and economic compulsion in the classification of financial instruments and asked the IASB whether anything could be done to achieve greater clarity. The issue is related to the fact that even though the terms and conditions of a financial instrument might grant the entity the right for either equity or liability

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settlement (leading to equity classification), there may be economic incentives for an entity to choose the liability option.

- 179 EFRAG welcomes the IASB's discussion on the role of economic incentives for classification purposes and agrees that 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 equity instrument.
- 180 EFRAG agrees with the views and arguments provided in paragraphs 8.18 to 8.21 of the DP that considering economic incentives on classification may raise more questions than answers. In addition, as further described below, EFRAG considers that improvements to the requirements for indirect obligations may alleviate some of the issues related to economic compulsion.
- 181 EFRAG acknowledges the argument that bifurcating hybrid instruments with two settlement alternatives into liability and equity components, and focusing on the measurement aspects, may be more useful than classifying the whole hybrid instrument as a liability or equity and would resolve the issue of economic incentives. However, EFRAG notes that such an approach would increase significantly the cost of application of IAS 32 and that new guidance would have to be developed.

Indirect obligations should be retained

- 182 EFRAG also considers that improving the requirements for indirect obligations in paragraph 20(b) of IAS 32 may alleviate some of the issues related to economic compulsion (to consider for example whether an entity is legally prohibited from exercising one of the settlement alternatives). EFRAG highlights that the IFRS IC already noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option.
- 183 EFRAG considers that the IASB could, for example, consider incorporating the notion of 'no commercial substance' which is currently used in paragraph 41 of IFRS 2 to reinforce the principles in paragraph 15 of IAS 32. The IASB could also consider the existing guidance in paragraph 19(a) of IAS 32 and reflect the need for the entity to obtain the approval from a regulatory authority for a particular form of settlement.
- 184 EFRAG considers that it is important to make clear that when the terms and conditions of a financial instrument grant the entity the right for an equity or liability settlement, as a first step an entity should always consider whether one of the settlement alternatives:
- (a) has no economic substance (e.g. equity settlement outcome is structured in such a way that its value would always exceeds the liability settlement outcome); or
 - (b) has no commercial substance (e.g. the entity is legally prohibited from issuing shares).
- 185 The IASB could also consider bringing more alignment between the indirect obligation requirements (paragraph 20 of IAS 32) and the contingent settlement provisions (paragraph 25 of IAS 32). For example, if an entity has an option for equity or liability settlement, for the contract to be classified as equity, the liability outcome should not be higher than the equity outcome in all genuine scenarios.

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?

EFRAG's response

EFRAG generally supports focusing on the substance of the contractual arrangement in a financial instrument. However, EFRAG highlights some of the challenges that arise in practice from the interaction between the contractual rights and obligations and EU regulation. In particular, there are concerns about the potential different outcomes for identical contracts where one entity incorporates the law in the contracts terms while another does not (e.g. bail-in instruments). EFRAG recommends the IASB to further consider this issue with regulators to better understand the challenges that arise in practice.

Finally, given the narrow fact pattern to which IFRIC 2 applies, EFRAG continues to believe it should continue to be applied by the entities for which it was originally designed. EFRAG also suggests the IASB to consider the possibility of integrating IFRIC 2 into IAS 32.

Contractual terms of a financial instrument consistently with the existing scope of IAS 32

- 186 EFRAG considers that the interaction between 'contractual rights and obligations' and 'regulatory and legal' requirements is an important issue.
- 187 Currently IFRS Standards are not consistent when dealing with the 'contractual rights and obligations' and 'regulatory and legal' requirements. For example, as mentioned in paragraphs 8.34 and 8.35 of the DP, IFRIC 2 considers the effects of legislative requirements for classification purposes while IFRS 9 does not. In addition, paragraph 4.31 of the *Conceptual Framework for Financial Reporting* states that many obligations are established by contracts, legislation or similar means. The latter could indicate that even if an obligation is not established by contract, an obligation could arise as a result of the legislation.
- 188 EFRAG acknowledges that many would prefer to have consistency within IFRS Standards. Nonetheless, taking into consideration the overall effects of regulation and legislation, the classification model would represent a significant change to current requirements and could have unintended consequences. EFRAG also notes that law and regulation can be changed unilaterally by an authority without agreement from the counterparties. Thus, an entity would need to continually monitor these changes in the law if an entity was to be required to consider the effects of all the laws in the jurisdiction for recognition, derecognition and classification purposes.
- 189 Therefore, EFRAG generally supports paragraph 15 of IAS 32, which focuses on the substance of contractual arrangement of a financial instrument. Nonetheless, EFRAG is aware of challenges that arise in practice from the interaction between the contractual rights and obligations and regulation. In particular with new financial products developed in the aftermath of the financial crisis:
- (a) many financial institutions have issued convertible bonds that may be mandatorily convertible into a variable number of own shares and/or written-down;
 - (b) the trigger event and form of resolution could be at the discretion of the regulator and it is not clear in advance which form of resolution the regulator will choose; and

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- (c) these financial instruments raised questions about how to provide transparent information to users, particularly information about conversion and write-down features in the contract.
- 190 Entities that issue bail-in instruments in different jurisdictions face challenges on how to take into account the interaction between the contractual rights and obligations and regulation (such as the Bank Recovery and Resolution Directive (BRRD)) when classifying these instruments. For example, an entity subject to the BRRD that issues a contract governed under the law of a third country will have to include a legally enforceable clause indicating that the instrument could be used for bail-in purposes. Such a legal requirement raises classification questions when an entity operates in different jurisdictions due to the different contractual clauses.
- 191 In addition, when these interactions apply, entities can face challenges determining whether particular requirements stem from the contract or from related law/regulation. For example, a contract might state that the entity is under the scope of specific legislation, provide a general reference to legislation or replicate the wording of the legislation.
- 192 Considering the challenges that arise in practice, particularly with bail-in legislation, EFRAG recommends the IASB to develop guidance to assist entities in addressing these issues. For example, the IASB could consider additional guidance on the distinction between contractual and legal obligations and additional disclosures about legislation that is relevant for investors to understand the substance of the contractual arrangement of a financial instrument (e.g. disclosures together with the terms and conditions of financial instruments as discussed in section 7).

IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

- 193 The DP explains that the IASB does not intend to reconsider the requirements in IFRIC 2 given that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice and that it is not aware of any challenges to its application.
- 194 EFRAG agrees that IFRIC 2 should continue to be applied by the entities for which it was originally designed. In particular EFRAG notes that:
- (a) IFRIC 2 builds upon the very specific features of members' shares and determines the condition for their treatment as equity. Since 2004 IFRIC 2, has become the blueprint for the design of members' shares for the majority of cooperative entities which have to prepare financial statements under IFRS Standards; and
 - (b) the approach of IFRIC 2 for the distinction between equity and liabilities is the basis for the recognition of members' shares of cooperatives banks as Common Equity in the European Union's Banking Supervisory Law (Regulation (EU) 575/2013 and Commission Delegated Regulation (EU) 241/2014).
- 195 EFRAG highlights that the DP has not considered in detail the business model of co-operative entities and how the 'amount feature' would apply to those that currently apply IFRIC 2. EFRAG considers that use of the 'amount feature' would place a large question mark upon the equity classification of cooperative member shares and member certificates. This is because the 'amount feature' does not take into account the way in which members participate in the capital of the cooperative (e.g. on liquidation members of cooperative entities typically receive their 'capital paid in' amount (face amount) and may participate in the losses). However, they may not participate in distribution of positive retained earnings.
- 196 Considering this, EFRAG emphasises its preference that IFRIC 2 continues to be applied by the entities for which it was originally designed. In addition, EFRAG

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recommends to the IASB to consider integrating IFRIC 2 to IAS 32 during any revisions to IAS 32.