Financial Instruments with Characteristics of Equity
Summary of the comments and feedback received

Objective

1 The objective of this paper is to update the EFRAG TEG on feedback received from the 27 comment letters received on the EFRAG Draft Comment Letter ('DCL) on the *Financial Instruments with Characteristics of Equity* ('FICE') Discussion Paper ('DP') of the IASB.

2 A detailed list of respondents can be found in Appendix 1 *List of respondents*.

Summary of the comment letters received

Section 1 - Objective, scope and challenges

3 In general, respondents acknowledged the challenges arising with IAS 32 and appreciated the IASB's efforts to address the existing challenges and diversity in practice by attempting to better articulate the principles in IAS 32. These respondents acknowledged that there is room to improve IAS 32, particularly on the accounting for new complex instruments such as contingent convertible bonds (CoCos).

4 However, as described below, there is less support for the IASB's preferred approach as described in the Discussion Paper (i.e. comprehensive specification of the principles underpinning classification) to address the challenges that currently arise in practice. Most concerns were related to the lack of clarity of the new terminology, the use of the amount feature and the cost-benefit trade-off of implementing new principles intended to result in (mostly) the same outcome.

5 Nonetheless, there was more support for specific improvements to current requirements in IAS 32, particularly for the classification of new complex instruments (e.g. CoCos) and improvements to current presentation and disclosure requirements. Some of these respondents considered the DP already identified some solutions to issues that arise in practice which could be a good basis for further discussions.

6 One respondent (EBA) suggested that, although prudential regulators have their own requirements for defining regulatory capital, the importance of the link between these requirements and the accounting standards should not be underestimated.

7 Finally, one respondent considered that currently IAS 32 does not raise significant application issues for the majority of financial instruments. This respondent is not convinced that there is an immediate need for change.

<u>Question to constituents on additional challenges with IAS 32</u>

8 Most respondents did not identify additional challenges with IAS 32 other than those already identified by the IASB and EFRAG. Yet, some respondents considered that:

(a) the IASB needed to further consider the classification of instruments settled with own shares and take into account whether an entity has shares available or right to issue shares to settle a contract to determine whether there is an obligation to deliver economic resources;

(b) the IASB should consider defining equity positively and not as a residual;

(c) whether symmetry of classification of equity instruments held as assets by other entities would be appropriate (i.e. symmetry of IAS 32 and IFRS 9 *Financial Instruments* and the use of the SPPI test);

(d) guidance is needed on:

(i) when contingencies should be considered as within the control of the entity or not, which is an issue that is frequently raised in practice;

(ii) when an instrument is under the scope of IAS 32 or IFRS 2;

(iii) reclassifying instruments from debt to equity;

(iv) the role of shareholders' discretion in the classification outcome and whether a party is acting as the entity or as an instrument's holder/investor; and

(v) reclassifications when features lapse or conditions change;

(e) whether own shares that are held for hedging purposes should be accounted for at fair value through profit or loss;

(f) for instruments with alternative classification outcomes, consider how the classification outcomes are affected when the holder of the financial instrument is also the majority shareholder of the issuer and, as such, has the ability to influence the instrument payoff; and

(g) the IASB needed to consider the inconsistency of principles between IAS 32, IFRS 2 *Share-based Payment*, and IAS 37 *Provision, Contingent Liabilities and Contingent Assets* and any potential impact of future changes on other standards (e.g. IFRS 9).

Section 2 - The IASB's preferred approach

9 The majority of respondents were **not convinced** that the IASB's preferred approach, as described in the Discussion Paper, was a **significant improvement when compared to IAS 32**.

10 Many of these respondents noted that currently the application of IAS 32 does not raise significant classification challenges for the majority of financial instruments and acknowledged that some of the existing issues could be solved with the new detailed guidance included in the IASB's preferred approach. One respondent highlighted that most companies are familiar with the fundamentals of IAS 32 and that fundamental changes in standards are only acceptable when they solve severe and widespread problems or provide a significant improvement over existing standards.

11 These respondents that did not support the IASB's preferred approach were particularly concerned that:

(a) the IASB's preferred approach is not always clear when applied to some instruments (e.g. Total Loss Absorbing Capacity and Minimum Requirement for own funds and Eligible Liabilities) and did not identify solutions to a number of current issues in IAS 32 (e.g. NCI puts) (more details below in section on classification outcomes);

(b) replacing a well understood standard (with its shortcomings), with a new complex standard will prove to be challenging;

(c) the IASB's preferred approach does not remove the need for exceptions; and

(d) the IASB's preferred approach does not remove the current discrepancy in the definition of liabilities between IAS 32 and the Conceptual Framework and contradicts fundamental principles such as the going concern assumption.

12 Many respondents also considered that **implementation costs were likely to exceed any benefit**, particularly when considering that the classification outcomes would be similar to IAS 32. One user representative noticed that a new standard could imply substantial changes which would require users to invest time to understand the new requirements.

13 When referring to next steps, many respondents **did not support at this stage a comprehensive review of current requirements**, which could involve the publication of a new standard, and would **prefer to have targeted amendments to IAS 32** to address the challenges that arise in practice, particularly for the classification of new complex instruments (CoCos) and improvements to current presentation and disclosure requirements.

14 Nonetheless, some of these respondents suggested that the IASB could in parallel continue to consider different approaches and potential improvements to the principles in IAS 32. For example, one respondent suggested it would be sufficient to rely on the timing feature alone as the criterion to distinguish between equity and debt.

15 Finally, some respondents noticed that the DP already identified some solutions to a number of current issues with IAS 32 which could be helpfully developed. For example, one respondent recommended the IASB to assess whether information about solvency and liquidity could be addressed by improving presentation and disclosure requirements. One user representative highlighted that improvements to disclosures, particularly on equity instruments, would not require a complete change of existing requirements.

16 In contrast, some respondents provided some support to the IASB's preferred approach, particularly the new guidance that would replace the fixed-for-fixed condition and the fact that the IASB's preferred approach was likely to bring more consistent application and enforceability of the classification.

17 Nonetheless, these respondents raised a number of concerns (e.g. amount feature) and called for an impact assessment to avoid any unintended consequences. In particular, one other respondent called for the IASB to undertake a cost-benefit analysis to ensure that the outcome of the FICE project would not lead to unintended consequences or undue operational costs. One other respondent that supported the IASB's approach considered that even if the IASB were not to proceed with the comprehensive review of IAS 32, it would still be necessary that the IASB makes targeted improvements to the standard to address the application issues in relation to derivatives on own equity.

18 Finally, some respondents suggested alternative approaches:

(a) one respondent called for the IASB to consider an approach focused on the timing feature (alpha approach);

(b) one user association would prefer a narrow definition of equity as it would contribute to a clearer understanding on debt-equity classification; and

(c) one national standard setter suggested the IASB to consider an approach based on the timing and amount feature without considering liquidation;

<u>The use of new terminology</u>

19 Many respondents, including those that supported the IASB's approach, raised **concerns about the use of new terminology**. In particular, respondents highlighted that the new terminology:

(a) is unclear and a significant change from current IAS 32 and Conceptual Framework terminology. For example, the IASB has not clearly articulated the concept of an 'amount independent of the entity's available economic resources' and the DP has not explained how it should be applied in practice (issues with amount feature described below); and

(b) may produce unintended consequences, new issues and raises uncertainties around the real impact to entities.

<u>Question to constituents on the use of the amount and timing feature</u>

20 Most respondents, including those that supported the IASB's approach, expressed concerns about the **use of the amount feature**, **particularly on liquidation**. Respondents argued that:

(a) using the amount feature on liquidation is inconsistent with the Conceptual Framework and its going concern principle;

(b) the notion of "an amount independent of the entity's available economic resources" and 'net amount' of a derivative is difficult to apply, very judgemental and not intuitive. In particular, any reference to the fair value of the entity's own shares needs to be assessed with care;

(c) considering claims that arise only on liquidation is unhelpful in trying to assess whether the entity has sufficient funds to meet current obligations. As a result some instruments would be classified as a liabilities even though there is no obligation to transfer economic resources other than at liquidation;

(d) all issued instruments are settled at liquidation and information about relative rankings and amounts can be covered by presentation and/or disclosure;

(e) entities would need to undertake a comprehensive impact assessment to conclude on the magnitude of any impact on their financial statements;

(f) the measurement complexity that arises from having to remeasure the timing and amount due at liquidation reinforce the idea that the amount criteria should not apply. For example, if liquidation became likely, the measurement of claims on liquidation could be affected;

(g) the amount feature is already raising issues in IAS 32; and

(h) claims indexed to EBITDA are considered to be of an amount independent of the entity's available economic resources while EBITDA is often the only relevant parameter for non-listed entities to make an assessment of an entity's economic resources.

21 In addition, a number of respondents highlighted that the IASB's had not taken into account the business model of **co-operative entities** and that the "**amount feature"** could be problematic for those currently applying IFRIC 2. These respondents considered 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. Some of these respondents welcomed EFRAG suggestion that IASB should take the opportunity to integrate IFRIC 2 in IAS 32 and considered that the IASB should clearly state that current application of IFRIC 2 would override the IASB new approach. The IASB has already addressed these concerns to some extent by proposing that the conclusions in IFRIC 2 should be carried forward.

22 Finally, respondents provided some suggestions related to the amount feature:

(a) instead of referring to an 'unavoidable obligation to transfer economic resources', the IASB could refer to 'no practical ability to avoid a transfer of economic resource' which would bring in the concept of economic compulsion;

(b) the IASB could make some targeted improvements in IAS 33 *Earnings per Share* to tackle issues related to the 'amount' feature;

(c) the IASB's definition of a liability could be amended to only refer to a "specified time other than at liquidation";

(d) the amount feature could be used to drive disclosure requirements;

(e) The IASB should carefully consider the impact of its proposals, particularly for non-problematic financial instruments;

(f) the amount criteria may be more relevant for presentation purposes;

(g) the IASB should provide additional guidance, clarifications and concrete examples. Additionally, the concept of 'independence of the entity's available economic resources' and the interaction with the 'timing feature' it would be important to understand how the obligation for an amount independent of the entity's available economic resources is to be assessed in the case of liquidation;

(h) only use the timing feature for classification and not use the amount feature; and

(i) the IASB should consider a model which uses only the "timing feature" for classification and uses the "amount feature" for the purpose of disaggregation in presentation or disclosure.

23 On the **timing feature**, some respondents also highlighted some concerns:

(a) the DP does not define or clarify the term "liquidation"; and

(b) the IASB does not explain how the liquidation scenario should be understood under a resolution mechanism.

24 Finally, some respondents considered that the IASB needed to make a **comprehensive analysis of the impact of its proposals,** including a cost-benefit analysis, before deciding whether to make such fundamental changes to avoid any unintended consequences, in particular for capital instruments issued by European banks according to requirements in CRR1 (e.g. additional tier 1 capital instruments).

Sections 3 to 5 – Classification of derivatives and non-derivatives

<u>Question to constituents on classification changes</u>

25 Many respondents highlighted that the IASB's preferred approach introduced **significant classification changes** and questioned their relevance. For example, respondents:

(a) noted that the IASB's preferred approach puts into question undisputed classifications with potentially detrimental effects on regulatory capital;

(b) questioned the relevance of classifying claims with cumulative features as financial liabilities as an entity does not have to pay other than at liquidation and users have not called for such a classification;

(c) noted that some hybrid instruments would be reclassified from equity to financial liabilities with knock-on consequences such as measuring those instruments at fair value through profit or loss;

(d) considered that the classification outcomes and the accounting for financial instruments under the IASB's preferred approach were more complex and difficult to understand when compared to IAS 32, particularly for derivatives on own equity;

(e) were concerned that derivatives on own equity which are net cash settled would be accounted for at fair value through OCI while financial instruments hedging them would be accounted for at fair value through profit or loss;

(f) noted that the IASB's preferred approach could affect the classification of irredeemable cumulative preference shares which are most commonly issued by corporates, and any change in the accounting classification of instruments issued by corporates entities could affect debt covenants and as consequence could have some consequential impacts in the market of hybrids instruments;

(g) did not consider that the IASB's preferred approach would solve entirely the issue of written puts on NCI. For example, it questioned why minority interests should be derecognised when a written put is granted to NCI as neither their right to dividends, nor their voting rights are extinguished;

(h) questioned whether the removal of the foreign currency rights issue exception would result in more useful information and suggested that the IASB should either consider keeping the exception or rework its preferred approach; and

(i) questioned the classification of claims that have cumulative features as a financial liability as an entity does not have to pay other than at liquidation and users have not called for such a classification.

26 Some respondents expressed significant concerns about the **impact of the classification changes** proposed by the IASB. For example, respondents highlighted that with the IASB approach:

(a) entities would no longer be able to account for billions of hybrid capital as equity. This would significantly reduce company's solvency ratio and could trigger the accounting call feature that exists in many hybrids. In addition, the opportunity to redeem outstanding hybrid capital could potentially inflict losses on investors. Finally, it could also lead to higher cost of capital either due to higher interest rates on debt in general or due to higher coupon on the hybrids when refinanced into hybrid structures to make it compliant with the new equity classification requirements. This respondent believed that the challenges identified by the IASB could be resolved with more informative disclosures without creating unnecessary costs and complexity; and

(b) analyses of data extracted from Bloomberg showing that perpetual subordinated bonds that allow issuers to defer coupon payments indefinitely (as a part of such hybrid capital claims) with a minimum notional amount of 120 billion euros outstanding in total are expected to change their classification. These claims are currently classified as equity under IAS 32 and have been issued in European and Non-European countries by entities with equity and/or debt instruments listed on a regulated market. This respondent expected that the total amount of claims that will change their classification to be significantly higher as, for example, comparable bonds issued via local or private placements are not considered in the numbers above.

27 Respondents also mentioned other classification changes not included in the DP:

(a) a preference share that is callable by the issuer would have similar treatment to an irredeemable non-cumulative preference share that requires a fixed amount to be paid at liquidation i.e. the classification outcome would change from equity to a liability under the IASB's preferred approach; and

(b) the classification of "savings shares" would change as these type of shares generally grant a higher dividend and have a lower seniority on liquidation than ordinary shares. Under the IASB's preferred approach, saving shares may be compound instruments, because these instruments may require a fixed amount to be paid on liquidation, even though the present value of this liability would be not material. It is possible that the value of the liability would change if a going concern issue arises.

28 There were mixed views on whether **accounting within equity** for a written put option on own shares that is issued together with ordinary shares is the same as accounting for a convertible bond. Some supported the IASB's proposals, others were against them arguing that to account for put options on own shares and convertible bonds identically appears more arbitrary and less relevant than current accounting.

29 Finally, one respondent was concerned about the suggestion to derecognise equity instruments as if they were transferred or expired even though they clearly are not and urged the IASB to clarify some of the knock-on effects of this preliminary view.

Question to constituents on most common FICE instruments

30 A number of respondents referred to instruments with contingent settlement options such as financial instruments that are mandatorily convertible into a variable number of shares or written down upon a contingent 'non-viability' event (e.g. additional Tier 1 instruments). Respondents also referred to non-cumulative perpetual bonds, convertible bonds and NCI puts.

31 Some of these respondents indicated that currently there is uncertainty and diversity in practice on the classification of such instruments and considered that with the IASB's preferred approach, uncertainty would continue to exist. These respondents recommended clearer guidance for such instruments (e.g. irredeemable non-cumulative preference shares with discretionary dividends and a write-down or a conversion feature (meeting the "fixed-for-fixed" criteria) in foreign currency). One respondent that supported the IASB's preferred approach suggested that the IASB should provide additional examples on the classification of treatment of compound instruments, particularly contingent convertible bonds that require the entity to deliver a variable number of its own shares, and derivative financial instruments. One other respondent considered that additional guidance on how to deal with contingent settlement options and the order in which to analyse components could represent an improvement to IAS 32.

32 One respondent detailed that within the Dutch market the most common non-derivative financial instruments with characteristics of equity are perpetual bonds with discretionary coupons. Other instruments used are shareholder loans in many forms, callable shares with discretionary dividends and cumulative and non-cumulative preference shares.

33 One respondent expressed concerns about the uncertainty and potential impact on the classification AT1 instruments with write down triggers, as in their view such instruments would meet the definition of compound instruments under the IASB's preferred approach, which might create additional complexities and diversity in practice. This respondent considered that current principles in IAS 32 on classification of compound instruments are relatively easy to understand and have served their purpose effectively.

NCI puts

34 Some respondents also considered that the IASB would need to provide additional guidance for compound instruments and **NCI puts**, including the recognition and measurement in separate financial statements. In particular, these respondents considered that the IASB needed to further consider the application issues that arise in the consolidated financial statements, such as the profit allocation to NCI once the NCI has been derecognised and the impact on earnings per share.

35 Two respondents would prefer the IASB to solve the issue of NCI puts by considering the concept of transaction with owners acting in their capacity as

owners. Such an approach could justify presenting revaluation of the liability of an NCI put through shareholder equity without extending the use of OCI.

36 Finally, one respondent considered that the IASB's preferred approach adequately addressed the challenges that arise in the course of the enforcement activity in relation NCI puts.

<u>Question to constituents on derivatives on own equity under IFRS 9</u>

37 In general, respondents did not support EFRAG's suggestion to account for **all derivatives on own equity under IFRS 9**. Nonetheless:

(a) one respondent agreed that such an approach would be a simpler approach and provide relevant information to investors;

(b) one respondent considered that derivatives on own shares which were not used for issuing or repurchasing equity from a long-term perspective would warrant a standard derivative treatment rather than equity treatment;

(c) one respondent considered that own shares that are held for hedging purposes should be accounted for at fair value through profit or loss; and

(d) one respondent considered that derivative contracts on own shares should be classified as liabilities if they are used as part of an investment bank activity, if the shares are used as means of payments to a third party and if the number of shares being delivered are floating.

38 Some respondents, including users' representatives, acknowledged that accounting for all derivatives on own equity under IFRS 9 would result in simpler accounting and reduce structuring opportunities. One user representative stated that 'this would allow a more structured approach regarding the often complex technicalities of derivatives'.

39 However, some of these respondents noted that such an approach:

(a) would be consistent with the proprietary perspective, rather than the entity perspective;

(b) the consequences for put options over own shares are not clear; and

(c) is inconsistent with the requirements of IFRS 2.

<u>Question to constituents on the Puttable exception</u>

40 Most respondents **did not provide data** as to whether the '**puttable instruments'** exception and the 'obligations arising on liquidation' exception are used in their jurisdiction. Nonetheless, some respondents noted that:

(a) in Norway the exemption was mainly used by various investment trusts in standalone financial statements;

(b) in Germany there were more than 390 000 entities with the legal form of a partnership where the shares are redeemable; and

(c) in the Netherlands the puttable instruments exception are mainly issued within the Asset Management industry (eg investment funds) and instruments that relate to the exceptions in paragraph 16C-16D are non-redeemable cumulative preference shares within the Private Equity industry. The issuance of these type of instruments are common practice within the industry for structured deals.

41 When referring to the **relevance of the exception**, many respondents were **in favour of retaining the exceptions** in paragraphs 16A–16B or 16C–16D of IAS 32. One respondent noticed that in Germany the puttable exception is highly relevant and appears to be working as intended. However, many partnerships are failing to meet some of the criteria necessary to qualify for the exception and are either trying

to tap the unregulated market instead of the regulated market (in order to avoid having to prepare IFRS financial statements) or seeking to a qualified audit opinion (i.e. they do not apply IAS 32). In addition, some of these respondents suggested that:

(a) the IASB may wish to consider a more consistent and principles-based solution in the future;

(b) the exception could be widened to also include cases when law requires an entity to pay minimum dividend to its shareholders; and

(c) the IASB should take the opportunity to identify and address the practical difficulties in the most common issues.

42 Finally, one respondent suggested that the IASB could consider having a symmetric approach for these instruments meeting the puttable exception and extending the exception on the asset side. As a consequence a puttable instrument meeting the criteria to be presented as an equity instrument on the liability side would be eligible to a FVOCI classification on the asset side.

43 In contrast, one respondent disagreed with the decision to retain the existing exceptions to the main principles in the standard as such exceptions would increase the complexity and reduce the usefulness of a revised IAS 32. For the same reason, this respondent agreed with the proposal to remove the foreign currency rights issue exception.

Section 6 - Presentation

44 As mentioned above, many respondents were more supportive of targeted improvements to IAS 32, including presentation requirements. Some of these respondents considered the DP already identified some solutions which could be a good basis for further development.

<u>Presentation of financial liabilities</u>

45 When referring explicitly to the IASB's proposals to separately present liabilities with equity-like returns, respondents provided mixed views.

46 A number of respondents were supportive of the IASB's suggestions to separately present financial liabilities with equity-like returns, particularly in the statement of financial performance. These respondents argued that:

(a) such an approach would be consistent with the presentation of gains and losses arising from changes in own credit risk of financial liabilities designated as measured at fair value through profit or loss under IFRS 9; and

(b) separate presentation of liabilities that behave like ordinary shares in OCI (without recycling) appears appropriate as these effects are not indicators of the entity's performance.

47 However, some of these respondents suggested that the IASB should:

(a) clearly identify all the financial instruments, which currently lead to counter-intuitive accounting under IFRS Standards;

(b) further investigate the scope of the separate presentation requirements for financial liabilities;

(c) not proceed with:

(i) the disaggregation approach;

(ii) the separation of all embedded derivatives from their host contracts;

(iii) a criteria approach to identify partly independent derivative instruments;

(d) consider applying the disaggregation approach rather than the criteria approach;

(e) separately present financial liabilities for a fixed amount only on liquidation;

(f) recycle gains or losses from OCI to profit or loss;

(g) present information about financial liabilities with equity-like returns in the notes rather than on the face of the primary financial statements; and

(h) examine a wider range of instruments and assess whether presentation in OCI without subsequent recycling provides adequate information. Some consider it intuitive that only those instruments (separately or in their entirety) that depend on the entity's available economic resources should be subject to this presentation.

48 In contrast, a number of respondents did not support of the IASB's proposal. These respondents argued that:

(a) separate presentation requirements for liabilities with equity-like returns may seem appealing from a user perspective, but in practice this will often be very judgemental and is not likely to provide useful information;

(b) separately disclose information about financial liabilities with equity-like returns in the notes;

(c) on the use of OCI:

(i) there were conceptual concerns around its use

(ii) practical concerns about the use of OCI include the fact that users do not often look at OCI and OCI is usually full of items that are difficult to understand;

(iii) there are concerns around the concept of recycling of OCI reserves;

(iv) using OCI to reflect income and expenses from financial liabilities with equity-like returns will create further mismatches from the holder's perspective with IFRS 9, under which derivatives are recognised at FVPL and certain debt instruments can be accounted at FVOCI with recycling; and

(d) the IASB was not striking the right balance between what is useful for users and the workload for the preparers.

49 One respondent highlighted that separate presentation of liabilities with equity-like returns could lead to the disclosure of sensitive information such as the entity's perspective about the fair value of a subsidiary.

Presentation of equity

50 Most respondents including those that supported the IASB's preferred approach, did not support the proposal to attribute comprehensive income to different types of equity and update their carrying amounts. Respondents argued that the attribution approach:

(a) would introduce a new, complex, costly and judgemental reporting mechanism involving fair value of equity items with a questionable benefit for users;

(b) would reduce the understandability of financial statements;

(c) would not necessarily reflect the entire effect of the transfer of wealth between existing shareholders and potential shareholders as there are financial instruments that are settled with own equity but are accounted for as liabilities in their entirety; and

(d) introduces a complicated analysis of reserves for all entities based on IAS 33, which currently only applies to listed entities.

51 Some of these respondents suggested that the IASB should review IAS 33 and require disclosure of information about dilution, rather than introducing specific presentation requirements for equity instruments. One respondent suggested that the IASB should consider the possibility of introducing a third category of claims: hybrid capital, as a complement to the debt and equity categories. Finally, one other respondent considered a disclosure approach would be better than an attribution approach.

52 In contrast, one respondent supported the attribution mechanism even though it is experimental thinking at this stage.

Section 7 - Disclosures

53 As mentioned above, many respondents were more supportive of targeted improvements to current requirements in IAS 32, including disclosure requirements. Some of these respondents considered the DP already identified some solutions which could be a good basis for further discussions.

54 Many respondents were **supportive of some or all of the proposed disclosures**. These respondents considered that:

(a) the suggestion of additional disclosures on the terms and conditions of financial instruments has merit as entities do not always disclose the key characteristics that drive the classification, events triggering payments, conversion dates and redemption period. This would include disclosures about financial instruments with alternative settlement outcomes that are controlled by the entity and identification of options that may currently be exercised and those that can only be exercised at a future date;

(b) improved disclosures are particularly relevant for regulated entities that issue hybrid instruments

(c) improved disclosure on areas of significant judgement could be explored further;

(d) improvements to the disclosure requirements on equity instruments would reduce the need for a new standard;

(e) highly unusual instruments, in particular those falling under exceptions from the general requirements of IAS 32 (such as NCI puts) should be disclosed separately from other categories of hybrid instruments;

(f) disclosures on potential dilution impact of derivatives is relevant for users of financial statements;

(g) disclosures on seniority and priority would provide relevant information for users of financial statements; and

55 Nonetheless, some of these respondents considered that:

(a) providing information about priority of claims on liquidation for consolidated financial statements can be challenging, or even misleading, as typically it is the legal entity that enters into agreements or contracts and assumes obligations, particularly when considering that entities may be located in different jurisdictions;

(b) there was a risk of disclosure overload, particularly when dealing with disclosures on the terms and conditions;

(c) the IASB should provide guidance to clarify which events would qualify as liquidation and how far an issue is from these events even if the financial statements are prepared under a going concern assumption; and

(d) it would be useful to understand from users of financial statements which information would be most useful for them and which could be viewed as less important and thus might not be mandated.

56 In contrast, some respondents were not supportive of some or all the IASB's proposals for additional disclosures. These respondents were concerned:

(a) about the incremental costs for preparers, particularly on the disclosures on the terms and conditions of financial instruments;

(b) that an entity would have to provide disclosures on priority on liquidation while reporting on a going concern basis and at a group level;

(c) that resolution may trigger conversions to equity and this can increase the complexity of such disclosures significantly;

(d) some proposed disclosures, such as the terms and conditions, seem to be too ambitious especially for financial institutions that have a variety of debt and equity instruments with different levels of seniority and subordination. This may result in either reporting too high a summary to be useful to users or adding considerably to the length and complexity of the financial statements; and

(e) that any effects of potential dilution are relevant for IAS 33 requirements, thus any additional disclosure should be addressed under IAS 33.

57 Finally, one respondent highlighted that financial institutions are highly regulated and have to provide extensive disclosures on own fund instruments. Therefore, cross references should be permitted and disclosures about priority should be limited to financial instruments classified as equity.

Section 8 - Contractual terms

Economic incentives

58 Many respondents accepted the IASB's preliminary decision to clarify that economic incentives should not be considered for classification purposes as it would raise several questions and uncertainties.

59 However, some of these respondents suggested that improving indirect obligations requirements in IAS 32, as suggested by EFRAG, could help addressing some of the issues around economic incentives. Another respondent considered that the IASB should consider whether a constructive obligation, which leads to a provision according to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, should lead to a financial liability. Finally, one respondent considered that additional disclosures in this area could be useful.

60 In contrast, one respondent considered that economic incentives needed to be considered when evaluating the characteristics of an instrument, particularly when considering that some contractual terms are not genuine or remote.

The effects of law

61 Some respondents supported the IASB's preliminary view to retain the IAS 32 requirement to only consider the contractual terms of a financial instrument in the assessment of its classification. However, respondents highlighted that:

(a) there are significant practical challenges in distinguishing between rights and obligations that arise from contractual terms and those that arise from law, particularly with bail-in instruments;

(b) IFRS 17 *Insurance Contracts* refers to specific legal issues; and

(c) It would be beneficial to identify the challenges in practice.

62 However, many respondents were not in favour of completely ignoring the effects of the law and called for further research on the relationship between contracts and law. In addition, some respondents considered that:

(a) the legal framework is particularly relevant for the classification of financial instruments settled with own equity, financial liabilities arising from agreements with governments, and bail-in instruments;

(b) purely focusing on contractual obligations would make IAS 32 inconsistent with other standards such as IAS 37 and IFRS 15 *Revenue from Contracts with Customers*;

(c) the IASB should clarify that the notion “contractual rights and obligations” refers to rights and obligations that arise from the existence of a contract, regardless of whether these rights or obligations are included in the contract itself;

(d) increasing the focus on contractual terms, ignoring law, expectations and economic compulsion is a retrograde step;

(e) irrespective of whether a legal requirement is reproduced or referred to in the contractual terms, it should be taken into account as part of the classification assessment; and

(f) the IASB could undertake a research project on whether it would be possible to more closely harmonise the accounting principles for financial instruments with the principles for accounting for claims that originate from law.

<u>Question to constituents on IFRIC 2</u>

63 One respondent noted that the most relevant group of entities using IFRIC 2 are financial institutions operating in the legal form of a cooperative. Although most of them are not entities with debt securities admitted to trading on a regulated market, they are under prudential supervision and are required to calculate their equity according to IFRS Standards. The total assets of these banking co-operatives in Germany were approximately 900 billion euros in 2017. All these entities are applying IFRIC 2.

64 One respondent noted that cooperatives generally are declining within the Dutch (European) market. Interest within cooperatives have become a specialised industry mainly focusing on food enterprises and other for entities to raise flexible funding.

65 Finally, a number of respondents welcomed the retention of IFRIC 2 and agreed that it was developed for a very specific fact pattern and should continue to be applied by the entities for which it was originally designed. Some of these respondents also considered that IASB should take the opportunity to integrate IFRIC 2 in IAS 32.

Questions for EFRAG TEG

66 Does EFRAG TEG have comments on the feedback received through the comment letters?

Appendix 1: List of respondents

CL01	Finance Denmark	Denmark	Business Association
CL02	Danske Revisorer	Denmark	National Standard Setter
CL03	The Institute of Chartered Accountants in England and Wales (ICAEW)	UK	Professional organisation
CL04	European Association of Co-Operative Banks	Europe	Business Association
CL05	Ørsted	Denmark	Energy Company
CL06	European Savings and Retail Banking Group	Europe	Business Association
CL07	Crédit Mutuel Group	France	Cooperative bank
CL08	Organismo Italiano di Contabilità (OIC)	Italy	National Standard Setter
CL09	Insurance Europe	Europe	Business Association
CL10	BNP Paribas	France	Financial Institution
CL11	UK Financial Reporting Council	UK	National Standard Setter
CL12	Erste Group	Germany	Financial Institution
CL13	European Fund Asset Management Association (EFAMA)	Europe	Business Association
CL14	European Federation of Financial Analysts Societies (EFFAS)	Europe	User Organisation
CL15	Accountancy Europe (AE)	Europe	Professional Organisation
CL16	Copa-Cogeca European Farmers European Agri-Coperatives	Europe	Cooperative
CL17	European Securities and Markets Authority (ESMA)	Europe	Regulator
CL18	KBC Group	Belgium	Financial Institution
CL19	Dutch Accounting Standard Board (DASB)	The Netherlands	National Standard Setter
CL20	Accounting Standards Committee of Germany (ASCG)	Germany	National Standard Setter
CL21	Polish Accounting Standards Committee (PASC)	Poland	National Standard Setter
CL22	Association for Financial Markets in Europe (AFME)	Europe	Business Association

CL23	The Swedish Financial Reporting Board (SFRB)	Sweden	National Standard Setter
CL24	Business Europe (BE)	Europe	Business Association
CL25	European Banking Authority (EBA)	European	Regulator
CL26	The Association of Chartered Certified Accountants (ACCA)	UK	Professional Organisation
CL27	Norwegian Accounting Standards Board (NASB)	Norway	National Standard Setter