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[XX Month 201X]

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.

EFRAG welcomes the IASB's efforts to address the current application issues and other challenges related to IAS 32 *Financial Instruments: Presentation*. EFRAG notes that the IFRS Interpretations Committee (IFRS IC) received several submissions related to the application challenges of IAS 32 and that in many cases it was unable to reach a conclusion. The IASB tried to address the conceptual challenges related to the distinction between equity and liability within its Conceptual Framework project but decided to further explore how to distinguish between liabilities and equity in its FICE research project.

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 particular, EFRAG 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'), 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.

In relation to the DP, EFRAG welcomes the fact that the IASB's preferred approach:

- retains the use of a binary split between liabilities and claims on equity;
- defines equity as 'the residual interest in the assets of the entity after deducting all of its liabilities';
- attempts to improve the disclosure requirements to address the challenges that arise from a binary approach, particularly on the equity side; and
- discusses the accounting for NCI puts, application of the fixed-for-fixed condition, the role of economic compulsion when the entity has alternative settlement options and the counterintuitive accounting that arises with instruments for which the amount depends on the entity's own performance.

However, EFRAG has a number of reservations on the IASB's preferred approach, particularly on the classification of financial instruments. These reservations are explained in detail in Appendix 1. In summary, EFRAG is concerned that:

- the IASB's preferred approach 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*;
- the IASB's preferred approach 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 a fundamental change to IAS 32;
- 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; and
- the benefits of the proposals are unlikely to outweigh 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, and would require entities to measure the fair value of derivatives on own equity for presentation purposes;

In the shorter term EFRAG 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. 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 by:

- improving disclosure requirements for equity instruments, particularly those instruments 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 in paragraph 20 for indirect obligations;

- 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; and
- incorporating IFRIC 2 into IAS 32.

EFRAG acknowledges that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity but EFRAG has not identified any consensus among those constituents on how to achieve this. EFRAG is however not persuaded that an introducing a completely new Standard is justified unless it represents a significant step forward in this regard. Accordingly, EFRAG considers that the underlying concepts on which a new Standard might be based need further analysis before moving the broader *Financial Instruments with Characteristics of Equity* ('FICE') project from the research agenda to the standard-setting agenda. EFRAG also acknowledges that developing a more conceptual and less rule-based approach is very challenging and that any alternative that results in widespread classification changes is likely to prove controversial. EFRAG therefore suggests that the IASB reconsiders whether to continue a comprehensive FICE project as part of its next agenda consultation.

EFRAG's detailed comments and responses to the questions in the DP are set out in Appendix 1. This letter also includes Appendix 2 *Executive Summary of Early-stage impact analysis on the IASB's preferred approach*.

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

Contents

Appendix 1 - 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 welcomes the IASB's efforts to address the current application issues and other challenges related to IAS 32.

EFRAG also welcomes the IASB discussions on presentation and disclosures as a way to address the existing limitations of a binary approach. EFRAG considers that improvements to presentation and disclosures are currently needed and constitute a significant part, or even the most important part, of this project.

However, EFRAG lists a number of general concerns, including that the DP's proposals are very ambitious.

Introduction

1 EFRAG welcomes the IASB's efforts to address the current application issues and other challenges related to IAS 32. EFRAG has highlighted many times the importance of this project, particularly for users of financial statements.

2 Currently, some of the existing guidance in IAS 32 is complex and raises a number of application challenges, particularly when applied to complex instruments settled in the entity's own equity instruments.

3 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

4 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.

5 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.

Scope of the project

6 EFRAG welcomes the IASB's efforts to address the challenges identified in relation to IAS 32, including the challenges related to applying its classification requirements in some circumstances. The proposals in the DP amount to a combination of refining existing guidance, adding new guidance and clarifying the underlying rationale of the distinction between liabilities and equity.

7 EFRAG also welcomes the fact that the DP focuses not only on classification issues but also on presentation and disclosures of financial instruments under the scope of IAS 32.

8 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 ESMA[1] 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.

9 However, EFRAG has concerns on a number of areas related to the scope of this project:

- (a) EFRAG considers that the scope of the project and the DP's proposals, taken as a whole, are very ambitious. As well as introducing new, or newly-articulated, classification principles, the DP proposes new requirements on presentation, attribution and disclosures. In EFRAG’s view, this may only be achieved with a new IFRS Standard that would replace IAS 32. 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).
- (b) during our consultation, EFRAG identified a number of other necessary improvements to IAS 32 which have not been discussed by the IASB and remain unresolved. For example:
  - (i) payments at the ultimate discretion of the issuer’s shareholders;
  - (ii) for the classification of instruments settled with own shares, whether there is an obligation to deliver economic resources when an entity does not have own shares available or rights to issue own shares to settle the contract;
  - (iii) whether symmetrical classification of equity instruments held as assets by other entities would be appropriate (i.e. symmetry of IAS 32 and IFRS 9);
  - (iv) clearer guidance on when contingencies are within the control of the entity;
  - (v) reclassifications when features lapse or conditions change; and

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

(vi) whether the requirements in paragraphs 16A and 16B on puttable instruments need to be improved or clarified.

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 welcomes 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 on some areas that leads to divergence 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.

In the shorter term EFRAG 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. 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

EFRAG acknowledges that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity but EFRAG has not identified any consensus among those constituents on how to achieve this. EFRAG is however not persuaded that an introducing a completely new Standard is justified unless it represents a significant step forward in this regard. Accordingly, EFRAG considers that the underlying concepts on which a new Standard might be based need further analysis before moving the broader *Financial Instruments with Characteristics of Equity* ('FICE') project from the research agenda to the standard-setting agenda. EFRAG also acknowledges that developing a more conceptual and less rule-based approach is very challenging and that any alternative that results in widespread classification changes is likely to prove controversial. EFRAG therefore suggests that the IASB reconsiders

whether to continue a comprehensive FICE project as part of its next agenda consultation.

The IASB's approach to improvements to classification

10 EFRAG welcomes 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 on some areas that leads to divergence in practice.

11 In particular, EFRAG welcomes the fact that the IASB:

(a) has not started from a blank sheet of paper and that the IASB focused on an approach that is generally consistent with classification outcomes of IAS 32;

(b) retains the existing binary classification of financial instruments. Most respondents to and participants in the outreach meetings on the EFRAG Discussion Paper *Classification of Claims issued* in 2014 considered that the current binary classification model in IAS 32 should be retained with a refinement of the liability definition. EFRAG continues to support explicitly splitting the claims side of the statement of financial position between liabilities and equity;

(c) retains the existing notion of equity as a residual category;

(d) continues to rely on the substance of the contract, particularly when considering the proliferation of instruments and features in the last few years (additional comments on the relation between contracts and the law are included in section 8); and

(e) clarifies that the classification of financial instruments is made from an entity's perspective.

12 EFRAG also acknowledges the fact that the IASB uses the 'timing' feature (an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation) for classification purposes, which reflects the idea that claims classified as equity should not have a maturity or require ongoing payments. The IASB also uses the 'amount' feature (an unavoidable contractual obligation for an amount independent of the entity's available economic resources) for classification purposes, which reflects the notion that claims classified as equity are claims for an amount that is subordinated to all the companies liabilities and has a loss absorption feature as mentioned in the EFRAG Discussion Paper *Distinguishing Between Liabilities and Equity* issued in 2008 (as the amount is dependent on the entity's available economic resources, the holder participates in losses).

13 However, EFRAG has a number of reservations on the IASB's preferred approach, particularly on the classification of financial instruments. More specifically, EFRAG is concerned that:

(a) the approach in 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 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 financial instruments that are settled only on liquidation can be classified as liabilities. More details on the specific challenges brought by the new terminology 'amount independent of the entity's available economic resources' are further described in section 3.

(c) that challenges may arise also with the articulation of the timing feature. For example, 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', which is avoided particularly when an entity is considered 'too big to fail'. From this perspective, the concept of resolution may need to be taken into account for classification of some financial instruments (e.g. additional tier 1 instruments). The intention is that the holders of such instruments should incur the same amount of losses that they could be expected to suffer if the bank is liquidated;

(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 undated or perpetual cumulative hybrid securities such as additional tier 1 instruments. In its early-stage Impact assessment, EFRAG notes that the many respondents to the survey either had no opinion or found 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.

14 In the shorter term EFRAG 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. 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 by:

(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 Interpretations Committee (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.

15 EFRAG considers that some of these targeted improvements could be done together with the *Primary Financial Statements* project.

16 EFRAG acknowledges that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity but EFRAG has not identified any consensus among those constituents on how to achieve this. EFRAG is however not persuaded that an introducing a completely new Standard is justified unless it represents a significant step forward in this regard. Accordingly, EFRAG considers that the underlying concepts on which a new Standard might be based need further analysis before moving the broader *Financial Instruments with Characteristics of Equity* ('FICE') project from the research agenda to the standard-setting agenda. EFRAG also acknowledges that developing a more conceptual and less rule-based approach is very challenging and that any alternative that results in widespread classification changes is likely to prove controversial. EFRAG therefore suggests that the IASB reconsiders whether to continue a comprehensive FICE project as part of its next agenda consultation.

17 If the IASB decides to continue a comprehensive FICE project, the IASB could further consider different approaches raised by EFRAG's constituents such as:

(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 notes that, although 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, particularly on the notion of 'an amount independent of the entity's available economic resources'. In particular, that under the IASB's preferred approach, some financial instruments would be classified as liabilities even if they are only settled on liquidation (e.g. cumulative preference shares).

18 EFRAG highlights that in terms of non-derivative instruments, challenges have typically arisen with the classification of:

(a) puttable instruments that include a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put (please see below paragraph 34);

(b) instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (please see below paragraph 34);

(c) instruments that are settled in the issuer's own equity instruments such as shares redeemable at fair value where the amount of the obligation changes in response to changes in the price of the entity's ordinary shares (please see below in section 6);

(d) non-derivative financial instruments with alternative settlement outcomes where the entity has the option for an equity or liability settlement (e.g. share with an embedded call option held by the issuer where the strike price is linked to a gold index and mandatorily convertible bonds where the entity has the option to exercise a cap); and

(e) a share with a dividend feature that does not accumulate but is reset periodically when not paid (please see bellow section 8).

Classification of non-derivative financial instruments

19 EFRAG acknowledges that the DP's approach to the classification of non-derivative financial instruments is generally similar to IAS 32 and, accordingly, that the classification outcomes will remain largely unchanged for most types of non-derivative financial instruments.

20 However, EFRAG notes that changes in classification would arise from the proposed clarifications of IAS 32's underlying rationale, particularly in relation to 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 is for a fixed amount that is independent of the entity's available economic resources. For example:

(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, including those that are contingent and can be exchanged for shares (fixed conversion price) if certain ratio is breached (e.g. Common Equity Tier 1 below a certain level).

21 Currently, these instruments are classified as equity in their entirety as the entity has no contractual obligation to deliver cash or a variable number of its own shares under any circumstance.

22 Under the IASB's preferred approach such instruments may be classified as financial liabilities. This is because, when a claim has optional deferral provisions, under the IASB's preferred approach there is a fundamental difference between financial instruments with cumulative payment features (which, when deferred, still accrue, and ultimately must be paid) and noncumulative payments features (where there is no obligation to address missed payments).

23 The new articulation of the amount feature would have the benefit of solving the issue that arises with shares that have a dividend feature that does not accumulate but is reset periodically when not paid. The fact that the dividend rate increases at a specified rate when it is not paid results in an amount that is independent of the entity's available economic resource.

24 However, EFRAG notes that under the IASB's preferred approach cumulative preference shares and undated or perpetual cumulative hybrid securities are accounted for as financial liabilities even though such instruments are only settled on liquidation. EFRAG considers that the IASB does not clearly explain why this is a better accounting outcome, EFRAG is not convinced that the identified changes in classification outcomes relate to areas of IAS 32 that are problematic. 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. 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 would trigger the accounting call feature contained in hybrid structures, thereby potentially inflicting losses to investors.

25

Non-derivative financial instruments with alternative settlement outcomes

26 In general, EFRAG welcomes the DP's proposals on non-derivative financial instruments with alternative outcomes and considers that the classification outcomes will remain largely the same for these types of non-derivative financial instruments (subject to EFRAG's reservations on the introduction of a new terminology).

27 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

28 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. In particular, the use of the amount feature ('amount independent of the entity's available economic resources)' for classification purposes.

29 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 issue complex instruments with many different variables. For example, in the DP the IASB refers 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.

30 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).

31 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).

32 Finally, EFRAG is particularly concerned about the use of the amount feature on liquidation for classification purposes as it would:

(a) 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;

(b) raise measurement questions when liquidation becomes likely; and

(c) mean that some instruments would be classified as a liabilities even though there is no obligation to transfer economic resources other than at liquidation.

Other potential improvements

33 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 welcomes the IASB decision to retain the puttable exception as the new IASB approach does not solve all the issues that gave rise to the exception.

EFRAG also welcomes the DP's proposal to retain the disclosure requirements in IAS 1 paragraph 136A for instruments that meet the puttable exception.

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

34 EFRAG welcomes the IASB efforts to remove some of existing exceptions in IAS 32 that override the definition of a liability in the Conceptual Framework, which make it inconsistent within itself and with other standards.

35 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.

36 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.

37 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.

38 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.

39 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 welcomes the IASB's efforts to clarify the existing guidance on derivatives on own equity to address the issues that arise in practice without fundamentally changing the classification outcomes. EFRAG also welcomes the DP's proposal to classify derivatives on own equity in their entirety.

However, EFRAG is concerned that although the classification outcomes will not be significantly affected, the proposed guidance 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.

Finally, EFRAG welcomes the additional guidance on whether an instrument meets the fixed-for-fixed condition (i.e. whether the net amount of derivative, embedded derivative and hybrid is affected by a variable that is independent of the entity's available economic resources). EFRAG considers that providing guidance in this area would be a good basis for targeted improvements to IAS 32. However, we highlight a number of specific issues and consider that it would be important to have clear application guidance, particularly on foreign currency, which would help entities to apply the principles described in the DP.

The IASB's discussions on derivatives on own equity in general

40 EFRAG welcomes the IASB's effort to better articulate the principles in IAS 32 and provide additional guidance with the objective of addressing the issues identified by

the IFRS IC in the past. In particular, EFRAG acknowledges and welcomes the fact that the DP's proposed guidance:

(a) continues to classify the derivative in its entirety rather than considering the individual 'legs' of the derivative;

(b) has identified the main challenges in practical application of IAS 32 and developed additional guidance to clarify some complex areas such as:

  (i) the fixed-for-fixed condition to derivatives on own equity;

  (ii) the redemption obligation requirements;

  (iii) the accounting within equity; and

  (iv) the accounting for instruments with contingencies;

(c) continues to focus on the substance of transactions rather than their form; and

(d) has not sought to change the accounting outcomes under IAS 32 significantly, but rather to improve the rationale of the existing requirements.

Different alternatives on accounting for standalone derivatives on own equity

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

41 Under the IASB's preferred approach, the accounting outcome would be broadly similar to IAS 32 for most of the derivatives on own equity. However, the carrying amount of different sub-classes of equity component within total equity would be updated through an attribution mechanism.

42 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.

43 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 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.

44 The IASB considered some of the challenges of such an approach (for example, the approach would be inconsistent with the classification of standalone obligations to issue a fixed number of ordinary shares as equity) and the fact that this approach would not meet the objectives of the IASB's preferred approach. Furthermore, the IASB considered that this would have similar limitations to the basic ownership approach considered in the predecessor project. Therefore, the IASB decided not to not to propose to classify all derivatives as derivative assets or liabilities under the scope of IFRS 9.

45 EFRAG agrees 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 not aligned 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

46 In the DP the IASB discusses whether it should require a detailed componentisation of all derivatives on own equity. For example, a warrant to deliver own shares in exchange for receiving cash may be classified as an equity component (i.e. the obligation to deliver own shares) and an asset component (i.e. the right to receive cash).

47 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. Therefore, EFRAG welcomes retaining existing principles in IAS 32 and IFRS 9 for derivatives, where the guidance is applied to contracts in their entirety.

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

48 For classification purposes, the IASB identified different types of derivatives on own equity. In particular, the IASB clearly distinguished those that could require the recognition of a liability for the redemption amount such as written puts or forward contracts to acquire own shares, which are discussed separately in section 5.

49 Therefore, this section impacts mainly the guidance on the amount feature that replaces the fixed-for-fixed condition in IAS 32, as well as the foreign currency rights exception.

The IASB's preferred approach in general for asset/equity and liability/equity exchanges

50 The DP proposes additional guidance on variables that affect the net amount of a derivative in paragraphs 4.45 to 4.66 of the DP, which is further discussed below. Gross-settled derivatives that are currently classified as equity in accordance with IAS 32's fixed-for-fixed condition are expected to be classified consistently in accordance with the proposed guidance.

51 The DP also proposes changes to current requirements in IAS 32 to reflect the features used under the IASB's preferred approach. This would result in some classification changes:

(a) foreign currency rights issues that meet the exception in IAS 32); and

(b) 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 of the entity's functional currency.

52 Although EFRAG generally supports the IASB's efforts to better articulate the classification principles in IAS 32 for derivatives on own equity, 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). 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 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 principled-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

(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.

53 Therefore, EFRAG would prefer 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) is a good basis for targeted improvements to IAS 32.

Foreign currency rights exception

54 EFRAG highlights that 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 fixes the exercise price of the rights in currencies other than their functional currency. These rights are commonly described as 'rights issues'.

55 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.

56 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.

57 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 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;

(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).

58 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

59 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.

60 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.

61 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 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.

62 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)

63 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).

64 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 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.

65 EFRAG considers that such guidance is useful to promote consistency in practice. In particular, we consider that it is useful to have a key principle that is supported by practical application guidance. Therefore, EFRAG generally supports the direction of the IASB proposals in the DP and considers that the guidance suggested in the DP (e.g. anti-dilution, time value of money) is a good basis for targeted improvements to IAS 32.

66 In regard to the variables analysed in paragraphs 4.45 to 4.66 of the DP, EFRAG raises a number of specific issues 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.

<u>Foreign currency</u>[2]

67 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.

68 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 as 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 (e.g. euros) other than its functional currency (e.g. Norwegian krone) for ease of access to investors.

69 As IAS 32 does not currently make a specific reference to this issue, entities have an accounting policy choice which impairs comparability. Generally, entities have considered guidance in IAS 39 *Financial Instruments: Recognition and Measurement*. In these standards, a contract in the functional currency of either counterparty would be closely related which reflects the bargaining power of both parties to the contract.

70 In addition, in November 2006 the IFRS IC discussed the issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency but did not take the matter onto its agenda. Considering the lack of guidance and clarity on this issue, EFRAG welcomes guidance on this topic.

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

71 EFRAG agrees with the principle included in paragraph 4.50 of the DP as the relevant determination for the separate/individual accounts. 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.

72 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).

73 EFRAG also notes that the foreign currency variable is also 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 arise from partly independent derivatives should be recognised in OCI (e.g. foreign currency denominated written put option).

<u>Dependency on the entity's economic resources before deducting all other claims</u>

74 EFRAG welcomes specific guidance on this topic in this section given the complexity of the model and the new terminology. However, EFRAG considers that this may still be the subject of significant debates between preparers and auditors and will require significant judgement, therefore further examples may be useful in this area.

75 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.

76 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.

<u>Time value of money</u>

77 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 needs to be consistent as far as possible to the explanation and guidance in IFRS 9.

78 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, 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.

79 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.

80 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.

<u>Dilution and distributions to holders of equity instruments</u>

81 Option contracts by unrelated parties (i.e. A sells a call option on the shares of C to B) generally does not include anti-dilutive provisions or provisions for distributions. On a theoretical basis, therefore, it is not clear why contracts where the issuer is involved need to include these adjustments.

82 However, given that in practice these clauses give rise to considerable efforts to determine whether fixed-for-fixed requirements have been met, additional guidance is welcome and the examples in 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.

<u>Non-controlling interests</u>

83 EFRAG welcomes that the DP confirms the principles in IAS 1 on NCI when considering derivatives over own shares.

84 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.

<u>Contingencies</u>

85 Examples of contingencies outside of the control of both parties 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); or

(g) Cross-default settlement clauses.

86 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 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.

87 EFRAG also suggests that the IASB should consider developing further guidance on what constitutes 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 is not convinced that the accounting for a written put option on own shares together with the previously issued ordinary shares should be the same as the accounting for a convertible bond. EFRAG does not consider that such transactions are similar and is concerned about the final outcome.

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), 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.

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 indirect obligation requirements 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)

Key challenges

88 EFRAG acknowledges that many of the challenges that arise in practice with derivatives on own equity are related to:

(a) whether it is appropriate that written put options and forward purchase contracts on an entity's own equity instruments are presented grossed-up rather than on a net basis like other derivatives (i.e. redemption obligation requirements);

(b) how to account for transactions within equity when an entity has an obligation to extinguish its own instruments (e.g. NCI puts);

(c) how to subsequently measure the redemption amount when the entity has to deliver the fair value of its own instruments (e.g. written puts with a fair value strike price);

(d) whether the liability component should include the effect of any conditionality (e.g. probability-weighting the liability component based on the likelihood of the liability settlement outcome occurring); and

(e) how to account for a financial instrument that gives the issuer the option for a liability or equity settlement.

89 In this section of the DP, the IASB explains how the IASB's preferred approach addresses these issues. EFRAG has provided its comments accordingly, however as under the IASB's preferred approach the redemption obligation requirements are closely related to the compound instruments guidance, EFRAG starts by providing its comments on compound instruments.

Compound instruments

90 EFRAG considers that the current approach under IAS 32 to be well understood and giving rise to few problems in practice.

91 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.

Redemption obligation requirements

92 EFRAG agrees with the DP's proposal to have the same settlement outcomes for instruments that are structured differently as this ensures the focus is on economic substance rather than legal form. However, EFRAG is not convinced that the accounting for a written put option on own shares together with the previously issued ordinary shares should necessarily be the same as the accounting for a convertible bond.

93 The suggested similarity between the economic substance of a written put and a convertible bond seems partly to be consequence of the IASB's decision to recognise a gross liability for the pay leg of the written put. 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.

94 EFRAG questions the resulting outcome of the accounting within equity, which is described below.

Accounting within equity for written put options

95 As a second step, and to improve consistency in the accounting for convertible bonds and written puts issued and the issued shares, the DP proposes new guidance on accounting within equity.

96 As already mentioned above, EFRAG does not consider that such transactions are necessarily similar and is concerned that the accounting for the equity component of a written put option reflects a written call or conversion option in a convertible bond. In particular, EFRAG considers that such an outcome is complex for users and preparers to understand, does not reflect the substance of the instruments and will not 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.

97 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.

98 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 conversion option in a convertible bond. EFRAG also considers 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 derecognition of equity 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 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.

Subsequent measurement of fair value written puts

99 Another important issue is how to subsequently measure written puts when the entity has to deliver the fair value of its own instruments. Currently, the subsequent measurement changes in the redemption amount are recognised in profit or loss. However, some argue that subsequent measurement changes in the redemption amount recognised in profit or loss result in counter-intuitive accounting.

100 As further explained in section 6, EFRAG considers that the IASB needs to further consider the relevance of its proposals on separate presentation of liabilities with equity-like returns before proceeding to a change in IAS 32 and whether such information should be provided in the disclosures.

Accounting for NCI puts

101 In the consolidated financial statements, put options over NCI follow the same basic accounting per IAS 32 paragraph 23.

102 The challenges of applying IAS 32 on written puts in general continues when applying the requirements to written puts of NCI. The challenges include whether:

(a) The NCI is derecognised, or a contra-equity account is recognised within the consolidated equity when recognising the liability for the redemption amount; and

(b) The subsequent measurement changes in the redemption amount is recognised in profit or loss or in equity, similarly to other transactions between equity holders.

103 In the DP the IASB clarifies that its proposals for the accounting within equity for a written put option would also apply to NCI.

104 EFRAG considers that the DP's proposals have the benefit of clarifying the accounting for NCI puts including those with a strike price at fair value and will ensure consistency with the accounting for shares redeemable at fair value. However, EFRAG considers that the IASB needs to further consider the scope and relevance of its proposals on separate presentation of liabilities with equity-like returns before proceeding to a change in IAS 32(please refer to our response in section 6).

105 EFRAG welcomes the DP's discussion on accounting within equity for put options over NCI as this is an issue that creates diversity in practice. Regarding the derecognition of the NCIs 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 96 above in regard to recognising an equity component that represents an implicit call option as compared to the put option.

106 Whilst the DP clarifies that the component of equity (whether shares issued or NCI) is derecognised, it does not deal 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 DP does not provide guidance on 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.

107 Therefore, EFRAG concludes that there are various conflicts that have to be resolved on the basis of derecognition of the equity component. Furthermore, as noted, EFRAG has serious concerns about both the recognition of a conversion option as well as an attribution process to components of equity.

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

108 In accordance with paragraph 19 of IAS 32 if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. Similarly, an obligation dependent on a counterparty exercising its right to redeem is a financial liability as the entity does not have the unconditional right to avoid delivering cash or another financial asset.

109 Paragraph 25 of IAS 32 also deals with situations where cash settlement is contingent on circumstances beyond the control of both the issuer and the holder of the instrument. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability.

110 The IASB's preferred approach is similarly based on whether an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that has the feature(s) of a financial liability. Any conditionality would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability.

111 It is worth noting that in regard to automatic mandatorily convertible bonds with a cap, on the IASB's preferred approach the entity would first classify the obligation to deliver a variable number of its own shares with a total value equal to a fixed amount as a non-derivative liability component. In identifying the liability component, the entity would not consider the uncertainty that arises from conditionality, i.e. the likelihood of the share price falling below the cap. Once the liability component is identified, the entity would classify the remaining rights and obligations applying the

classification principle of the IASB's preferred approach for derivative financial instruments.

112 EFRAG considers that the suggestions 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. The IASB's suggestions would also have the benefit of bringing more bring 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 component. 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.

113 Nonetheless, due to the complexity of the IASB's preferred approach, particularly on the amount feature on liquidation, EFRAG is concerned 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, uncertainty and diversity in practice could 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) 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

114 Some financial instruments have alternative settlement outcomes and give the entity an unconditional right to choose the settlement outcome, such as a reverse convertible bond that gives the issuer the option to settle with a fixed number of own shares or deliver cash.

115 Under IAS 32, this financial instrument would be classified as equity in its entirety as the entity has the unconditional right to avoid delivering cash. Also, the entity has no contractual obligation to deliver a variable number of its own equity instruments.

116 Under the IASB's preferred approach, this instrument would also be classified as equity in its entirety as the entity has the unconditional right to avoid the liability settlement. In the absence of further specific requirements, these instruments will be classified in their entirety even if the alternative settlement outcome may be affected by variables that are independent of the entity's available economic resources (e.g. gold indexed callable share). As a result, information about the variability resulting from such variables will not be provided.

117 The IASB discussed potential ways to provide information about the alternative settlement outcomes, including separation of embedded derivatives from the equity host instrument or presentation and disclosure, such as attribution within equity.

118 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, enhancing embedded derivative

requirements and separating embedded derivatives would be a significant change to current requirements, and consequently to current practice.

119 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).

120 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 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).

121 Therefore, 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 components within 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.

122 EFRAG also consider that improvements to the indirect obligation requirements 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?

EFRAG's response

EFRAG considers that, as a first step, the IASB needs to clearly identify all the cases (derivatives and non-derivative financial instruments) which currently lead to counter-intuitive accounting under IFRS Standards and further consider the scope of the separate presentation requirements for financial liabilities.

In addition, EFRAG considers that such information could be provided within disclosures and apply only to 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.

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

123 EFRAG welcomes the DP's discussion on providing additional information to users, particularly about liabilities that have equity-like returns. We consider that improvements to presentation are important even if stakeholders disagree on the best classification approach.

124 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.

125 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;

(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.

126 Nonetheless, as further explained below, EFRAG would welcome more information about financial liabilities with equity-like return within disclosures.

Statement of financial performance

127 Some obligations of an entity to transfer economic resources are linked to its own performance (e.g. obligation to transfer cash equal to the fair value of ordinary shares). Remeasuring the amount of these obligations through profit or loss may lead to what some consider counter-intuitive accounting. This is because when an entity performs well, the liability increases and a loss is recognised (and vice-versa). Recognising changes in the carrying amount of such financial instruments in profit or loss may also appear counter-intuitive due to the accounting mismatch that arises

from incomplete recognition of changes in the value of other assets and other liabilities of an entity.

128 This counter-intuitive accounting was one of the concerns that led to the puttable exception in IAS 32. Somewhat similar concerns led to the 'own credit risk' amendments to IFRS 9. In its comment letter to the IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, EFRAG also noted that requirements in IFRS Standards have led to financial reporting that many believe is counter-intuitive for a number of instruments such as puttable shares, derivatives over own equity (including NCI puts), perpetual instruments that entitle holders to discretionary payments that are fixed or determinable, and instruments that require an entity to distribute an amount based on a proportion of profit or revenue. Finally, in its Discussion Paper *Classification of Claims*, EFRAG mentioned that bail-in instruments classified as liabilities could lead to counter-intuitive accounting. This is because the entity records income when the measurement of these instruments (but not the amount owed) is written-down.

129 To address the concerns linked to counter-intuitive accounting, the DP refers to the possibility of presenting income and expenses that arise from financial liabilities and derivatives where the amount depends on the entity's own performance separately, in OCI or using a separate line item within profit or loss. Under the IASB's preferred approach an entity should separately present in OCI, without subsequent recycling, income and expenses arising from financial liabilities and derivative financial assets and liabilities that depend on the entity's available economic resources.

130 EFRAG considers that, as a first step, the IASB needs to further assess which situations (relating to derivatives and non-derivative financial instruments) lead to counter-intuitive accounting under IFRS Standards and why this is the case. EFRAG further that separate presentation in OCI is one potential solution to counter-intuitive outcomes in profit or loss, but 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.

131 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.

132 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).

133 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.

134 In addition, EFRAG notes that many believe that there are cases where an increase (decrease) in a financial liability should be reflected as performance, 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:

(a) the use of OCI is a controversial issue which interacts with the revised *Conceptual Framework for Financial Reporting*. EFRAG notes that if the IASB decides to expand the use of OCI, there is likely to be a call for a new 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 IASB 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 hybrids[3]. 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.

135 In balance, while EFRAG considers that in some cases separately presenting income and expenses in OCI could provide useful information (e.g. shares redeemable at fair value), EFRAG doubts that it would result in the most useful information in all cases. Thus, EFRAG considers that the IASB should, further consider whether more information about financial liabilities with equity-like returns (i.e. those that the price is linked to the entity's own performance) could be provided within disclosures.

Partly independent derivatives

136 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**. That is, an entity would be required to separate the effects of the variables that affect the amount of an instrument into profit or loss (e.g. foreign currency) and OCI (e.g. value of share). This is because splitting the different components would provide a better reflection of the effect of the entity's own performance in comprehensive income.

137 However, EFRAG considers that such 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.

138 EFRAG acknowledges that the **criteria-based approach** would address the cost issue of the disaggregation approach. However, EFRAG considers that the 'criteria-based approach' (all in or all out):

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

(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 also widen the use of OCI.

139 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. 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.

140 Nonetheless, if the IASB were to proceed with the proposals in the DP, EFRAG would prefer that such information 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

141 EFRAG considers that if the requirements for separate presentation of financial liabilities in OCI are to be implemented, then these requirements should apply only to embedded derivatives that are separated from the host (but not required) and hybrid instruments that, as a whole, are solely dependent on the entity's available economic resources (e.g. shares redeemable at fair value);

142 EFRAG considers that separate presentation of all embedded derivatives in hybrid instruments would maximise the benefits of the separate presentation requirements. However, EFRAG is concerned about the costs and complexity of always requiring the split of hybrids instruments just for the purpose of using OCI. If the IASB decides to proceed, EFRAG would then recommend the IASB to assess the impact of such proposals.

143 Nonetheless, EFRAG would prefer that such information be provided within disclosures and apply only to embedded derivatives that are separated from the host (but not required) and hybrid instruments that, as a whole, are solely dependent on the entity's available economic resources (e.g. shares redeemable at fair value).

Statement of financial position

144 In regard to the statement of financial position, the DP proposes the use of additional lines 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).

145 EFRAG notes that the IASB will 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.

146 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).

147 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.

148 In regard to the DP's discussion on arranging claims by priority, 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.

149 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.

150 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) would 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) mean that users could face additional difficulties in determining the working capital of an entity;

(d) raise the same issues described in paragraph 211 below (i.e. defining priority within consolidated financial statements can be challenging)

151 EFRAG would prefer to have information related to priority on liquidation reflected in the disclosures (please see section 7). Such an approach would less disruptive than presentation on the face, 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 the same 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.

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.

Expand the attribution of income and expenses to some equity instruments other than ordinary shares

Information on subclasses of equity

152 EFRAG notes that the identification of subclasses of equity is not an entirely new concept. Currently, the Conceptual Framework already mentions (previous versions also) 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 (paragraph 4.20 of the 2010 Conceptual Framework and paragraph 65 of the 1989 Framework).

153 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;

(e) other comprehensive income;

(f) profit of the year attributable to the shareholders of the parent; and

(g) non-controlling interest.

154 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.

155 Therefore, EFRAG welcomes the DP's discussion on potential improvements to the presentation of subclasses of equity instruments and how they could provide additional information to users, even though it will create the need for the IASB to develop new definitions for the new subclasses of equity.

Definition and scope of each subclass of equity

156 The IASB's preferred approach would require total equity, and changes in equity, to be disaggregated between *ordinary shares* and *equity instruments other than ordinary shares*.

157 The DP states that an *ordinary share* is the class of equity that is the most subordinate claim and requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred at liquidation is equal to a pro-rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.

158 EFRAG notes that *equity instruments other than ordinary shares* would encompass non-derivative instruments (e.g. non-cumulative preference shares and participating equity instruments) and derivative instruments.

159 However, EFRAG considers that if the IASB is to differentiate a subclass of *equity instruments other than ordinary shares*, then EFRAG considers that it would be useful to have additional guidance:

(a) the classification of the many different types of ordinary shares with different rights, while determining the most residual class of financial instrument, 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 bonds[4] 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 shares[5], in case of resolution (for more details on additional Tier 1 convertible bonds please see paragraph 243);

[4] A perpetual bond is a non-redeemable bond with no maturity which pays a stream of interest indefinitely.

[5] Additional Tier 1 instruments that have a trigger that kicks-in before resolution can absorb losses before equity.

(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.

Assessment of the attribution requirement proposals

160 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 type of equity instruments;

(b) reflecting the same 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.

161 EFRAG considers that such information could be particularly useful if it reflected the full fair value changes of each individual equity instrument. For example, information about fair value changes of each individual forward or option would provide useful information about the wealth transfer between the ordinary shareholders and potential shareholders.

162 However, 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.

163 Furthermore, in paragraph 6.63 the DP argues that the attribution of comprehensive income to equity instruments other than ordinary shares and subsequent update would be similar to the presentation of NCI. However, in EFRAG's view the attribution of comprehensive income to equity instruments other than ordinary shares has a different nature.

164 Its objective is not to reflect the relative interests of holders of equity instruments other than ordinary shares. Although the carrying amount of NCI is currently updated, it simply reflects changes in the part of the residual (assets less liabilities) owned by non-controlling interests or changes in the proportion held by NCI. The allocation of profit or loss and comprehensive income to NCI and owners of the parent are currently required by IAS 1 and follows the consolidation method set out in IFRS 10. It is not a separate measurement method for the equity instruments. This method currently requires that 'when potential voting rights or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and NCI is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives'. Therefore, EFRAG considers that the objective of showing 'how the equity instruments affect each other's returns' is conceptually and economically different from existing guidance on attribution.

165 Considering all the challenges identified, in paragraph 188 EFRAG suggests an alternative approach to the IASB.

Attribution requirements and their impact on primary financial statements

166 In this section, EFRAG identifies general concerns that affect the primary financial statements (concerns related to each primary financial statement are described in the following sections).

167 Overall, EFRAG has the following comments:

(a) EFRAG is concerned about the increased complexity and costs of the DP's proposals, 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 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 corporate. 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.

Attribution requirements in the statement of financial performance and EPS

168 Under IAS 1, an entity is required to attribute total comprehensive income to owners of the parent and non-controlling interest. In the DP the IASB is considering expanding the attribution of total comprehensive income to *equity instruments other than ordinary shares*.

169 EFRAG notes that the DP's approach is focused on the attribution of total comprehensive income to equity instruments other than ordinary shares (i.e. a change to paragraph 81B(b) of IAS 1). However, EFRAG considers that 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.

170 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.

171 EFRAG notes that Basic EPS is a fundamental measure of an entity's performance and that the IASB should carefully consider the impact of its preferred approach on the calculation of Basic EPS. Finally, if the calculation method of Basic EPS is going to be actually changed, EFRAG is concerned about changing it simply through a consequential amendment.

Attribution requirements in the statement of financial position

172 EFRAG notes that the discussion in the DP is mainly focused on the statement of changes in equity and statement of financial performance. However, EFRAG regrets that the IASB does not deal with the statement of financial position.

173 EFRAG highlights that 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. To ensure the understandability of the attribution requirements on the face of the statement of financial position, the IASB may need to reconsider the format of the statement of financial position. In particular, the use of tabular format for the equity section may be required, where all line items are either attributed to ordinary shares or classes of equity other than ordinary shares.

174 Furthermore, if the attribution mechanism is applied to equity component recognised as an *equity instrument other than ordinary shares* and the IASB uses an attribution other than full fair value, EFRAG questions the relevance of the information provided on the face of the statement of financial position.

175 Although it is not clear from the DP, EFRAG would expect that any amount recognised as 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 would reflect both instruments that have been already settled and instruments that will be settled in the future. Arguably, new ordinary shareholders

will only be interested in information regarding instruments that will be settled in the future.

Statement of changes in equity

176 EFRAG is also concerned that an attribution approach would increase significantly 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

177 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.

178 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.

179 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.

180 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

181 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 by 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 there were to be considered as liabilities).

182 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 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.

183 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.

Disclosures only approach

184 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.

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

186 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.

187 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

188 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).

189 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

190 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.

191 Therefore, EFRAG considers that the IASB should 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

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

193 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.

194 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.

195 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) 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.

196 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.

197 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 enhance IAS 33 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

198 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.

199 EFRAG generally welcomes the IASB'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.

200 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.

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

(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.

202 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.

203 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.

204 In addition, in its early-stage impact assessment 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

205 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 its one own rights, benefits, costs and risk**.**

206 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.

207 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) if they are investors in the entity, the position of their investments in the capital structure.

208 In addition, in its early stage impact assessment, EFRAG noticed that many considered useful to have information about priority of claims on liquidation.

209 Therefore, EFRAG supports the DP's proposal to improve disclosures on priority of financial liabilities and equity instruments on liquidation.

210 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.

211 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.

212 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

213 Currently, entities have a variety of liability and equity instruments that gives 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.

214 In paragraphs 7.13 - 7.15 of the DP the IASB identifies 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 an historical measure and not a predictor of dilution or a forward-looking number.

215 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.

216 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.

217 EFRAG recalls that, in its comment letter to the IASB Discussion Paper *Conceptual Framework for Financial Reporting*, it had already 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.

218 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

219 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.

220 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 assessment, EFRAG noticed that many users referred to instruments where classification is currently unclear.

221 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.

222 For example, if the Common Equity Tier 1 ratio of a bank falls below 5.125%, additional Tier 1 instruments may automatically be converted into Common Equity Tier 1 instruments or written down. The specific mechanism may be specified in the contractual conditions.

223 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;

224 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

225 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, undistributable 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 with the DP's proposal to clarify 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 retaining and improving the indirect obligations requirements 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

226 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.

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

228 EFRAG welcomes the DP's proposal to clarify that economic incentives that might influence the issuer's decision to exercise its rights would not be considered when classifying a financial instrument as a financial liability or equity instrument.

229 EFRAG agrees with the views and arguments provided in paragraphs 8.18 to 8.21 that considering economic incentives on classification may raise more questions than answers. In addition, as further described below, EFRAG considers that improvements to the indirect obligations requirements may alleviate some of the issues related to economic compulsion.

230 Finally, EFRAG welcomes the fact that the IASB's preferred approach would solve the issue of 'callable preferred shares with a 'step-up' dividend clause' without the need to consider economic incentives or compulsion.

231 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. 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

232 Notwithstanding the stated right of the entity to choose an equity settlement outcome in some claims with alternative settlement options, the terms and conditions may establish an indirect obligation for a liability settlement.

233 IAS 32 already includes some requirements to help establish whether a financial instrument establishes an obligation that would meet the definition of a liability indirectly through its terms and conditions. In particular, paragraph 20(b) of IAS 32 provides the example that an indirect contractual obligation would be established if a financial instrument provides that on settlement the entity will deliver either cash or its own equity instruments whose value is determined to exceed substantially the value of the cash.

234 In the IASB's preliminary view, the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained. EFRAG considers that retaining the current requirements on indirect obligations can alleviate some of the issues that arise when the manner of settlement of a financial instrument is at the option of the entity. EFRAG also highlights that this would be in line with previous discussions by the IFRS IC which 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.

235 However, EFRAG considers that the IASB should also take the opportunity to improve these requirements to incorporate the notion of 'no commercial substance' which is currently used in paragraph 41 of IFRS 2. This paragraph states that an 'entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (e.g. because the entity is legally prohibited from issuing shares)'. 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.

236 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).

237 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 retaining the broad approach in paragraph 15 of IAS 32, which focuses 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 welcomes the fact that the IASB decided to retain IFRIC 2.

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

238 EFRAG considers that the interaction between 'contractual rights and obligations' and 'regulatory and legal' requirements is an important issue.

239 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.

240 In accordance with paragraph 5 of IFRIC 2, the contractual right of the holder of a financial instrument to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter. By contrast, under IFRS 9 the effect of the regulation that introduces different contractual cash flows is not considered when assessing whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

241 In addition, EFRAG notes that 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.

242 EFRAG acknowledges that many would prefer to have consistency within IFRS Standards. Nonetheless, taking into consideration the overall effects of regulation and legislation in 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 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.

243 Therefore, EFRAG generally supports retaining the broad approach set out in 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

(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.

244 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.

245 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.

246 Considering the challenges that arise in practice, particularly with bail-in legislation, we recommend 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 investor 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

247 The DP explains that the IASB does not intend to reconsider the requirements in IFRIC *2* given IFRIC 2 was developed for a very specific fact pattern with limited effect in practice that it is not aware of any challenges to its application.

248 EFRAG agrees that the IASB should not reconsider the guidance in IFRIC 2. In particular EFRAG notes that:

(a) the recognition of members' shares in cooperatives as equity under IFRS Standards is governed by IAS 32 and the related Interpretation IFRIC 2 issued in 2004. The Interpretation 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.

(b) the approach of IFRIC 2 for the distinction between equity and liabilities is also 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).

249 However, EFRAG considers 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.

250 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.

251 Considering this, EFRAG emphasises its preference that the IASB should take the opportunity to integrate IFRIC 2 in any revisions to IAS 32.

EFRAG
European Financial Reporting Advisory Group

Appendix 2 – *Executive Summary of Early-stage impact analysis on the IASB's preferred approach*

Introduction

252 The during the IASB's consultation period EFRAG outreached its constituents to better understand the impact of the DP's proposals on the financial statements of the entities. EFRAG used this information to develop an early stage impact analysis of the IASB proposals.

253 This early stage impact analysis gives emphasis to the real-world consequences of changing current IFRS requirements and is intended to help EFRAG and its constituents understand the potential impact of the new approach developed by the IASB on classification and presentation of financial instruments under the scope of IAS 32.

Executive Summary

254 The early-stage impact assessment is based on quantitative and qualitative data gathered from several sources including preparer and user surveys, aggregated data in commercial databases, EFRAG's review of the financial statements of the largest EU financial institutions and from obtaining stakeholder views on impact from outreaches and responses to EFRAG's draft comment letter on the IASB DP.

255 European Public Good - Economic consequences: To assess economic consequences, we considered the potential impact on competition for capital, economic development and behavioural impacts including on the issuance of instruments and on covenants and compensation contracts. Highlights of our findings include the following:

(a) There is no anticipated impact on competition for capital due to differences in accounting standards across different jurisdictions. At the same time, most preparer and user survey respondents did not expect a significant impact on the cost of capital.

(b) There could be potential for significant short-term market disruption to existing and prospective issuance of perpetual hybrid bonds as these instruments could potentially be reclassified from equity to debt under the IASB DP proposals. This disruption may arise from the call feature of perpetual hybrid bonds (i.e. enforced redemption at price 101) that may encourage the early call of current issues or deter new issuances. Early calls may impose costs to existing issuers and costs to investors. Furthermore, based on the prevailing coupon rates of hybrid bonds, preparers may perceive that issuances considered as 'cheap equity' have transformed to 'expensive debt'.

(c) At this stage, we have only obtained indicative estimates of the market size of outstanding issued perpetual hybrids by EU non-financial entities and some indicative estimates of impact at individual entity level but we do not have any evidence of the possible second order effects of such disruption at an aggregate level or whether it has any ramifications for economic development and financial stability. We also consider that there could be measures (e.g. transitional arrangements) taken to mitigate the mentioned potential market disruption.

(d) The IASB DP (Paragraph IN19C) notes that the provisions in IFRIC 2 Members' Shares in Cooperative Entities will be retained. However, a number of co-operative banks expressed uncertainty about the implications of the IASB DP and expressed concerns about the impact of a potential reclassification of their member shares from equity to liabilities.

256 European Public Good - In addition to economic consequences, we considered impact on financial stability and sustainability as part of the assessment of European public good.

(a) To assess the impact on financial stability, we considered the potential interaction between the IASB DP proposals and prudential regulatory requirements for banking and insurance entities. From a banking regulatory capital perspective, there could be the following mechanisms of impact:

(i) Reclassification between equity and liabilities for accounting purposes could impact regulatory capital if the accounting reclassification changes the regulatory classification of the instruments. However, as we understand, the regulatory capital classification (CET1 and AT1) categories will not be affected by the IASB DP proposals.

(ii) Reclassification from equity to liability could increase volatility in profit or loss due to the remeasurements of the financial liabilities that were previously classified as equity. Profit or loss for the period could change due to carrying value/notional amount remeasurements and due to changes in the amount of interest expense recognised (i.e. effective interest charge). In turn, subject to tax, the profit or loss effects could impact retained earnings.

(iii) From a prudential perspective, regulatory capital volatility would also increase should the reported comprehensive income that updates CET 1 not be subject to prudential filters that strip out volatility arising from accounting remeasurement. In effect, in the absence of prudential filters, financial statement line items affected by the remeasurements (carrying value changes and interest recognised in profit and loss) could potentially affect the level and volatility of CET1 capital.

The proposed attribution of comprehensive income could reduce retained earnings included in the highest quality of capital, CET1. This is because portions of amounts that are currently attributed to ordinary shareholders would be attributed to secondary equity claims if the IASB attribution approaches that result in an update of the statement of equity and carrying value on statement of financial position were adopted.

(b) With regards to insurance solvency requirements: As own funds (both basic and ancillary own funds) refer to the absorption of losses, the reclassification of financial instruments for accounting purposes will not directly impact the basic and ancillary own funds because the ability to absorb losses arises from the economic substance of an instrument rather than its classification for financial reporting purposes.

(c) Overall, any effect on regulatory capital will ultimately depend on the extent to which prudential authorities decide to adapt or not adapt prudential filters to align with or deviate from the accounting.

(d) We are not aware of any evidence or stakeholder concerns that suggests that the accounting classification of liabilities and equity could impact on the sustainability of EU business entities.

257 An assessment of whether the IASB DP will lead to an improvement in financial reporting is set out below. When considering the expected effects on entities'

financial statements it is however important to notes that the IASB DP is a preliminary consultation document and does not cover all the matters or the level of detail that would be expected in a final IFRS Standard.

(a) The new terminology related to classification has been identified by many stakeholders (both preparers and users) as unclear and challenging, which raises the possibility that the IASB DP proposals on classification could lead to new interpretative challenges and concurrent challenges in the analysis of financial statements.

(b) Specifically, concerns have been raised that because users analyse financial statements with an assumption that reporting entities are going concerns, they are unclear about the use of liquidation in the IASB DP's proposed definition of financial liabilities. Furthermore, the meaning and application of 'independent of an entity's available economic resources' in the definition of financial liabilities was considered unclear.

(c) In relation to the classification concerns summarised above, there is recognition in the IASB DP that no matter what criteria are applied for a binary classification of financial liabilities versus equity, the ever- widening range of complex financial instruments that have characteristics of both debt and equity will limit the information that can be conveyed to users of financial statements through classification. The IASB DP argues that enhanced presentation and disclosure requirements have a role in meeting the information needs of users.

(d) However, there are mixed views on the usefulness of the IASB DP presentation proposals. There was some support for the IASB DP proposals for presentation of financial liabilities with more support for the proposals related to the statement of financial position than for the statement of financial performance. For the presentation of equity instruments, there was a particular concern on the complexity and relevance of attribution of comprehensive income to equity instruments other that ordinary shares. There was more support for only disclosures and improvements to the earnings per share calculation than the approaches that would result in an update of the carrying value of equity instruments other than ordinary shares in the statement of financial position and statement of changes in equity.

(e) User feedback indicates that the proposed IASB DP disclosures are useful but could be refined to be as relevant as intended (e.g. priority on liquidation and terms and conditions).

258 Anticipated costs and benefits of the proposals in the DP: The findings show that:

(a) A majority of preparer respondents expect the costs of implementing the IASB DP proposals to be minor.

(b) There are contrasting views between users and preparers on the costs versus benefits with preparers viewing that costs outweigh benefits and users taking the opposite view. It is notable that a majority of preparer respondents expect costs to outweigh benefits while at the same time expecting only minimal or zero implementation costs. This could mean that preparers could be considering other costs beyond the direct implementation costs and/or they perceive no benefits from the proposals.

259 The impacts on the financial statements: Key findings are as follows

(a) Reclassification of perpetual hybrid bonds will likely affect a number of financial and non-financial entities. There is some evidence that the impact on key ratios can be quite significant at an individual reporting entity level.

(b) A number of financial institutions highlighted a potential significant impact on their financial statements due to the potential reclassification from equity to debt of some instruments that are classified as AT1 under regulatory capital classification.

(c) From the preparer survey respondents, there is no evidence of a significant impact on financial statements due to the potential reclassification of irredeemable, fixed rate cumulative preference shares, net share-settled derivatives and foreign currency rights issue.

260 Reporting and use of non-GAAP information. The findings show that the majority of both user and preparer survey respondents expect there to be either no impact of the IASB DP proposals on the reporting and use of non-GAAP measures or they found it difficult to assess. This result could be indicative that either these respondents

(a) Do not expect the need for a change in adjustments to financial liabilities and equity instruments related line items in the statement of financial position and statement of financial performance; or

(b) Are unsure about whether the classification principles of the IASB DP will better reflect economic leverage than is the case under IAS 32.