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(EFRAG)
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Ref: EFRAG's comment letter on IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's consultation relating to the IASB's Discussion Paper (DP) *Financial Instruments with Characteristics of Equity*. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

The DP addresses the fundamental question of the distinction between liability and equity for the purpose of classifying financial instruments. In the past years, ESMA and European enforcers, as well as market participants, have raised with the IASB and the IFRS Interpretations Committee, several application issues relating to IAS 32 *Financial Instruments: Presentation* and the related disclosures. Therefore, like EFRAG, we welcome the IASB's initiative to propose clear principles to address the classification issues which have arisen in practice. As consistently underlined, ESMA believes that these application challenges, which have also been highlighted by the IASB in the DP, should be addressed on a timely basis.

We overall support the IASB's proposed classification approach (also referred to as the 'Board's preferred approach') and the fact that it builds on the information needs of users of financial statements. Like EFRAG, we concur with the IASB that the binary classification outcome between equity and financial liability can only describe some of the features of financial instruments and, therefore, we also support the development of adequate presentation and disclosure requirements to provide the necessary complementary information. We believe that even when the Board's preferred approach does not result in significant changes in the expected classification outcomes compared to IAS 32, this approach would nevertheless improve the consistent application and enforceability of the classification of financial instruments with characteristics of equity, thanks to the clearer articulation of the classification principles.

ESMA's view is that the Board's preferred approach also adequately addresses challenges that have arisen in the course of the enforcement activity in relation to the derivative instruments on own equity held by the issuer's non-controlling interests (so called NCI puts). However, we note that the DP proposals do not address the outstanding issue of the role of shareholders' discretion in the classification outcome, for example, when a financial instrument's payoff depends on actions that are determined by the issuer's general assembly.

In addition, like EFRAG, we believe that some of the terminology used in the Board's preferred approach to describe the distinction between equity and liability would need further explanation and in our view the IASB should seek alignment with notions already included in the *Conceptual Framework for Financial Reporting* or, alternatively, provide explanations of why it departed from these notions. In this respect, ESMA has already highlighted in its 2014 comment letter on the IASB's Exposure Draft on the revised *Conceptual Framework for Financial Reporting*¹ the importance of providing the conceptual underpinning for the distinction between equity and financial liability within the IASB's Framework.

Regarding the DP proposals on separate presentation of financial liabilities, ESMA supports the Board's proposed requirements, but like EFRAG we disagree with the Board's proposal to adopt a criteria-based approach to identify the partly-independent derivative instruments which should be eligible for separate presentation. We would also recommend the IASB to consider requiring separate presentation of financial instruments (and related income and expense) which would qualify as a liability because they contain an unavoidable obligation to pay an amount independent from the entity's economic resources only upon liquidation.

With respect to the DP proposals on separate presentation of equity instruments, we welcome the IASB's efforts to improve the information provided on equity instruments. However, like EFRAG, we do not support the proposed approach to expand the attribution of the entity's total comprehensive income to all financial instruments qualifying as equity under the DP proposals, as we believe that, compared to the current requirements, it may reduce the understandability of financial statements, especially when considering that this approach would be applied for the attribution of total comprehensive income to derivative equity instruments.

Like EFRAG, ESMA is also generally supportive of the disclosure requirements as proposed in the DP and we particularly welcome the proposal to require information on the priority of claims on liquidation, potential dilution of ordinary shares and a summary of the significant terms and conditions of financial instruments.

Finally, like EFRAG, while we agree with the DP proposals not to expand the requirements on economic compulsion beyond the existing requirements in IAS 32, we are concerned that the DP does not adequately address the relationship between contractual provisions and legal requirements in setting obligations arising from financial instruments. We believe that, irrespective of whether a legal requirement is reproduced or referred to in the contractual terms, it should be taken into account as part of the classification assessment.

¹ https://www.esma.europa.eu/sites/default/files/library/2015-1733_esma_cl_-_ed_conceptual_framework_and_update_of_references.pdf



Our detailed comments on the DP are set out in the Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Steven Maijoor'. The signature is stylized and fluid, with a long horizontal stroke at the bottom.

Steven Maijoor

Appendix – ESMA’s detailed answers to the questions in the DP

Question 1

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

a. Do you agree with this description of the problems and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

b. Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

1. We agree with the description of the problems and their causes, as described in the DP. We believe that IAS 32 has generally worked well in practice, however classification, presentation and disclosure issues have arisen in practice.
2. Amongst the classification issues, we have consistently highlighted the need to provide adequate standard-setting on the treatment of financial instruments which are put options on non-controlling interest where diversity in practice has been observed for a long period of time.
3. Furthermore, in the course of the enforcement activity, we have also noted that IAS 32 is not clear as to how the classification outcomes are affected when the shareholder of the issuer has discretion to influence the payoff of an issued financial instrument. Some of these issues have been subject to IFRS IC decisions².
4. Amongst the presentation and disclosure issues, we have found that information in the notes to the financial statements on financial instruments with characteristics of equity could be improved in several areas. For example, in our experience, issuers do not always provide key characteristics of the instruments such as contractual terms which are relevant to understand the classification outcomes, the events triggering payments and, for convertible instruments, the conversion dates. We note that the lack of information is particularly pronounced for those instruments that are currently classified as equity. When it comes to presentation, even when additional line items were included in the primary statements, we note that there is no common basis as to how issuers choose these additional line items. In this respect, we agree with the IASB that users are not only affected by challenges in distinguishing liabilities from equity, but also by the lack of accompanying information about claims and the risks underlying the instruments issued³.
5. For this reason, even if from a preliminary analysis no major changes to classification outcomes would seem to arise from the DP proposals, we believe that standard setting activity would still be necessary to address these open issues.
6. Furthermore, in our view, irrespective of whether the review of IAS 32 will result in a fundamental rethinking of the distinction between a financial liability and equity, the IASB should address the issues which are currently still open when applying IAS 32, including but not limited to the areas of presentation and disclosures.

² See IFRS IC decision at the January 2010 meeting on Shareholder discretion

³ See ESMA Activity Report on Enforcement and Regulatory Activities of Accounting Enforcers https://www.esma.europa.eu/sites/default/files/library/esma32-63-424_report_on_enforcement_activities_2017.pdf

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?

7. We welcome the IASB's discussion as to how the binary classification outcomes of liability and equity may need to be complemented by presentation and disclosure requirements that enable users to make a complete assessment of the different features of the claims against an entity. We agree that it is necessary to make a distinction between information on features of claims which should be addressed primarily via classification and information which should be provided by means of improving the presentation and disclosure requirements in IAS 32.
8. With respect to the information on features of claims which should be primarily conveyed via classification, we agree with the identification of a 'timing feature' and an 'amount feature' as being relevant ones. However, we note that the Board's preferred approach draws the demarcation line between equity and liability in a way that would result in the amount feature determining a liability classification even for instruments which impose an unavoidable obligation for an amount independent of the entity's available economic resources only upon liquidation.
9. We would recommend that the implications of the Board's preferred approach especially in this latter case be carefully assessed against practical examples of instruments to understand what the information needs of users are with regards to those instruments. For example, while a liability classification may be appropriate for certain instruments, such as perpetual bonds with step-up interest, for which it may be very unlikely that the entity will defer payment of interest until liquidation, the Board's further assessment would be useful for instruments such as irredeemable cumulative preference shares for which the Board's preferred approach would change current practice where no significant issues seem to have arisen with respect to those instruments.
10. More in general, we have considered the Board's discussion of the information provided in relation to the timing and amount feature and, in our understanding, the timing feature aims at capturing the risks associated with a timed obligation prior to liquidation, while the

amount feature of a claim relates to the assessment of the economic sustainability of the obligations assumed by an issuer, independently from the point in time at which the claims are due. We consider that providing information on these characteristics is potentially relevant for all claims and not only for financial instruments, however we note that the definition of liability proposed in the DP would differ from existing definitions of a liability in IFRS, for example in the *Conceptual Framework for Financial Reporting* and in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Therefore, it would be useful that the IASB considers more broadly how the Board's preferred approach could lay the conceptual foundations for the definition of a liability also elsewhere in IFRS, starting from the *Conceptual Framework for Financial Reporting*.

11. We would also recommend that in relation to the definition of the timing feature, the IASB consider how the notion of liquidation should be interpreted in the context of resolution regimes (e.g. as laid down in accordance with Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms in the EU⁴). At this stage, having no information on the potential impact of an expansion of the notion of liquidation, our view is that the notion of liquidation should remain limited and not expanded to the notion of resolution for instance.
12. Furthermore, in relation to the amount feature, ESMA would suggest that in explaining the notion of the 'amount independent of the entity's available economic resources' the reference to both recognised and unrecognised assets and claims of the entity is further clarified. When reading the DP, it is not clear what the unrecognised assets and claims are supposed to be, we would recommend to clarify how the notion of 'available economic resources' is consistent with the notion of economic resources in in paragraph 4.2 of the *Conceptual Framework for Financial Reporting*.
13. For example, it is not entirely clear why the notion of 'available economic resources' in the DP – where it seems to refer to an entity's (recognised and unrecognised) net assets – should differ from the notion in the *Conceptual Framework for Financial Reporting* which refers to total assets gross of claims. It would also be helpful to clarify what value notion should be considered for assessing the available economic resources, for example whether a book value instead of the current value measurement should be referred to.
14. In addition, it would also be important to clarify how par. 3.18b of the DP would apply to a financial instrument with a cap when, for example, the amount of the obligation changes as a result of changes in the entity's available resources, but does so in a way that the amount may exceed the available economic resources of the entity up to a certain threshold.
15. Finally, while it is understandable that there will be new terminology introduced as a result of reinforcing the conceptual foundations of the distinction between equity and financial

⁴ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance

liability, we believe that the IASB should build as much as possible on the notions already existing in IAS 32 to avoid unnecessary complexity.

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?

16. On the basis of a preliminary analysis of the classification outcomes resulting from the application of the DP proposals to real-life examples of financial instruments addressed in the course of enforcement activities, we believe that overall the DP will lead to more robust basis for classification than under IAS 32, even if the classification outcomes would not change for most instruments compared to the current situation. In this respect, we believe that the DP proposals can improve enforceability of the classification requirements and contribute to certainty for preparers.
17. In terms of the relevance of the information provided by the application of the Board's preferred approach, as already mentioned in response to Question 2, we believe that the amount and timing features highlight important aspects of the financial instruments being classified.
18. However, while we are supportive of the Board's preferred approach, with respect to the amount feature we note that upon liquidation, in case of insufficiency of resources of the entity, the ultimate cost for an issuer of its obligations would depend on the respective priority in the waterfall of the different claims. This is particularly relevant for obligations which would be triggered only at liquidation and which would qualify as liabilities under the Board's preferred approach as they may be very similar to equity instruments. Therefore, we suggest the IASB to further explore the presentation of a distinct line item for such instruments.

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?

19. We support the retention of the exception as we concur with the IASB that the reasons underlying this exception would still remain under the Board's preferred approach.

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?

20. We support the IASB's initiative to address the practical issues relating to derivatives on own equity. ESMA has already highlighted to the IASB⁵ the need to provide clarity on existing issues relating to the application of IAS 32 in this area. We believe that, even if the Board were not to proceed with the comprehensive review of the conceptual foundations of the classification criteria in IAS 32, it would still be necessary that the IASB makes targeted improvements to the standard to address the application issues in relation to derivatives on own equity.
21. We welcome the IASB's proposal to continue classifying derivatives in their entirety as a single unit of account, as this strikes the right balance between avoiding excessive complexity while still providing relevant information on the substance of the instrument.
22. As a consequence of this approach, we agree with the Board's preliminary view that partly independent derivatives would be classified as financial assets or financial liabilities as an equity classification would give rise to an inconsistency with the treatment of non-derivative contracts that include only claims that are independent of the entity's economic resources. Furthermore, we agree with the IASB that the presentation proposals could mitigate the impact of value changes in the partly independent derivatives arising from dependent variables.
23. Finally, in relation to the elimination of the exception for foreign currency rights issues in IAS 32, while we understand that the result of mechanically applying the Board's preferred

⁵ See ESMA's latest response to the IFRS IC tentative agenda decision on IAS 32: Accounting for a written put option over non-controlling interests to be settled by a variable number of the parent's shares available at: https://www.esma.europa.eu/sites/default/files/library/2016-1161_comment_letter_to_the_ifrs_ic_tad_on_ias_32.pdf

approach would be to consider these issues as liabilities, we are not convinced that replacing the classification exception currently in IAS 32 with a separate presentation as proposed in the DP would improve financial reporting. In fact, the separate presentation seems to be conceived in the DP to avoid the counterintuitive effects arising from presenting in P&L all value changes of partly independent derivative including those arising from the partly dependent component of these derivatives. However applying the presentation exception in relation to the foreign rights issues would essentially result in applying the separate presentation to account for changes in the partly independent component of the derivative, i.e. the foreign currency component. We believe that this approach would not be necessarily conceptually sounder than the existing classification exception in IAS 32 and, therefore, we suggest to retain the classification exception therein for foreign rights issues.

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?

24. We generally agree with the proposals in the DP in relation to derivative instruments that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares. We note that the consequence of applying the DP proposals to derivatives, such as written put options on non-controlling interests will be the application of IFRS 9 for these derivatives. While this may represent a change under certain accounting treatments, ESMA supports this proposal.

25. We believe that the DP provides much needed clarity, especially in relation to the accounting within equity, for written put options on non-controlling interests. ESMA and European enforcers have encountered several enforcement cases (for example see decision EECS/0214-036) in which diversity in practice has arisen in relation to these

⁶ Recognition of a liability payable to equity holders, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-esma-1373_-_16_extract_eecs_database_published.pdf

issues. We also agree that the substance of a written put option on own equity instruments and a convertible bond is economically the same.

26. In relation to the alternative settlement outcomes, we consider that it would be important to have adequate guidance as to how the classification outcomes are affected when the holder of a financial instrument is also the majority shareholder of the issuer and, as such, it has the ability to influence the instrument's payoff. This clarification would be relevant to identify whether the instrument effectively gives rise to an unavoidable contractual obligation or whether it has alternative settlement outcomes which are deemed to be controlled by the issuer.
27. In relation to financial instruments with alternative settlement outcomes which are controlled by the issuer, we preliminarily believe that the challenges described in the DP in relation to the separation of the embedded derivative from the host equity instrument may not result in information that is easily understandable by users of financial statements. We particularly refer to the example in paragraph 5.46b of the DP in relation to the gross-up effect of assets and equity which may provide misleading information when a share conversion option is deep out of the money. We therefore would suggest to deal with this issue via disclosure.
28. Finally, for financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer), we highlight that, according to the DP, if the financial instruments have alternative settlement outcomes and give the entity an unconditional right to choose the settlement outcome so the issuer may have the unconditional right to avoid the liability settlement and therefore the entity would classify the financial instrument as a whole as an equity instrument. We note that this approach may differ from the definition in paragraph 4.34 of the Conceptual Framework which refers to the practical ability to avoid transferring an economic resource. It would be important that the IASB provide adequate basis to explain why it has departed from the notion of practical ability.

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?

29. We generally agree with the Board's proposal to require a separate presentation in the statement of financial position and the statement of financial performance. Particularly, the introduction of specific presentation requirements for subclasses of liabilities that have only one of the two liability features as, this could enable users to better assess the different nuances in the liability assessment, thus enabling a more accurate assessment of balance sheet solvency. However, we believe that disclosure requirements should build

as much as possible on the existing requirements in IFRS 7 Financial Instruments: Disclosures.

30. With respect to the separate presentation proposals for the statement of financial performance, we are concerned by the Board's proposals to apply the separate presentation requirements using the criteria-based approach. While we understand the implementation challenges described in the DP in relation to the disaggregation approach and the fact that this approach may require further work for users to have a holistic view of the impact of value changes on the concerned assets and liabilities, we believe that a disaggregation approach would better reflect the substance of the different features of the recognised assets and liabilities. Additional disclosures could be provided for users to understand the total amount of value changes attributable to each category of instruments which have been subject to disaggregation and separate presentation in the primary statements. We also consider that if the disaggregation approach is deemed to be too complex, it should be noted that the criteria-based approach, especially for hybrid instruments, may result in an incentive to structuring instruments with the objective of presenting the impact of income and expense arising from independent variables in OCI while, in our view, the effect of independent variables should always be reflected in P&L.
31. In relation to the alternative approaches proposed for the separate presentation of hybrid instruments, we are not convinced that the separate presentation suggested for embedded derivatives for which the preparers decided to apply the fair value through profit or loss measurement (i.e. with no separation from the host instrument) would provide relevant information to users. While we consider that, in principle, separate presentation for not-closely related embedded derivatives that are part of hybrid instruments in all circumstances could provide relevant information for investors, we are nevertheless concerned that this proposal could de facto neutralise the simplification allowed for the accounting of hybrid instruments under IFRS 9. We would therefore support Alternative A, i.e. require separate presentation only for embedded derivatives that are separated from the host contract.
32. Regarding the separate presentation for embedded foreign currency derivatives, ESMA does not support this proposal as discussed in response to Question 5.
33. Finally, we would support the use of OCI to apply the separate presentation requirements, if the disaggregation approach is also applied. In this respect, we also agree with the Board's preliminary view that when OCI is used for separate presentation, no recycling to P&L would be allowed.

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?

34. We welcome the IASB's efforts to try improving the presentation requirements for different classes of equity and the relevance of the statement of changes in equity, however we are not convinced by the proposals relating to the attribution of total comprehensive income to all equity instruments due to the risk that it may result in increased complexity for users of financial statements.
35. While we would agree in principle with the analogy in paragraph 6.63 the DP that the attribution of comprehensive income to equity instruments other than ordinary shares and subsequent update is similar to the separate presentation of non-controlling interests, we are concerned that the extensive application of attribution of total comprehensive income to instruments that do not yet give a right on a return linked with total comprehensive income, such as warrants, may ultimately reduce understandability of the financial statements.
36. If following the assessment of the balance between benefits and costs particularly for users of financial statements, the IASB would conclude that an approach that attributes total comprehensive income to equity instruments other than ordinary shares will provide more relevant information, we note that guidance would be needed to select relevant subclasses of equity in a way that is conducive to comparability.
37. Finally, while we believe that in light of implementation challenges relating to the application of the earnings per share requirements in IAS 33 it would be useful to consider how these requirements could be improved, in principle we agree that the existing calculation for basic earnings per share in IAS 33 represents a useful starting point in case the IASB decides to take forward the proposals to set a methodology to attribute total income to non-derivative equity instruments other than ordinary shares. However, at this stage, it would seem to us that IAS 33 would need to be reviewed and further developed to cater for the attribution of total comprehensive income to all the different types of instruments which would qualify as equity under the DP proposals.

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?

38. Based on our experience and as indicated already in response to Question 1, disclosures on financial instruments classified in accordance with IAS 32 need to be further improved. We therefore welcome the proposed disclosure requirements in the DP.
39. In our view, the information on the priority of claims at liquidation is useful and we encourage the IASB to continue to developing the proposals to improve disclosures on priority of claims on liquidation both on separate and, if practicable, consolidated financial statements and any interactions between these two. One aspect for further consideration in this area is to clarify how the disclosures of priority of claims on liquidation should be prepared and presented in the context of going concern. As we already indicated in response to Question 2, it would be helpful that the IASB defines what circumstances qualify as liquidation for the equity and liability classification. Then, consistently with this definition, an issuer should briefly describe under which entity-specific circumstances liquidation would be triggered. This may help clarifying to users of financial statements what are the events which would qualify as liquidation and how far an issuer is from these events even if the financial statements are prepared under a going concern assumption.
40. We also concur with the IASB's observation that disclosures regarding equity instruments can be improved and therefore we particularly support developments in this area as this would also take partially the pressure off from the binary distinction between equity and liability. In principle, we are of the view that starting point for disclosure should be the same whether the instrument is classified as a financial liability or as equity.
41. Finally, regarding disclosures on contractual terms and conditions, we believe that it would be important to highlight the key judgemental areas leading to the equity liability distinction. While we agree with the DP proposals in paragraphs 7.26- 7.28, we believe that the IASB should highlight the need to provide disclosures on areas where judgment is requirement with respect to the mechanism and the party (whether the issuer or the holder) which has the power to determine the alternative settlement outcomes and the key terms based on which the entity established that it has an unavoidable obligation that independent from the available entity's economic resources.

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?

42. We generally support the IASB's approach to retain the current approach in IAS 32 in relation to economic incentives or compulsion. We agree that IAS 32 has worked well in practice in relation to the application of paragraph 20 of IAS 32 according to which a

financial instrument may establish an obligation indirectly through its terms and conditions. Nevertheless, as highlighted during some IFRS IC discussions, not taking into account the economic compulsion may lead to counterintuitive results for the users in some cases (i.e. the instrument is presented as equity even if it economically rational to expect that it will be settled as liability).

43. We believe that expanding the scope of this project to broader considerations on the role of economic incentives would result in a classification model that is far more complex and judgemental and would be also contrary to the IASB's approach to build conceptual foundations for the classification outcomes without resulting in fundamental changes to areas where IAS 32 has worked well. Nevertheless, we encourage the Board to carry on working on this aspect for instance by assessing the impact of aligning paragraph 25 and 20 of IAS 32 so as to deal with some economic compulsion aspects and/or working on a distinct presentation of instruments with an economic compulsion characteristic.
44. We agree with the Board's assessment in the DP that classifying a financial instrument based on economic incentives may represent the likely outcome, it would not provide information about whether the entity has an unavoidable contractual obligation with the features of a financial liability. However, as already indicated in response to Question 6, this notion should be reconciled with paragraph 4.34 of the Conceptual Framework which refers to the practical ability to avoid transferring an economic resource.
45. Finally, we believe that it would be important to have additional disclosures explaining the circumstances under which economic incentives may affect the classification outcomes and have ultimately an impact on an issuer's funding of liquidity, solvency and performance.

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?

46. We note that in several jurisdictions the contractual terms incorporate either directly or indirectly the provisions of applicable laws and regulations. Therefore, we consider that it would be important that the classification outcomes reflect consistently contractual terms that explicitly repeat legal requirements and contractual terms that make indirectly reference to the same requirements.
47. In our view, consistency in this area is necessary to avoid arbitrage and structuring opportunities as well as to properly reflect the substance of financial instruments. In this respect, we consider that it would be important to incorporate the guidance on contractual terms already existing in IFRIC 2 into any revision of IAS 32. IFRIC 2 working well, it should be incorporated but not modified.
48. We encourage also the IASB to consider the practical implications of applying the Board's preferred approach to certain financial instruments, such as the so called bail-in

instruments, without taking into account the powers conferred by law to public authorities on these instruments in specific circumstances. In our view, if classification outcomes would change depending on whether these powers provided by law are taken into account or not, the IASB should consider on a comparative basis the relevance of the information provided – with and without consideration of these powers – and make an assessment as to whether the resulting information is in line with the users' needs with respect to analysing liquidity, solvency and performance of the concerned issuer.