FEEDBACK RECEIVED BY THE IASB

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

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EFRAG
European Financial Reporting Advisory Group

Section 1: Objective, scope and challenges

IASB Discussion Paper

In section 1 of the DP, the IASB describes the objective of the project, its scope and the application challenges that arise with IAS 32. Subsequently, the IASB seeks views on whether these challenges are pervasive enough to require standard-setting activity.

EFRAG position

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

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

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

Feedback received by the IASB

Almost all respondents agreed with the challenges identified by the IASB. Many respondents, including EFRAG, also highlighted a number of other challenges that should be addressed by the IASB (e.g. if the payment of cash is at the ultimate discretion of the issuer's shareholders and whether an entity is required to reassess the classification of a financial instrument after initial recognition especially when its contractual terms are unchanged

Almost all respondents supported the IASB developing a standard-level solution to address the challenges identified. However, respondents suggested a wide range of different directions for the project:

- many respondents suggested making targeted improvements to IAS 32 by amending, clarifying or adding guidance to IAS 32;
- some respondents suggested undertaking a fundamental review to develop an approach to distinguishing liabilities from equity;
- some respondents supported the IASB pursuing a principles-based solution. Some of these respondents suggested proceeding with the IASB's preferred approach to classification subject to clarification of the new terminology used or a closer alignment of terminology and/or the classification outcomes with IAS 32. Some other respondents suggested more significant modifications to the IASB's preferred approach to classification; and
- a few respondents suggested a disclosure-only approach.

Section 2: The IASB's preferred approach

IASB Discussion Paper

In section 2 of the DP, the IASB discusses its preferred approach to the classification of financial instruments based on its analysis of various features of claims, including the proposed 'timing' and 'amount' features.

The IASB's preferred approach to classification, described in the DP, would classify a claim as a liability if it contains:

- an unavoidable obligation to transfer economic resources at a specified time other than at liquidation (the timing feature); and/or
- an unavoidable obligation for an amount independent of the entity's available economic resources (the amount feature).

The DP also proposed that information about other features of claims, such as priority of claims, should be provided through presentation and disclosure.

EFRAG position

EFRAG appreciated the IASB's efforts to improve IAS 32's requirements on classification of financial instruments. However, EFRAG was concerned that the IASB's preferred approach introduced completely new terminology, used an amount feature on liquidation for classification purposes and was likely to result in considerable implementation costs for preparers and disruption in the market due to reclassification changes, particularly for entities with complex financing and capital structures such as financial institutions. Accordingly, EFRAG did not support the IASB's preferred approach.

EFRAG suggested the IASB to focus on targeted improvements to IAS 32 and other standards, particularly on improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions. EFRAG noted that the DP already identified some practical solutions to the issues that arise in practice with IAS 32 which could be a good basis for further discussions.

EFRAG acknowledged that some constituents were calling for a more conceptual to distinguishing debt from equity. However, EFRAG did not identify any consensus among those constituents on how to achieve this. Thus, developing a more conceptual approach was going to be very challenging and controversial. Accordingly, EFRAG suggested that the IASB reconsiders whether to continue a comprehensive FICE project

Feedback received by the IASB

Most respondents supported the IASB's decision to continue the binary distinction between liabilities and equity and define equity as the residual interest. While acknowledging that some financial instruments indeed contain features of both equity and a liability, most respondents including users of financial statements, expressed the view that other approaches such as introducing a 'mezzanine' class of financial instruments would give rise to increased complexity and reduced understandability for users of financial statements.

Most respondents agreed with the IASB that both the timing of the required transfer of economic resources and the amount of the obligation are the relevant features of financial instruments for the purpose of distinguishing financial liabilities from equity.

However, most respondents were not supportive of the amount feature assessment as described in the IASB's preferred approach, in particular, how it applies to obligations for an amount payable only on liquidation. These respondents highlighted that such an application is inconsistent with the going concern assumption, is different from the existing classification requirements in IAS 32 and questioned the usefulness of the information provided by such an approach.

Respondents also highlighted a number of challenges associated with the new terminology used to articulate the amount feature such as 'independent amount' and 'available economic resources' and that the concept of 'unavoidable obligation' is inconsistent with 'practical ability to avoid' in the Conceptual Framework. Many respondents, primarily from the banking sector, also questioned how to interpret the term 'liquidation' as included in the timing feature. Some respondents acknowledged the inherent difficulty in defining 'residual interest'.

Most respondents agreed with the proposal in the DP that information about other features of claims, such as priority of claims, should be provided through presentation and disclosure.

Section 3: Classification of non-derivative financial instruments

IASB Discussion Paper

In this section the IASB explains how the IASB's preferred approach for classifying financial instruments applies to non-derivative instruments.

The DP proposes that a non-derivative financial instrument should be classified as a financial liability if it contains:

- an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (the timing feature); and/or
- an unavoidable contractual obligation for an amount independent of the entity's available economic resources (the amount feature).

EFRAG final position

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

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

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

Feedback received by the IASB

Almost all respondents agreed with the timing feature of the IASB's preferred approach. Further, most respondents agreed that both the timing of the required transfer of economic resources and the amount of the obligation are the relevant to distinguishing financial liabilities from equity. However, most respondents were not supportive of the amount feature assessment as described in the IASB's preferred approach.

Many respondents highlighted that applying the amount feature of the IASB's preferred approach lead to classification changes from equity to financial liabilities for particular types of non-derivative financial instruments. Notably, for financial instruments that contain an obligation for an amount independent of the entity's available economic resources that arises only at liquidation or that can be deferred at the issuer's discretion until liquidation - a feature common in many financial instruments issued by banks and perpetual bonds issued by corporates.

Many respondents including investors and issuers of such instruments expressed concerns that these classification changes may lead to market disruption - some disagreed with the liability classification while others did not welcome any change in classification of financial instruments that in their view are well understood.

Some also highlighted application challenges that would arise from classifying these instruments (wholly or partly) as a financial liability.

Most of the respondents to Question 4 in the DP agreed with retaining the puttable exception. However, some respondents disagreed with the proposal and suggested some alternative approaches that would overcome the need for the puttable exception.

Some of the respondents that agreed with retaining the puttable exception highlighted application issues arising in practice and recommended the IASB to address these application challenges. For example, relating to identifying the most subordinated instrument or determining whether puttable instruments have identical features.

A few respondents that disagreed with retaining the puttable exception suggested the IASB undertake further work to establish the extent to which the puttable exception is used in practice, identify the application challenges and whether potential improvements to paragraphs 16A-16D of IAS 32 could be identified before deciding whether to retain the exception.

Sections 4 and 5: Classification of derivative financial instruments

IASB Discussion Paper

In sections 4 and 5 of the DP the IASB explains how its preferred approach should be applied to derivatives on own equity, including those instruments that have a redemption obligation, and compound instruments. Under the IASB's preferred approach, a derivative on own equity would be classified in its entirety and would be classified as a financial asset or a financial liability if:

- it is net-cash settled; and
- the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources

For a derivative that results in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, an entity would recognise a financial liability for the present value of the unavoidable redemption obligation (the same as for a convertible bond).

For financial instruments with alternative settlement outcomes in which the entity controls the settlement outcomes in the absence of an unavoidable obligation that has the features of a financial liability, an entity would classify the entire instrument as an equity instrument.

EFRAG final position

EFRAG was concerned that the IASB's preferred approach differed significantly from current guidance, particularly in terms of terminology, which would introduce new uncertainties. In addition, EFRAG noted that the proposed classification changes were not related to areas of IAS 32 that are problematic and was concerned about the potential impact that these changes would bring to the market.

Nonetheless, EFRAG decided to highlight that the DP identified some potential solutions to the issues that arise in practice with derivatives on own equity. EFRAG considered that this could be a good basis for further consideration of targeted improvements to IAS 32 (e.g. incorporating some of the detailed guidance on the difficulties related to the fixed-for-fixed requirement).

EFRAG was also not convinced that the accounting within equity for a written put option should be the same as for a convertible bond and considered that the IASB should better explain its reasoning.

For financial instruments contingent on an uncertain event, EFRAG highlighted that, due to the complexity of the IASB's preferred approach (particularly the amount feature), 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.

Finally, for financial instruments with alternative settlement outcomes that are controlled by the entity, EFRAG considered 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 considered that improvements to the requirements for indirect obligations as described in section 8 could also improve the classification in specific cases.

Feedback received by the IASB

Most respondents agreed with the challenges identified by the IASB, noting that a vast majority of practice challenges with IAS 32 relate to classification of derivatives on own equity, particularly the application of the fixed for-fixed condition in IAS 32.

Classification of derivative financial instruments

Most respondents supported the IASB's proposal for a derivative on own equity to be classified in its entirety

Many also agreed that derivatives on own equity should be classified as equity instruments, financial assets or financial liabilities (rather than all as financial assets or financial liabilities). However, few respondents expressed the view that derivative instruments should not be classified as equity because they thought that the future delivery or receipt of own equity should not be considered as part of an entity's equity prior to the actual delivery or receipt of the equity instruments.

Many respondents were not supportive of the IASB’s preferred approach to classification of derivatives on own equity, in particular due to the concerns arising from the application of the amount feature. However, some of these respondents considered that several existing application challenges with the fixed-for-fixed condition in IAS 32 would be addressed if the IASB further developed some of the proposals described in the DP.

Compound instruments and redemption obligation arrangements

Generally, respondents acknowledged diversity in the current accounting practice and welcomed the IASB efforts to address the accounting for compound instruments and in particular written put options on non-controlling interests (NCI puts) and the IASB attempts to minimise divergence in practice.

However, a few respondents noted that the preferred approach for compound instruments and redemption obligation arrangements seems to be overly complex i.e. more complex than the current requirements in IAS 32 which are relatively easy to understand and have in their view served their purpose effectively.

Most respondents to Question 6 of the DP focused on the requirements proposed for redemption obligation arrangements and in particular, NCI puts, rather than discussing proposals for compound instruments in general.

Respondents expressed mixed views on the proposed accounting for redemption obligation arrangements (including NCI puts). This was largely based on whether or not respondents believed own shares and a written put option on own shares were fundamentally and economically different from a convertible bond.

Most respondents expressed concerns about proposed derecognition of own shares, particularly when they represent NCI, and the potential impacts on the consolidated financial statements regardless of whether they broadly agreed or disagreed with the IASB’s preliminary views.

In this regard, many respondents highlighted or raised questions on the impact of the DP’s proposals on other IFRS Standards such as IFRS 10, IFRS 3 and IAS 33.

Financial instruments with alternative settlement outcomes

In their response to the questions related to financial instruments with alternative settlement outcomes controlled by the entity, many respondents agreed with some parts of the proposals in the DP while they disagreed with other parts.

Most respondents to these questions agreed that the IASB should address the issue and most of them were in favour of the IASB addressing the issue through additional disclosures. Some respondents suggested alternative approaches to classifying these instruments that would take into consideration the impact of economic compulsion and indirect obligations.

Section 6: Presentation of liabilities

IASB Discussion Paper

In section 6 of the DP, the IASB discusses potential improvements to presentation of financial instruments to address the existing limitations of a binary approach. In particular, this section discusses whether entities with financial liabilities with equity-like returns should separately present their carrying amounts in the statement of financial position; and present income and expenses arising from those instruments in OCI in the statement of financial performance, without subsequent reclassification.

EFRAG position

EFRAG considered that expanding the use of OCI may not be the most appropriate way to address the concerns related to counter-intuitive accounting. Instead, EFRAG decided to recommend the IASB to consider providing such information within disclosures. More specifically, EFRAG recommended providing disclosures on liabilities, derivatives and embedded derivatives that are solely dependent on an entity's available economic resources. The disclosures should only apply to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, solely depend on the entity's available economic resources.

EFRAG also noted that if the IASB did pursue the OCI approach, EFRAG considered that its scope needs further development and the question of recycling should be considered further.

Feedback received by the IASB

With regards to the specific proposals in the DP to provide further information on the amount feature through separate presentation of some financial liabilities, there were mixed views from respondents

Many of the respondents that commented on the question about presentation **in the statement of financial position** disagreed with the IASB's proposal to present separately the carrying amounts of liabilities with equity-like returns as it would increase complexity and reduce understandability of financial statements. Nonetheless, some respondents supported the IASB proposals for the statement of financial position as it provided useful information and alleviated some of the concerns with the liability classification of these instruments.

Many respondents that commented on the presentation in the **statement of financial performance** disagreed with presenting income and expenses arising from liabilities with equity-like returns in OCI without subsequent reclassification. Those that disagreed can be categorized as follows:

- oppose to non-recycling of OCI;
- concerns expressed on the proposals related to partly independent derivatives. Mainly, they suggested that:
    - the proposals should only apply to liabilities that are solely dependent on the entity's available economic resources;
    - there is a concern with the criterion related to denomination in foreign currency imposed by an external factor;
    - a disaggregation approach is better
- preferred either:
    - separate presentation in profit or loss; or
    - disclosures in the notes to the financial statements

Nonetheless, some respondents agreed with the IASB's proposals for the statement of financial performance as it would allow a better depiction in profit or loss of the return the entity expected and avoided counter-intuitive accounting.

Regarding the proposal to require the separation of embedded derivatives from hybrid instruments measured at fair value through profit or loss, most respondents considered that separate presentation requirements should apply only to embedded derivatives that are separated from the host and hybrid instruments that do not contain any obligation for an amount independent of the entity's available economic resources. They considered that applying the separate presentation requirements to all embedded derivatives was too complex and costly.

Section 6: Presentation of equity instruments

IASB Discussion Paper

In this section of the DP, the IASB discusses potential improvements to presentation of financial instruments to address the existing limitations of a binary approach. In particular, this section discusses the creation of subclasses of equity and the attribution of comprehensive income to those subclasses.

- For non-derivatives, the attribution should follow the calculation for basic earnings per share in IAS 33 *Earnings per Share*.
- For derivative equity instruments, three approaches to attribution are considered in the DP and the IASB did not reach a preliminary view on which method is preferred

EFRAG position

EFRAG acknowledged that the attribution approach had some benefits, such as providing information about distribution of returns among the different types of classes of equity and reflecting similar information as the ‘narrow equity’ approach.

However, EFRAG considered 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) were likely to exceed the related benefits.

Instead, EFRAG recommended 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 recommended 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.

Feedback received by the IASB

Many respondents agreed with the IASB that it would be useful for investors to have information about the distribution of returns among the different types of equity instruments and supported the objective of the presentation proposals for equity instruments.

However, most respondents were not supportive of any of the attribution approaches for derivative equity instruments proposed in the DP because they believed the benefits of the resulting information would not outweigh the cost of preparation (e.g. all proposed attribution methods require determining the fair value of derivative equity instruments and estimating the fair value of their own equity instruments could be costly and subject to significant judgement, particularly for non-listed entities).

There were also questions on the usefulness of information resulting from attribution of current period income and expenses to those who are not yet shareholders of the entity.

Many respondents suggested that rather than developing an attribution approach for derivative equity instruments, the IASB pursue a disclosure solution instead.

In their view, the disclosures proposed in the DP along with the information already required by IAS 33 *Earnings per Shares* would be sufficient in meeting the IASB’s objective of providing useful information about equity instruments. However, some respondents also suggested that IAS 33 requirements could be improved and encouraged the IASB to do some further work in this regard.

On the presentation of financial position, a few respondents said that it could be improved by presenting equity instruments using sub-classes, for example, distinguishing existing shareholders from potential shareholders or other equity holders.

Section 7: Disclosures

IASB Discussion Paper

In section 7 of the DP, the IASB explores possible improvements to disclosure requirements for priority of claims on liquidation, potential dilution of ordinary shares and terms and conditions of financial instruments.

EFRAG position

EFRAG considered that disclosures were a key part of the project and welcomed the IASB's discussions. EFRAG acknowledged that the proposed disclosures, as a whole, would represent a significant extension of disclosures on financial instruments on own equity.

However, the disclosures 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 noted 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 recommended the IASB to further consider the scope of such disclosures. Finally, EFRAG provided a number of suggestions to improve current disclosures without creating disclosure overload.

Feedback received by the IASB

Most respondents were supportive of the disclosure proposals set out in the DP. A few respondents further said that the IASB should proceed with improving disclosures even if the IASB decided not to proceed with the classification and presentation proposals in the DP.

However, many respondents including those who are supportive of the proposed disclosures have highlighted a number of challenges that would arise when providing the disclosure, most of which relate to providing such information on a consolidated basis. For example, respondents feared that the disclosure of priority on a consolidated level would misrepresent the assets available to settle the financial instruments and suggested requiring disclosure of priority on liquidation on an individual entity basis only. Some also highlighted differences in scope compared to IAS 33 and the risk of disclosure overload, especially for entities with complex capital structures.

By contrast, a few respondents did not support some of the proposed disclosures mainly for one of the following reasons:

- any resulting disclosure will be of limited value.
- concerns about the scope of the potential dilution disclosures as such disclosures will be onerous for non-listed entities that do not apply IAS 33 currently; and
- concerns over disclosure overload.

Section 8: Contractual terms

IASB Discussion Paper

In section 8 of the DP, the IASB discusses whether economic incentives and effects of law should affect the classification of financial instruments.

In the DP, the IASB proposes that the effects of law and 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. In addition, the IASB considered that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained.

EFRAG final position

EFRAG agreed that economic incentives that might influence the issuer's decision to exercise its rights should not be considered for classification purposes. This is because EFRAG considered that considering economic incentives for classification purposes may raise more questions than answers.

EFRAG also considered that improving the requirements for indirect obligations in paragraph 20(b) of IAS 32 may alleviate some of the issues related to economic compulsion.

EFRAG supported focusing on the substance of the contractual arrangement in a financial instrument. However, EFRAG highlighted some of the challenges that arise in practice from the interaction between the contractual rights and obligations and EU regulation (e.g. bail-in instruments).

Finally, EFRAG reinforced its view that IFRIC 2 should continue to be applied by the entities for which it was originally designed. EFRAG also suggested that the IASB considers integrating IFRIC 2 into IAS 32.

Feedback received by the IASB

Most respondents acknowledged that this is a difficult issue to solve and that there are merits in both sides of the argument, ie for and against taking into account economic incentives in classifying financial instruments as financial liabilities or equity.

Most respondents agreed with the IASB's preliminary view 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 an equity instrument. These respondents noted that considering economic incentives would complicate the classification of financial instruments and would raise several challenges (e.g. significant judgment, how far the consideration of economic incentives should be considered, etc).

Most respondents agreed with the IASB's preliminary view that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained as the requirements helped in reducing structuring opportunities.

Most respondents agreed with the IASB's preliminary view 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 (i.e. ignore the effects of law). Some noted that reflecting the effects of laws and regulations in classification would require significant effort in analysing and continuously monitoring the effect of laws and changes thereof in classifying financial instruments.

In addition, many respondents highlighted practice challenges that exist in these areas and recommended the IASB analyse the challenges further and provide clarification or guidance. Regardless of whether respondents agreed or disagreed with the IASB preliminary views, they requested clarification or additional guidance on these areas.

Almost all the respondents that commented on the classification of IFRIC 2 instruments strongly supported the requirements in IFRIC 2 being carried forward. They considered that co-operative shares that meet the IFRIC 2 conditions and represent the most subordinated claim should be classified as equity under any classification approach. In addition, some respondents were concerned that the IASB's proposals with respect to the amount feature would affect the equity classification outcome of IFRIC 2 instruments.