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Financial Instruments with Characteristics of Equity

Cover Note

Introduction and objective

1 The objective of the session is to discuss and approve a final comment letter on the Exposure Draft *Financial Instruments with Characteristics of Equity*, issued by the IASB in November 2023.

Overview of outreach activities

2 Refer to the overview of outreach activities in agenda paper 02-04.

Overview of comment letters received

3 Refer to the executive summary of the comment letters received in agenda paper 02-04. At the time of writing, 18 comment letters have been received.

Key changes to EFRAG's Comment Letter

IASB questions	Significant changes made to EFRAG's comment letter compared to EFRAG's draft comment letter
Cover letter	• Suggest separating the topics on the effects of relevant laws and regulations and written put options on non-controlling interest from the remaining topics in the ED and deal with them in a separate project. • The below changes were reflected in the cover letter also
Question 1 - The effects of relevant laws or regulations	• General change of EFRAG's initial position • EFRAG disagrees with the IASB proposals on the effects of relevant laws and regulations and considers that there is a need for a more comprehensive discussion and outreach activities with constituents. This topic is complex and difficult to be addressed within the remits of the current narrow scope amendment project. • EFRAG calls for the IASB to reconsider its proposals on the effects of relevant laws and regulations, as the IASB´s clarifications that are proposed in the ED are likely to raise application challenges and uncertainty, lead to a significant change in existing practice, and introduce the risk of unintended consequences and new diversity in practice, particularly for instruments for which some or all key parameters are regulated by law or regulation

IASB questions	Significant changes made to EFRAG's comment letter compared to EFRAG's draft comment letter
	• Express significant concerns on the IASB proposals on their current status as it seems to solve limited issues but risks of raising many new others and unintended consequences • In particular, instruments for which some or all key parameters derive from law and regulation and some cooperative banks' products
Question 2 - Classification: Settlement in an entity's own equity instruments (including fixed-for-fixed condition in IAS 32)	• No significant changes to the initial position • Suggested that the IASB should provide additional examples and guidance on preservation adjustments and passage-of-time adjustments to help with implementation. • Propose additional guidance regarding which functional currency should the reference point be in determining whether a derivative is denominated in a foreign currency
Question 3 – Obligation to purchase an entity's own equity instruments	• Added a paragraph explaining that the issues are too broad and complex for the current narrow-scope project (therefore, the proposal to separate the issue into a separate project, as proposed in the cover letter) • Added a further argument against the treatment at initial recognition proposed by the IASB (reference to paragraphs BC11, BC68 and AG29 of the existing IAS 32) • Correction of the initial EFRAG position to explore the net presentation - deleted in the cover letter on the basis that no feedback supported it and considering emphasis that this change would be too fundamental for this narrow scope-project • Following a recommendation from EFRAG FR TEG, added a paragraph suggesting that the IASB considers an approach where subsequent remeasurement would be treated via OCI, similarly to the treatment of the own credit risk component of financial liabilities measured at fair value through profit or loss

Question 4 - Contingent settlement provisions	• EFRAG acknowledges that there are mixed views among our stakeholders on the relevance of the IASB´s proposals. Thus, EFRAG suggests that the IASB discuss measurement issues of financial liabilities under the scope of IAS 32 (i.e. do not exclude from the scope of the project issues relating to the measurement of financial liabilities, as mentioned in paragraph BC82 of the Basis for Conclusions).
	• More specifically, EFRAG suggests that the IASB discusses further measurement issues of financial liabilities with contingent settlement provisions under the scope of IAS 32 including the issue of:
	    o whether the liability should be measured at a full amount of the conditional obligation or at a probability weighted amount, and
	    o the accounting treatment of the difference between the full obligation amount (that can be higher than the consideration received due to, for example, the fact that the obligation measurement ignores any probability or due to the existence of a cap) and the consideration received when the entity issued the instrument (which could lead to a negative equity component in order to comply with the requirements of IAS 32 that the sum of

IASB questions	Significant changes made to EFRAG's comment letter compared to EFRAG's draft comment letter
	all components of the instruments must equal the fair value of the whole instrument or a loss on initial recognition) • Also indicated that if the IASB proceeds with the measurement proposals, it puts pressure on the definition of "present value of the redemption amount" and that the IASB would have to provide more guidance in this area, including interaction with IFRS 9 and IFRS 13
Question 5 - Shareholder discretion	• Indicated support for the IASB's proposals (previously EFRAG indicated that it was unsure of the factors and would conduct testing to gather evidence on the impact of the factors)
Question 6 - Reclassification of financial liabilities and equity instruments	• Whilst maintaining our disagreement with the IASB's proposals, added a paragraph explaining that stakeholder feedback reflected that assessing at each reporting period for 'passage-of-time changes' is not an issue and is needed for the disclosures in any case.
Question 7 - Disclosures	• General agreement with the IASB's proposals. Mentioned the support from users on the disclosure requirements. • Indicated that some stakeholders expect significant operational challenges relating to the disclosures on liquidation (the nature and priority of claims against the entity on liquidation; and terms and conditions related to priority on liquidation). Also indicated that some others consider that the disclosures on liquidation should be clear that they do not provide a full picture of what would happen on liquidation. • Added that the disclosure requirements would be subject to materiality in IAS 1 and suggested that the IASB develop some guidance on an appropriate level of aggregation in order to provide relief on these operational challenges.
Question 8 – Presentation	• Added a paragraph indicating that the benefits of the proposals should be emphasised.
Question 9 – Transition	• No changes made.
Question 10 - Disclosure requirements for eligible subsidiaries	• No significant changes made.

EFRAG FR TEG discussions and advice to EFRAG FRB

4 EFRAG FR TEG discussed the updated EFRAG comment letter at its 05 April 2024 meeting. At that meeting, EFRAG FR TEG recommended the final comment letter for approval by the EFRAG FRB subject to changes being made as indicated below.

5 The following key changes (and comments) were proposed by EFRAG FR TEG which have been incorporated in the comment letter:

(a) *Cover letter*:

(i) To recommend to the IASB to separate the proposals related to effects of relevant laws and regulations and the accounting treatment of written put options over non-controlling interest from the FICE project into a separate project, given that these topics are complex and difficult to be addressed within the scope of the current project which is only intended to introduce narrow-scope amendments.

(ii) Suggestion that EFRAG should delete the reference to avoiding classification changes for financial instruments that currently do not raise concerns in practice as the focus should be on addressing the issues that arise in practice and not avoiding classification changes.

(iii) The IASB should develop additional outreaches in the future as the timing of the IASB´s 2023 ED did not allow a comprehensive discussion with preparers (year-end closing of the financial statements).

(b) *Effects of law or regulation:*

(i) To state that it seems conceptually incorrect to require contractual rights or obligations created solely by laws or regulations to be ignored when determining the classification of a financial instrument.

(ii) To note that the issues that arise from the IASB´s proposals on the effects of laws or regulations are prevailing issues that not only significantly affect financial institutions but also a wide range of other industries and companies.

(Question 1 of the ED).

(c) *Fixed-for-fixed condition*:

(i) Recommend that the IASB should provide additional examples on adjustments that meet the preservation adjustment principles as both the Basis for Conclusions and Illustrative Examples seem to be more focused on instruments that do not meet the preservation adjustment principle.

(ii) Improve the section on which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency.

(Question 2 of the ED).

(d) *Written put options on NCI*:

(i) Agreement with not having an EFRAG view on subsequent measurement of the financial liability.

(ii) To indicate that some consider that the IASB may explore the accounting for subsequent changes in the NCI put liability in other comprehensive income (‘OCI’) instead of profit or loss (Question 3 of the ED).

(e) *Contingent settlement provisions*: suggest that the IASB discuss measurement issues of financial liabilities under the scope of IAS 32 (i.e. do not exclude from the scope of the project issues relating to the measurement of financial liabilities, as mentioned in paragraph BC82 of the Basis for Conclusions) (Question 4 of the ED).

(f) *Disclosures*:

(i) To indicate agreement with the disclosure requirements but also mentioning that some stakeholders expect significant operational challenges relating to the disclosures on liquidation (the nature and priority of claims against the entity on liquidation; and terms and conditions related to priority on liquidation).

(ii) To indicate that the disclosure requirements would be subject to materiality in IAS 1 and suggested that the IASB develop some guidance on an appropriate level of aggregation in order to provide relief on these operational challenges.

(Question 7 of the ED).

Agenda papers

6 In addition to this cover note, the agenda papers for this session are:

(a) Agenda paper 02-02 – Updated EFRAG comment letter (clean);

(b) Agenda paper 02-03 – Updated EFRAG comment letter (marked-up compared to EFRAG's draft comment letter); and

(c) Agenda paper 02-04 – Comment letter analysis and outreach feedback; and

(d) Agenda paper 02-05 – Summary of EFRAG's survey results.

7 In addition, please find a link here to all the comment letters received that are on EFRAG's website (section 'Documents').

Question for EFRAG FRB members

8 Does EFRAG FRB approve the final comment letter on the ED?