EFRAG

Financial reporting

[Draft] Comment Letter

You can submit your comments on EFRAG's draft comment letter by using the 'Express your views' page on EFRAG's website, then opening the relevant news item and clicking on the 'Comment publication' link at the end of the news item.

Comments should be submitted by 20 March 2024.

International Accounting Standards Board

7 Westferry Circus, Canary Wharf

London E14 4HD

United Kingdom

[XX Month 202X]

Dear Mr Barckow,

Re: Exposure Draft *Financial Instruments with Characteristics of Equity*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB's Exposure Draft *Financial Instruments with Characteristics of Equity* (IASB/ED/2023/5), issued by the IASB in November 2023 (the 'ED').

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 the endorsement of definitive IFRS Standards in the European Union and European Economic Area.

In general, EFRAG welcomes the IASB's efforts and approach to addressing issues that arise in practice related to IAS 32 *Financial Instruments: Presentation* by clarifying some of the underlying principles in IAS 32 and adding application guidance to facilitate the consistent application of the principles.

EFRAG notes that this project is particularly relevant for financial institutions that issue complex financial products developed in the aftermath of the financial crisis, such as bail-in instruments, which test the requirements in IAS 32. It is also important for non-financial corporates that currently are increasingly using hybrid instruments to obtain financing (for a variety of reasons and purposes including capital management, taxation) and offering alternative investment opportunities to market participants.

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 in its discussions on the *Conceptual Framework for Financial Reporting* and in its 2018 Discussion Paper *Financial Instruments with Characteristics of Equity (2018 DP)*.

However, in its comment letter to the IASB's 2018 DP, EFRAG noted that it had not identified consensus on a more conceptual approach to distinguish debt from equity, and it suggested that the IASB focus on targeted improvements to existing requirements in IAS 32 and related standards.

Therefore, EFRAG is pleased that the IASB's ED is in line with EFRAG's suggestion in its comment letter. Nonetheless, as highlighted below and in the Appendix, EFRAG provides a number of suggestions to the IASB.

Classification

In general, EFRAG welcomes the IASB's approach to addressing the issues that arise in practice on classification and the list of issues that the IASB considered in this project. EFRAG also welcomes many of the IASB's clarifications, particularly on the fixed-for-fixed condition.

However, EFRAG suggests that the IASB should:

(a) avoid classification changes for financial instruments that currently, to EFRAG's knowledge, do not raise concerns in practice to avoid unintended consequences (e.g., impact on hedge accounting). If any new clarification brings about such changes, this should be justified by a clear explanation of why it leads to a better accounting outcome;

(b) consider whether a liability should be recognised for a Mandatory Tender Offer (MTO);

(c) discuss more comprehensively measurement issues of financial liabilities under the scope of IAS 32 - such as those that arise from obligations to redeem own equity instruments and financial instruments with contingent settlement provisions - where there are different views in practice on how to determine the 'full amount' or 'present value of the redemption amount' (e.g., for instruments with a cap and floor) and on whether probability weighted amounts should be used;

(d) reconsider the initial accounting within equity for written put options on non-controlling interest (NCI written put), as EFRAG disagrees with the IASB's proposal to

continue recognising non-controlling interest on initial recognition and considers that the debit entry should be against non-controlling interests (similar to the alternative view of Mr Uhl in paragraph AV5 of the Basis for Conclusions);

(e) consider that many stakeholders disagree with presenting subsequent changes to the carrying amount of the financial liability in profit or loss, as this would be in conflict with the requirement to account, in equity, effects of transactions with owners in their capacity as owners, and that it would be counterintuitive to have measurement changes being presented in profit or loss, as performance decreases when the value of the shares subject to the put option increases, and vice versa;

(f) explore the alternative model to treat contracts which meet the definition of a derivative as a stand-alone derivative at fair value through profit or loss (similar to the alternative view of Mr Uhl in paragraph AV3 of the Basis for Conclusions) or the possibility of recognising changes in the fair value of the derivative within equity (considering that it is a transaction with owners in their capacity as owners); and

(g) allow reclassification of 'passage-of-time changes' as this would reflect the substance of the contractual terms for the remaining life of the instruments instead of disclosures on terms and conditions that become, or stop being, effective with the passage of time.

In addition, at this stage EFRAG is unsure of the outcome of the four factors, in paragraph AG28A of IAS 32 in the ED, needed in assessing whether shareholders' decisions are treated as entity decisions and will conduct testing to gather evidence on the impact of the factors.

Disclosures

EFRAG welcomes the improvements to the disclosures on issued instruments and considers that it is important to ensure that they are clear and can easily be implemented by entities. It is also important to ensure that there is an adequate balance between the benefits to users of financial statements and the costs for preparers. Therefore, field-testing will be essential in this context.

In this regard, EFRAG has the following concerns and suggestions:

(a) On disclosures on an entity's contractual nature and priority on liquidation, especially for distinguishing between subordinated and unsubordinated claims, entities may face challenges determining whether priority stems from the contract or from related law/regulation. In addition, EFRAG considers that it may be useful to provide information based on subgroups if they are located in different jurisdictions

and information on how the structure of the group affects the priority on liquidation; and,

(b) on disclosures related to terms and conditions of financial instruments with both financial liability and equity characteristics, EFRAG considers that it would be useful to provide disclosures on the effects of law on the classification as financial liabilities or equity instruments.

Presentation

EFRAG supports the IASB's proposals to separately present the amounts attributable to ordinary shareholders from the amounts of other owners of the parent in the primary financial statements. It is fundamental for users of financial statements not to have information about multiple equity providers and financial instruments aggregated in a single line. This will help them better understand how the proceeds will be distributed on the sale of a business and evaluate the ordinary shareholders' value.

Fieldwork and outreach events

EFRAG highlights the importance of assessing, through fieldwork and outreach events, the likely effects of the changes proposed by the IASB, particularly the importance of applying the proposed changes to individual transactions or contracts as if the proposed Standard was already in effect. This is done with the objective of better assessing the costs and benefits of the IASB proposals, the potential classification changes of financial instruments under the scope of IAS 32 and whether there are any unintended consequences arising from the IASB's proposals. For example,

- for a mandatory convertible bond convertible into a fixed number of shares upon a contingent non-viability event (classified as equity) whether an entity should consider the enforceability of such contract if the resolution authorities have the power to mandate conversion into a variable number of shares (thus classified as a compound instrument with an equity component that has a value of zero in accordance with the IASB's clarifications); and
- the potential impact to the classification of financial instruments under *IFRS 9 Financial Instruments* from the holder perspective (i.e., as financial assets), particularly when considering the requirements set in IFRS 9 on classification asymmetry[1] between the

[1] where the holder of an investment assesses whether the instrument meets the definition of equity from the perspective of the issuer.

holder (classification under IFRS 9 that is focused on the contractual terms) and the issuer of the financial instruments (classification under IAS 32 that would be focused on the contractual terms and the effects of law, including those under paragraphs 16A to 16D), which can impact the presentation of changes in fair value in OCI.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

EFRAG is planning to do outreach activities and field tests on the different topics. Therefore, EFRAG's views may change depending on the results of such tests and activities.

If you would like to discuss our comments in further detail, please do not hesitate to contact Sapna Heeralall or me.

Yours sincerely,

Wolf Klinz

EFRAG FRB Chairman

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Appendix – EFRAG's responses to the questions raised in the ED

Question 1 – Classification: The effects of relevant laws or regulations

Notes to constituents – Summary of proposals in the ED

1 *Per paragraph 15 of IAS 32, the issuer of a financial instrument shall classify an instrument on initial recognition in accordance with the "substance of the contractual arrangement" and the definitions of a financial liability, a financial asset and an equity instrument (which also refer to "contractual rights and contractual obligations" in paragraph 11 of the IAS 32).*

2 *However, issues arise in practice on whether and how laws or regulations -such as statutory or regulatory requirements - applicable to a financial instrument affect the classification of a financial instrument; for example, for*

(a) ***bail-in instruments (AT1 instruments)**: whether laws that impose a contingent conversion into ordinary shares or a write-down of the principal amount should be treated as part of the contractual terms and considered in classifying such instruments as financial liabilities or equity instruments. Also, whether reproducing that legal requirement in the contract would make it part of the contractual terms (e.g., through issuance of similar instruments in a foreign market where the banking resolution regulation does not apply in the same way); for*

(b) ***legal obligation to pay dividends**: whether that legal obligation to distribute a specified percentage of profit gives rise to a financial liability in itself and, if not, whether reproducing that legal requirement in the contract would make it part of the contractual terms; and for*

(c) ***mandatory tender offers**: whether the legal requirement to make an offer should result in recognition of a liability when the acquirer acquires a specific level of shareholding from the acquiree.*

3 *To address the issues that arise in practice, in paragraph 15 of the ED the IASB proposes to clarify that only contractual rights and obligations that are <u>enforceable</u> by laws or regulations, in addition to those created by relevant laws or regulations, are considered in classifying a financial instrument (or its component parts) as a financial liability, financial asset or equity.*

4 *Thus, if a right or obligation is created by relevant laws or regulations and would arise regardless of whether it is included in the contractual arrangement, an entity would not consider that right or obligation for classification purposes.*

Question 1 - The effects of relevant laws or regulations (paragraphs 15A and AG24A–AG24B of IAS 32)

The IASB proposes to clarify that:

(a) only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts (paragraph 15A); and

(b) a contractual right or obligation that is not solely created by laws or regulations, but is in addition to a right or obligation created by relevant laws or regulations shall be considered in its entirety in classifying the financial instrument or its component parts (paragraph AG24B).

Paragraphs BC12–BC30 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

5 EFRAG welcomes the IASB's discussions on the interaction between the terms and conditions of a contract and applicable law to avoid a blanket rejection of the effects of the law from classification (i.e., to avoid deficiencies of a strict contract-only approach as for example legal requirements, which can limit or otherwise affect the rights and obligations arising from the contract), and supports the direction of travel.

6 EFRAG acknowledges that the combination of both contractual and legal regulations (enforceable framework) is necessary to understand the contract. EFRAG notes that a classification solely based on contractual terms may lead to outcomes that contradict the principle-based nature of IFRS Accounting Standards.

7 However, EFRAG notes that taking into consideration the overall effects of laws (all-inclusive approach) could represent a significant change to current requirements, which would be beyond the scope of the FICE project, particularly when considering that IFRS 9 is a contractual-based Standard. An all-inclusive classification approach (i.e., requiring the issuer of a financial instrument to consider contractual terms and rights as well as obligations established by relevant laws or regulations) could lead to significant classification changes, such as changes on the classification of ordinary shares with statutory minimum dividends, which would become liabilities (at least in part). EFRAG also notes that law and regulation can be changed unilaterally by an authority (without agreement from the counterparties in the contract) and that thus, in an all-inclusive

approach, this could lead to continuous classification changes when there are frequent changes in the law.

The effects of laws and regulations on the contractual rights obligations

8 EFRAG welcomes the IASB's clarification that only contractual rights and obligations that are enforceable by laws or regulations and that are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts.

9 EFRAG also welcomes the introduction in paragraph AG24B of the clarification that, when applying the proposed principles, an entity should not be required to separate a single obligation into two liabilities, i.e., a financial and non-financial liability in cases such as distribution of dividends above the percentage required by law. Such guidance avoids complex accounting treatments related to the distribution of dividends.

10 The IASB's approach has the benefit of addressing many of the issues that arise in practice (e.g., bail-in instruments and legal obligation to pay dividends) without fundamentally reconsidering the existing principles and requirements in IAS 32, IFRS 9 and IFRIC 2.

11 EFRAG also welcomes that such a clarification would be consistent with the principle in paragraph 8 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* whereby, if the redemption of an instrument is unconditionally prohibited by local law, regulation or an entity's governing charter, the instrument is classified as equity.

12 Nonetheless, EFRAG highlights some practical challenges that arise from applying the IASB's proposals. In particular, EFRAG notes that it may be complex to assess whether the terms explicitly stated in the contract are actually in addition to what is established by law (i.e., an entity would have to consider all the elements of the law to assess whether the rights and obligations are in addition to those), particularly for international groups with subsidiaries in many different jurisdictions with different law requirements. Therefore, the IASB's proposals need to be connected to its disclosure proposals, where preparers explain the interaction between the contractual terms and applicable law. Such disclosures are important for investors 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 our response to Question 7 below).

13 EFRAG also highlights the importance of testing the IASB's approach against some well-known financial instruments, such as bail-in instruments and instruments that involve mandatory distribution of dividends by law or by contractual terms, to better understand

potential classification changes and whether there are any unintended consequences on the classification of financial instruments under IAS 32 and IFRS 9; for example,

(a) for a mandatorily convertible bond convertible into a fixed number of shares upon a contingent non-viability event (classified as equity), whether an entity should consider the enforceability of such a contract if, for example, the resolution authorities have the power to mandate conversion into a variable number of shares (thus classified as a compound instrument with an equity component that has a value of zero in accordance with the IASB´s clarifications); and

(b) the potential impact to the classification of financial instruments under *IFRS 9 Financial Instruments* from the holder perspective (i.e., financial asset), particularly when considering the requirements in IFRS 9 on classification asymmetry[2] between the holder (classification under IFRS 9 that is focused on the contractual terms and the business model) and the issuer of the financial instruments (classification under IAS 32 that would be focused on the contractual terms and the effects of law, including those under paragraphs 16A to 16D), which can impact the presentation of changes in fair value in OCI (i.e., the option to present the changes in fair value in OCI refers only to equity instruments defined as such by IAS 32; it does not apply to instruments defined as financial liabilities but classified as equity by the issuer, such as puttable instruments classified as equity by the issuer).This issue should be clarified in the application guidance.

Mandatory Tender Offers

14 EFRAG notes that when applying the IASB's proposals to MTOs, an entity is likely to conclude that the legal requirement to make an offer to non-controlling shareholders is not part of the contractual terms and therefore the MTO is not recognised. Such an approach does not seem to address the concerns raised by stakeholders about not recognising an obligation (i.e., liability) at the date in which the acquirer acquires a specified level of shareholding. In addition, the IASB's proposed clarifications that only contractual rights and obligations that are in addition to those created by relevant laws or regulations are considered do not seem to help in solving the issue of when to recognise a liability (e.g., when there is a legal obligation for the entity to make an offer, when an entity launches an

[2] where the holder of an investment assesses whether the instrument meets the definition of equity from the perspective of the issuer.

offer as a result of the law or when an entity makes a contractual offer, given that even a contractual offer may not be considered to lead to a financial liability on the basis that it is not in addition to what is required by law).

15 EFRAG acknowledges the IASB's concern that it would be difficult to resolve the issue related to MTO without fundamentally reconsidering the requirements in IAS 32 and that it should therefore be outside the scope of this project. However, EFRAG considers that this is a significant issue that should be addressed by the IASB as there is a perception of inconsistency between the accounting for MTOs and the accounting for written put options on non-controlling interests (NCI puts).

Questions to constituents

16 When applying the IASB proposals on the effects of applicable laws on the contractual terms of financial instruments, do you expect any classification changes on instruments such as *(i)* bail-in instruments, *(ii)* ordinary shares with statutory minimum dividends, *(iii)* IFRIC 2-type instruments or *(iv)* any other financial instruments or situations (e.g., limited life companies or limited partnerships)?

17 Do you consider that the IASB should address MTOs?

18 EFRAG was made aware that the IASB's proposal, when read in conjunction with the Basis for Conclusions, could have unintended consequences in terms of either excluding certain banking products, such as loans or banking saving deposits, from the scope of IFRS 9 / IAS 32, or in classifying such instruments as equity. In the latter case, those instruments would end up being classified as equity instruments (classified as equity in the entity's financial statements and with a corresponding debit entry as financial asset measured at fair value through profit or loss).

Do you consider that the IASB's proposal could lead to the accounting of some banking products in their jurisdiction, such as loans or banking saving deposits, being disrupted by the proposal. Please explain.

Question 2 – Classification: Settlement in an entity's own equity instruments (including fixed-for-fixed condition in IAS 32)

Notes to constituents – Summary of proposals in the ED

Derivatives that are settled with the issuer's own equity instruments

19 *Paragraph 16(b) of IAS 32 contains classification requirements for financial instruments that will or may be settled in the issuer's own equity instruments, including what is commonly referred to as the fixed-for-fixed condition for derivatives.*

20 *As there is limited guidance in IAS 32 on the fixed-for-fixed condition, various questions have arisen in practice on how requirements in IAS 32 should be interpreted and applied in practice (e.g., adjustment clauses that alter the conversion ratio to prevent dilution or adjustments to the exercise price of an option to compensate the option holder for earlier exercise of the option). This lack of clarity has also led to diversity in practice.*

21 *To address the issues that arise in practice, the IASB proposes to clarify the principles in IAS 32 on the fixed-for-fixed condition. More specifically, in paragraphs 16, 22B and 22C of the ED the IASB clarifies that the fixed-for-fixed condition is met if either one of the following are satisfied:*

(a) ***foundation principle**: the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be <u>fixed</u> and denominated in the entity's functional currency; or*

(b) ***adjustment principles**: the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency and <u>variable</u> solely because of*

(i) *<u>preservation adjustments</u> that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders and/or*

(ii) *<u>passage-of-time adjustments</u> that are predetermined, that vary with the passage of time only, and that have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments (paragraphs 22B–22C).*

22 *Furthermore, in paragraph AG 27A(b) the IASB clarifies that if a derivative gives one party a choice of settlement between two or more classes of an entity's own equity instruments, the entity considers whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative is an equity instrument only if all settlement alternatives meet the fixed-for-fixed condition.*

Share-for-share exchanges that are fixed

23 *Currently IAS 32 does not address a fact patten that involves a share-for-share exchange where both legs of the exchange are a fixed number of own shares.*

24 *In paragraph 22D of the ED, the IASB clarifies that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument.*

Question 2 - Settlement in an entity's own equity instruments (paragraphs 16, 22, 22B–22D, AG27A and AG29B of IAS 32)

The IASB proposes to clarify when the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32 is met by specifying that the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency, and either:

(a) fixed (will not vary under any circumstances); or

(b) variable solely because of:

(i) preservation adjustments that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders; and/or

(ii) passage-of-time adjustments that are predetermined, vary with the passage of time only, and have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments (paragraphs 22B–22C).

The IASB also proposes to clarify that if a derivative gives one party a choice of settlement between two or more classes of an entity's own equity instruments, the entity considers whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative is an equity instrument only if all the settlement alternatives meet the fixed-for-fixed condition (paragraph AG27A(b)).

The IASB further proposes to clarify that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument (paragraph 22D).

Paragraphs BC31–BC61 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

25 EFRAG welcomes the IASB's efforts to clarify the principles in IAS 32 on the fixed-for-fixed condition to particular derivatives on own equity as currently this is one of the main sources of accounting challenges to solve. As there is limited guidance in IAS 32 on the fixed-for-fixed condition, various questions have arisen on how requirements in IAS 32 should be interpreted and applied in practice (e.g., adjustment clauses that alter the conversion ratio to prevent dilution). This lack of clarity has also led to diversity in practice.

26 In general, EFRAG supports the IASB's proposed foundation principle and adjustment principles as the clarifications proposed by the IASB would improve consistency and are fairly aligned with current practice.

Foundation principle

27 EFRAG supports the IASB's proposed foundation principle that is based on the certainty of the amount of cash exchanged per unit of equity instrument. The IASB's proposed foundation principle would require that the issuer knows the exact exchange or conversion ratio at the inception of the derivative ('fixed exchange ratio'). This principle seems to stem from the current wording for the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32 and is aligned with current practice. The principle can be expressed as fixed functional currency units per share or a fixed number of shares for each functional currency unit.

28 EFRAG also welcomes the IASB clarification that the fixed-for-fixed condition is met if a derivative provides one party to the contract with a choice of settlement between two or more classes of the entity's own equity instruments and if all of the settlement alternatives result in a fixed exchange ratio as described in paragraph BC35.

29 As currently IAS 32 does not address a fact patten that involves a share-for-share exchange where both legs of the exchange are a fixed number of own shares, EFRAG supports the IASB's proposal to introduce new guidance and classify as equity a contract that can be settled by exchanging a fixed number of non-derivative own equity instruments with a fixed number of another type of non-derivative own equity instruments.

30 Finally, EFRAG welcomes that the IASB will not reconsider the requirements that were added to IAS 32 in 2009 for 'foreign currency rights issues' and will retain the foreign currency rights issue exception, as it is considered useful. Such an exception would be retained even if the IASB clarifies that, for the fixed-for-fixed condition to be met, the

amount of consideration to be received or paid for each of an entity's own equity instruments is expressed in units of the entity's functional currency.

Adjustment principle

31 EFRAG also supports the IASB's proposed adjustment principle that will encompass preservation adjustments and passage of time adjustments.

32 Nonetheless, EFRAG considers that it is important that the IASB provides guidance to help preparers to assess whether an adjustment is a preservation adjustment or a passage of time adjustment depending on what they are intended to compensate the bondholder for (e.g., flowchart). This is because such a distinction might not always be clear.

Adjustment principle – preservation adjustments

33 On preservation adjustments, EFRAG generally agrees with the IASB's proposals, which aim to allow equity classification as long as the adjustments preserve the relative economic interests of the future shareholders to an equal or a lesser extent compared to the existing underlying equity instrument holders (from the issuers' perspective), for example, change of control provisions.

Adjustment principle – passage of time adjustments

34 EFRAG welcomes the IASB's proposal to allow passage of time adjustments in order classify a derivative as equity. We also welcome the fact that the adjustment should in principle have the effect of fixing the cash amount per share in terms of present value (i.e., that the value varies only with the passage of time).

35 In general, EFRAG also agrees that the adjustment has to be pre-determined at inception (i.e., be a pre-determined amount or a pre-determined formula as long as the inputs to the formula only vary with time; that is, time is the only input).

36 Finally, EFRAG welcomes that the IASB will not reconsider the requirements that were added to IAS 32 in 2009 for 'foreign currency rights issues' and will retain the foreign currency rights issue exception, as it is considered useful.

Adjustment principle – passage-of-time adjustments – options that can be exercised at different predetermined dates

37 EFRAG notes that for options where the strike price varies with an interest rate benchmark or an inflation index, the IASB concluded in paragraph IE86 of the Illustrative Examples that the adjustment to the strike price is neither a preservation adjustment nor a passage-of-time adjustment as specified in paragraph 22C. However, in cases where the benchmark interest rate represents the time value of money that is relevant to the derivative and where the inflation index is not leveraged and relates to inflation in the issuer's own

economic environment, it could be argued that the adjustment is based on a pre-determined formula where the inputs to the formula only vary with time (i.e., time is the only input) and thus meet the fixed-for-fixed condition.

38 Similarly, EFRAG also notes that for a call option that can be exercised for pre-determined amounts at pre-determined dates (e.g., €100 in Y1, €150 in Y2 and €500 in Y3), the adjustment to the strike price may not be an allowable passage-of-time adjustment because the adjustment is not fixing the amount of cash to be exchanged for each share in terms of present value (i.e., the changes to the amount of consideration to be paid on each settlement date does not represent only compensation proportional to the passage of time).

39 EFRAG considers that these two cases would represent a change to current practice and includes a question for its constituents. Furthermore, EFRAG requests clarity on whether the fixed-for-fixed condition is met for a convertible loan of variable interest rate (where both principal and interest are compounded to the convertible amount), similarly to the fixed interest rate loan. It is considered to be the case but, given that it is not explicit, EFRAG would like to remove any risk by seeking explicit confirmation.

Question to constituents

40 Do you consider that the IASB's proposals on passage-of-time adjustments will lead to classification changes for options that can be exercised at different pre-determined dates (as described above)? If so, how pervasive would these classification changes be?

Question 3 – Classification: Obligation to purchase an entity's own equity instruments (e.g., written put-options on non-controlling interest)

Notes to constituents – Summary of proposals in the ED

41 Paragraph 23 of IAS 32 requires a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset to be recognised as a financial liability (e.g., written puts on non-controlling interest). The financial liability is recognised initially at the present value of the redemption amount and is reclassified from equity.

42 Currently, many questions arise on the application of paragraph 23 of IAS 32, including

(a) *whether the writer of a put option should recognise a financial liability for the present value of the option's exercise price (gross basis) or a derivative liability at fair value (net basis);*

(b) *how to account for transactions within equity when an entity has an obligation to extinguish its own instruments (e.g., whether the NCI is derecognised or a contra-equity account is recognised within the consolidated equity when recognising the liability for the redemption amount);*

(c) *whether the subsequent measurement changes in the redemption amount are recognised in profit or loss or in equity, similarly to other transactions between equity holders; and*

(d) *how an entity should apply the requirements if a contract containing an obligation for the entity to purchase its own equity instruments expired without delivery.*

43 *There are different views on how to account for such derivatives, leading to diversity in practice.*

44 *To address these questions and current diversity in practice, the IASB is proposing clarifications to the recognition and measurement of obligations to redeem own equity instruments, including the accounting on initial recognition as well as on expiry, their presentation (gross basis), and their initial and subsequent measurement. More specifically, the IASB clarifies that*

(a) *a financial liability is recognised initially at the present value of the redemption amount;*

(b) *the initial amount of the financial liability would be removed from a component of equity other than non-controlling interests or issued share capital if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates (non-controlling and other shareholders retain their rights to the returns associated with an ownership interest);*

(c) *on subsequent measurement, an entity is required to measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption;*

(d) *any gains or losses on remeasurement of the financial liability are recognised in profit or loss; and that,*

(e) *if the contract expires without delivery, the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial*

liability and that any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss.

Question 3 - Obligations to purchase an entity's own equity instruments (paragraphs 23 and AG27B–AG27D of IAS 32)

The IASB proposes to clarify that:

(a) the requirements in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instruments also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments (paragraph 23).

(b) on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would, therefore, be removed from a component of equity other than non-controlling interests or issued share capital (paragraph AG27B).

(c) an entity is required to use the same approach for initial and subsequent measurement of the financial liability—measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right (paragraph 23).

(d) any gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraph 23).

(e) if a contract containing an obligation for an entity to purchase its own equity instruments expires without delivery:

(i) the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial liability.

(ii) any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss. However, the entity may transfer the cumulative amount of those gains or losses from retained earnings to another component of equity (paragraph AG27C).

(f) written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled—consideration is exchanged for own equity instruments—are required to be presented on a gross basis (paragraph AG27D).

Paragraphs BC62–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

45 EFRAG welcomes the IASB's discussion on the accounting for contracts that contain an obligation for an entity to purchase its own equity instruments, particularly on derivatives such as written put options on non-controlling interest (NCI puts), where there is diversity in practice that needs to be addressed by the IASB.

46 Currently, this is a topic where there are different views on how to account for such derivatives and where companies use different accounting policies when accounting for obligation to purchase an entity's own equity instruments (e.g., written put options on non-controlling interest), mostly on the initial accounting within equity and the presentation of the subsequent measurement of the redemption amount (changes in the redemption amount presented either in profit or loss or equity). Therefore, any clarifications are likely to change current practice.

Classification for obligations to purchase an entity's own equity instruments

Recognising obligation to repurchase own equity at present value of redemption amount

47 EFRAG welcomes the IASB's efforts to clarify the requirements on the gross presentation of the liability for redemption obligations to purchase an entity's own equity instruments (e.g., written put options and forward purchase contracts), even when an entity uses a variable number of (the parent's) own equity instruments to settle a contract (i.e., to recognise a gross liability for the pay leg of the written put). Such clarifications have the benefit of ensuring consistency on the accounting for obligations to purchase an entity's own equity instruments (that are not net settled nor issued as part of a business combination), whilst largely maintaining the gross presentation requirements in paragraph 23 of IAS 32.

48 On the initial accounting within equity, EFRAG notes that current practice is mixed due to lack of guidance in IAS 32. Some consider logical to derecognise the NCI, while others consider such derecognition inappropriate. As explained in paragraph BC80 of the Basis for Conclusions, the IASB concluded that if an entity does not yet have access to the rights and returns associated with the ownership of the equity instruments to which the obligation relates, then the related NCI should continue to be recognised.

49 EFRAG disagrees with the IASB's conclusion and proposal to continue recognising non-controlling interest on initial recognition and considers that the debit entry should be presented as part of non-controlling interests (similar to the alternative view of Mr Uhl in paragraph AV5 of the Basis for Conclusions). EFRAG considers that the IASB's proposal on initial accounting to not remove non-controlling interest would not provide relevant information to users of financial statements, as

(a) it is counterintuitive to have a redemption amount recognised as a liability (reflecting a claim from NCI) and at the same time have the related NCI recognised within equity (the contra to the liability would be a general reduction);

(b) recognising the liability amount against the parent's ownership interests would double-count the non-controlling interests subject to the contract; and

(c) reducing the carrying amount of non-controlling interests by the forward or written put option would better reflect the economic substance of the transaction.

50 EFRAG also acknowledges that there are stakeholders who consider that an entity should account for the contract that meets the definition of a derivative as a stand-alone derivative (similar to the alternative view of Mr Uhl in paragraph AV3 of the Basis for Conclusions) as well as in the separate financial statements. Therefore, EFRAG considers that there is merit in exploring an alternative model (please see the question to constituents in paragraph 52 below), including the possibility of recognising changes in the fair value of the derivative within equity (considering that it is a transaction with owners in their capacity as owners) as supported by appropriate disclosures.

51 Considering, the above, EFRAG includes a question to constituents.

Questions to constituents

52 Regarding the accounting for the obligations to purchase an entity's own equity instruments (NCI written put option), do you support

(a) the gross presentation, as outlined by the IASB, whereby an entity initially recognises a financial liability for the redemption amount with the debit side going against the parent's equity if the entity does not yet have access to the returns associated with ownership of those equity instruments? If so, are you not concerned that the accounting depends on whether the entity does have access to the returns associated with ownership of the equity instruments? Please explain.

(b) Do you support the gross presentation whereby an entity initially recognises a financial liability for the redemption amount with the debit side going against non-controlling interests on the basis that not doing so would not reflect the economic substance of the transaction and would result in double-count of the non-controlling interest as highlighted in paragraph BC77 of the Basis for Conclusions or as argued by Mr Uhl in paragraph AV5 of the Basis for Conclusions? Please explain.

(c) Do you support the net approach resulting in the recognition of a stand-alone derivative measured at fair value as indicated by Mr Uhl in the Basis for Conclusions (paragraphs AV1 to AV6)? Please explain.

53 Do you have any views on how NCI puts should be accounted for in the separate financial statements? Please explain.

Initial and subsequent measurement of obligations to purchase an entity's own equity instruments

54 EFRAG highlights that due to lack of guidance in IAS 32, in practice there are different views on how to determine the present value of the redemption amount. For example, as mentioned in paragraph BC81 of the Basis for Conclusions, questions arise in practice on how the financial liability is measured if the amount payable on redemption is variable (such as an instrument puttable at fair value or based on a formula) or subject to a cap. There are also different views on whether the probability and estimate of the timing of the contingent event occurring should be considered.

55 EFRAG regrets that the IASB has not addressed the issues related to measurement of liabilities under IAS 32 in a more comprehensive way in the ED (where the present value of the redemption amount seems to be a third measurement approach for financial liabilities), including the use of caps.[3] Therefore, EFRAG suggests that the IASB addresses more comprehensively the questions that arise in practice related to the measurement of liabilities under IAS 32.

Gains and losses on remeasurement of the financial liability

56 On the presentation of the subsequent measurement of the redemption amount, EFRAG notes that many stakeholders disagree with the IASB's clarifications. This is because it

[3] Even if discussed by the IASB in September 2022 on *Obligations to redeem own equity instruments* but seemingly not reflected in the ED.

would be in conflict with the requirements to account in equity for transactions with owners in their capacity as owners and would be counterintuitive to have measurement changes being presented in profit or loss, as performance decreases when the value of the shares subject to the put option increases, and vice versa (particularly if NCI and other owners of the parent retain ownership rights).

57 Nonetheless, EFRAG acknowledges that some consider that the IASB's clarifications have the benefit of addressing current diversity in practice, improving comparability and being consistent with current requirements in IAS 32, IFRS 9 and IAS 1 (as explained in paragraph BC87 in the Basis for Conclusions).

58 Considering the different views, EFRAG has included questions for its constituents.

Questions to constituents

59 Assuming that the gross presentation is retained, do you consider that subsequent changes to the carrying amount of the financial liability should be presented

(a) in profit or loss (as proposed by the IASB),

(b) within equity (on the basis that it is a transaction with owners in their capacity as owners, particularly if NCI and other owners of the parent retain ownership rights), or

(c) based on any other approach, such as in OCI in full or a split between profit or loss and OCI? Please explain.

60 Assuming that the net approach is retained, do you consider that subsequent changes to the fair value of the stand-alone derivative should be presented

(a) in profit or loss (in line with all other derivatives) or

(b) within equity (on the basis that the derivative stems from a transaction with owners in their capacity as owners)?

Accounting for the expiry of a written put option

61 EFRAG notes that many of the questions that arise on the accounting for the expiry of a written put option are related to their initial recognition and measurement and are thus directly related to the concerns raised above.

Question 4 – Classification: Contingent settlement provisions

Notes to constituents – Summary of proposals in the ED

62 *Paragraph 25 of IAS 32 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. Paragraphs 28–32 of IAS 32 specify requirements for classifying separately the liability and equity components of compound financial instruments.*

63 *There are many issues that arise in practice related to these requirements and the main issues are related to*

(a) *the order for applying requirements in IAS 32 (e.g., whether instruments that do not have a stated maturity date but that are mandatorily convertible into a variable number of shares if the issuer breaches the Tier 1 Capital ratio meet the definition of a financial liability in its entirety or must be classified as a compound instrument);*

(b) *whether the probability of a contingent event occurring affects classification;*

(c) *whether the probability of a contingent event occurring affects measurement;*

(d) *how an entity accounts for any subsequent discretionary distributions made (i.e., whether directly in equity in accordance with paragraph AG37 of IAS 32 or in profit or loss in accordance with paragraph 36 of IAS 32); and*

(e) *the assessment of 'not genuine' in paragraph 25(a) of IAS 32 and the meaning of the term 'liquidation' in paragraph 25(b) of IAS 32.*

64 *To address these issues, the IASB proposes to clarify that*

(a) *the compound instrument requirements apply first before any specific classification requirements. Thus, some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A);*

(b) *the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A); and that*

(c) *payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37).*

65 *Finally, the IASB clarifies the terms 'liquidation' and 'not genuine' that are used in paragraph 25 of IAS 32. These clarifications try to address the questions that arise in practice on whether liquidation refers to the end of the process when an entity ceases to exist and whether the not genuine assessment is based solely on the probability of the contingent event occurring.*

Question 4 - Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)

The IASB proposes to clarify that:

(a) some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A);

(b) the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A);

(c) payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37);

(d) the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations (paragraph 11); and

(e) the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring (paragraph AG28).

Paragraphs BC94–BC115 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

66 EFRAG welcomes the IASB's proposals to clarify initial recognition and measurement of financial instruments with contingent settlement provisions. Such clarifications seem to be fairly aligned with current practice and current requirements in IAS 32.

Classification of financial instruments with contingent settlement provisions

67 EFRAG welcomes the IASB's clarification that some financial instruments with contingent settlement provisions, such as those that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event, are compound financial instruments with a liability and equity components (i.e., an entity applies both sets of requirements in paragraph 25 and paragraphs 28-30 of IAS 32).

Measurement of financial instruments with contingent settlement provisions

68 EFRAG also welcomes the IASB's clarification that financial liabilities arising from a financial instrument with a contingent settlement provision and the liability component of a compound financial instrument with contingent settlement provisions should be initially measured at the present value of the settlement, where the settlement amount is discounted based on the assumption that settlement will occur at the earliest possible settlement date specified in the contract (even if IFRS 9 currently requires a financial liability to be recognised at fair value on initial recognition), as this is in line with existing principles in IAS 32 and provides relevant information to users (i.e., would reflect that immediate settlement may be required).

69 However, there could be a contingent settlement feature or a liability component, which can include the existence of caps, that has a higher value than the entire consideration that was received by the entity when it issued the instrument (for example, when the instrument is contingent on an event that is unlikely to happen). EFRAG is not clear on how this interacts with the current proposals and requests clarity on the accounting treatment of the difference between the full obligation amount (that can be higher than the consideration received) and the consideration received when the entity issued the instrument.

70 On subsequent measurement of financial instruments with contingent settlement provisions, EFRAG notes that there are different views on whether the liability should remain measured at the full amount of the conditional obligation subsequently or whether the probability and estimate of the timing of the contingent event occurring should be considered. Some see the benefits of the IASB's approach on subsequent measurement where an entity is required to measure the liability at the present value of the redemption

amount and ignore the probability and estimated timing of the counterparty exercising that redemption right. Such an approach has the benefit of being consistent with initial measurement requirements by not introducing significant changes to current requirements and not adding complexity to the measurement calculation, as it would involve significant judgement, continuous reassessment and additional costs to preparers. However, there are also stakeholders who consider that it is preferable to measure the liability that arises from hybrids at a probability-weighted amount as the market prices of the financial instruments consider probabilities, and it is the basis for the amortised cost accounting. Considering this, EFRAG includes a question for its constituents below on measurement.

Accounting for discretionary payments

71 EFRAG welcome the IASB's clarification that payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero.

72 However, EFRAG considers that the IASB's proposals have to be properly linked to the IASB's proposals on disclosures and presentation requirements to ensure that users understand why related payments of interest are recognised as dividends (i.e., within equity)

73 In addition, EFRAG highlights that if the payments at the discretion of the issuer are recognised as equity, then an entity cannot hedge the interest payments made in a foreign currency. This could be a problem for entities that issue these instruments in a currency that is different from its functional currency.

Other clarifications

74 In general, EFRAG welcomes the IASB's clarifications of the terms 'liquidation' and 'non-genuine'. Nonetheless,

(a) on the meaning of 'liquidation', considering that different jurisdictions have different requirements for the liquidation process (different stages and may take significant time until completing close of business), the IASB should clearly explain the meaning of the process for permanently ceasing operations (e.g., how it interacts with resolution and administration processes and also how it interacts with insolvency) as this may impact classification of instruments; and,

(b) on the meaning of 'non-genuine', it might be useful to link this clarification to the concepts of 'not being legally enforceable' and 'not substantive' and to see how 'non-genuine' is used in other IFRS Standards.

Questions to constituents

75 Do you have concerns that the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would ignore probability? Please explain.

76 From the IASB's proposals, do you expect a classification change on how payments to holders are recognised in the financial statements (in the statement of profit or loss or equity)? Will such a change affect your hedge accounting?

77 Do you consider that the clarifications of the terms 'liquidation' and 'non-genuine' are sufficient? If not, what issues remain?

Question 5 – Classification: Shareholder discretion

Notes to constituents – Summary of proposals in the ED

78 In applying paragraph 19 of IAS 32 to classify a financial instrument as a financial liability or an equity instrument, an entity considers whether it has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. In some cases, the settlement is at the discretion of the entity's shareholders. For example, an entity might issue preference shares that require the entity to pay coupons, which are subject to ordinary shareholders' approval.

79 Currently, there is diversity in practice regarding whether to treat a shareholder decision as an entity decision and how shareholder decision-making rights affect whether the entity that has an unconditional right to avoid delivering cash or another financial asset.

80 The ED sets out factors that an entity would be required to consider in assessing whether shareholder decisions are treated as entity decisions (paragraph AG28A of IAS 32 in the ED).

81 *An entity will need to consider relevant factors when assessing whether a particular shareholder decision is treated as an entity decision and whether the factors proposed in paragraph AG28A of IAS 32 in the ED are not exhaustive. The weightings applied to each factor in making that assessment depend on the specific facts and circumstances. Different factors might provide more persuasive evidence in different circumstances.*

Question 5

The IASB proposes:

(a) to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions (paragraph AG28A).

(b) to describe the factors an entity is required to consider in making that assessment, namely whether:

> (i) a shareholder decision would be routine in nature—made in the ordinary course of the entity's business activities;
>
> (ii) a shareholder decision relates to an action that would be proposed or a transaction that would be initiated by the entity's management;
>
> (iii) different classes of shareholders would benefit differently from a shareholder decision; and
>
> (iv) the exercise of a shareholder decision-making right would enable a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) (paragraph AG28A(a)–(d)).

(c) to provide guidance on applying those factors (paragraph AG28B).

Paragraphs BC116–BC125 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

82 EFRAG, in its comment letter to the 2018 DP, suggested that the IASB should consider developing further guidance on what is in the control of the entity, which can be complex in practice. EFRAG also suggests considering making an assessment based on 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).

83 Nevertheless, EFRAG highlights the difficulty and subjectivity of developing guidance on how to determine whether the shareholders are acting in their individual capacity or as

part of the entity's operating and corporate governance processes. Any proposed factors should help preparers in reaching a conclusion on whether the shareholder's decision should be treated as a decision of the entity or of the shareholder, and the outcome should be clear.

84 EFRAG, at this stage, is unsure of the outcome of the four factors and will conduct testing to gather evidence on the impact of the factors.

85 In addition, EFRAG considers that paragraph 122 IAS 1, whereby an entity should disclose its significant accounting policies that have the most significant effect on the amounts recognised in the financial statements, would help provide transparency to users on the judgements made in making the assessment of whether a shareholder decision is treated as a decision of the entity.

Questions to constituents

86 Do you expect changes in classification from the IASB proposals, particularly changes to the classification of financial instruments from equity to liability? What would cause these expected changes to classification?

87 Where local regulation or law is not clear about whether shareholders are part of the governance of the entity, should the IASB consider

(a) mandating a particular treatment, thereby not leaving room for judgement in order to avoid lack of comparability, or

(b) leaving room for judgement based on proposed factors and, if so, which other factors (in addition to those given by the IASB) should be considered? Please explain.

Question 6 – Classification: Reclassification of financial liabilities and equity instruments

Notes to constituents – Summary of proposals in the ED

88 Currently, IAS 32 has no general requirements on reclassification between financial liabilities and equity instruments. Questions arise in practice on whether IAS 32 permits or requires reclassification after initial recognition where there has been no modification to the contract.

89 The IASB is proposing to prohibit reclassification unless paragraph 16E of IAS 32 applies or the substance of the contractual arrangement changes because of a change in circumstances that are external to the contractual arrangement, e.g., a change in an

entity's functional currency or a change in an entity's group structure (paragraphs 32B – 32C of IAS 32 in the ED).

90 *For cases where reclassification is allowed, as described above, the entity should apply the reclassification prospectively from the date in which the change in circumstances occurs (paragraphs 32D of IAS 32 in the ED).*

91 *As per the Basis for Conclusions, there are three approaches to reclassifying a financial instrument as a financial liability or as an equity instrument after initial recognition. One of them was requiring reclassification of the instrument for all changes in the substance of the contractual arrangement. However, the IASB considered that under this approach, an entity would be required to assess at each reporting date, for each financial instrument issued, whether there has been a change in substance that affects whether the instrument meets the definition of a financial liability or an equity instrument at that date. The Board concluded that this approach would require a fundamental change to the current approach in IAS 32 and that it is, therefore, beyond the scope of this project (paragraph BC139 of the Basis for Conclusions to the ED).*

Question 6

The IASB proposes:

(a) to add a general requirement that prohibits the reclassification of a financial instrument after initial recognition, unless paragraph 16E of IAS 32 applies or the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement (paragraphs 32B–32C).

(b) to specify that if the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement, an entity would:

(i) reclassify the instrument prospectively from the date when that change in circumstances occurred.

(ii) measure a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification would be recognised in equity.

(iii) measure an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification. No gain or loss would be recognised on reclassification (paragraph 32D).

> (c) provide examples of changes in circumstances external to the contractual arrangement requiring reclassification (paragraph AG35A).
>
> Paragraphs BC126–BC164 of the Basis for Conclusions explain the IASB's rationale for these proposals.
>
> Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.
>
> Would the proposal to reclassify the instrument prospectively from the date when a change in circumstances occurred give rise to any practical difficulties? If so, please describe those practical difficulties and the circumstances in which they would arise.

EFRAG's response

92 EFRAG welcomes the IASB's efforts to address the issue of lack of guidance on reclassification in IAS 32.

93 However, EFRAG expresses concerns on the prohibition to reclassify 'passage-of-time changes' and instead requires disclosures on terms and conditions that become, or stop being, effective with the passage of time. If this disclosure is useful for users of financial statements, EFRAG questions why it is not relevant that the instrument be reclassified if the change from passage of time is such that the reason why it was classified, for example as a financial liability, is no longer applicable.

94 For the above reason, and also because reclassification for 'passage-of-time changes' would reflect the substance of the contractual terms for the remaining life of the instruments, EFRAG suggests allowing reclassification if there are changes to the effective terms and conditions of the financial instruments.

95 In addition, EFRAG acknowledges that there is some guidance in paragraph 32C related to what 'external to the contractual arrangement' means. However, we are unclear as to whether this also means as per law and regulation.

96 Furthermore, if there are substantial modifications made to a financial liability, there is guidance in IFRS 9 on how to deal with these modifications. However, if there are substantial modifications made to an equity instrument or a compound instrument, it is unclear to EFRAG what requirements to apply. EFRAG considers that guidance or clarification on this would be helpful.

Question 7 – Disclosures

Notes to constituents – Summary of proposals in the ED

General comments and scope of IFRS 7

97 *EFRAG will be conducting an extensive field-test and a simplified survey and will organise/attend outreach events with various stakeholders during the consultation period of EFRAG's draft comment letter to gather input on IASB proposals including disclosures.*

98 *The IASB is proposing to expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its current and potential ownership structures are (paragraph 1(c) of IFRS 7 in the ED).*

99 *In addition, the IASB is proposing to include disclosure requirements for compound financial instruments (paragraph 17A of IFRS 7 in the ED).*

Financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in its net assets

100 *Stakeholders had commented that fair value gains are recognised if an entity underperforms, and fair value losses are recognised when an entity performs well. The IASB considered that recognising those changes in other comprehensive income would represent a fundamental change to the requirements in IAS 32, which is outside the scope of the FICE project (paragraph BC181 of the Basis for Conclusions of the ED).*

101 *The IASB concluded that financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in its net assets would generally be measured at fair value through profit or loss. Therefore, for these financial liabilities, the IASB is proposing to separately disclose gains or losses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in its net assets (paragraph 20(a)(i) of IFRS 7 in the ED).*

102 *In the IASB's view, if any of these instruments are measured at amortised cost, the proposed disclosure requirements in the 2023 Exposure Draft: Amendments to the Classification and Measurement of Financial Instruments (see paragraphs 20B and 20C[4] of proposed*

[4] *20B To help users of financial statements understand the effect of contractual terms that could change the timing or amount of contractual cash flows based on the occurrence (or non-occurrence) of a contingent event that is specific to the debtor, an entity shall disclose*

(a) a qualitative description of the nature of the contingent event;

amendments to IFRS 7 in that Exposure Draft) would provide the information needed by users of financial statements.

The nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments

103 *The IASB is proposing to require an entity to group claims arising from financial liabilities and equity instruments within the scope of IAS 32 into classes of claims based on their contractual nature and priority on liquidation and to provide some disclosures at a minimum, for example, by distinguishing between subordinated and unsubordinated claims (paragraphs 30A- 30B of IFRS 7 in the ED).*

104 *In addition, illustrative guidance is provided depicting one of the ways in which an entity might disclose in its financial statements the nature and priority of claims on liquidation arising from its financial liabilities and equity instruments (paragraphs IG14A–IG14C of the Illustrative Examples and Implementation Guidance on the ED).*

The terms and conditions of financial instruments with both financial liability and equity characteristics

105 *Users of financial statements have asked for more information about how the terms and conditions affect the nature, amount, timing and uncertainty of cash flows arising from complex financial instruments, with characteristics of both financial liability and equity, to be issued by an entity. Therefore, the IASB is proposing the following.*

106 *Paragraph 30D of IFRS 7 reflects that an entity shall disclose*

(a) *the terms and conditions of financial instruments that determine their classification as financial liabilities or equity instruments and*

(b) quantitative information about the range of changes to contractual cash flows that could result from those contractual terms; and

(c) the gross carrying amount of financial assets and the amortised cost of financial liabilities subject to those contractual terms.

20C An entity shall disclose the information required by paragraph 20B separately for each class of financial assets measured at amortised cost or fair value through other comprehensive income and for each class of financial liabilities measured at amortised cost. The entity shall consider how much detail to disclose, the appropriate level of aggregation or disaggregation and whether users of financial statements need additional explanations to evaluate any quantitative information disclosed.

(b) *cash flow characteristics not representative of classification, including*

(i) *'debt-like characteristics' for instruments classified as equity instruments and*

(ii) *'equity-like characteristics' for instruments classified as financial liabilities.*

107 Paragraphs B5B–B5G of IFRS 7 provide guidance on debt-like characteristics and equity-like characteristics.

(a) *An **equity instrument with debt-like characteristics** has contractual terms with cash flows that are similar to those of a financial liability but without a contractual obligation to deliver cash. An equity instrument with debt-like characteristics has terms and conditions that*

(i) *might result in payments to the instrument holder of fixed amounts or determinable amounts based on a market rate of interest on specified dates, despite the issuer's contractual right to avoid or defer making those payments before its liquidation;*

(ii) *incentivise the issuing entity to make payments to the instrument holder of fixed amounts or determinable amounts based on a market rate of interest on specified dates, despite the issuer's contractual right to avoid making those payments before its liquidation;*

(iii) *include a contractual right for the issuer to choose whether to settle the instrument in either a fixed amount of cash or a fixed number of its own equity instruments at a specified date; or that*

(iv) *include a contractual right for the issuer to redeem a perpetual instrument after a specified number of years for a fixed amount of a specified currency.*

(b) *A **financial liability with equity-like characteristics** has contractual terms with cash flows that are similar to those of ordinary shares. A financial liability with equity-like characteristics has terms and conditions that either*

(i) *will or might result in payments to the instrument holder of amounts that are variable or indeterminable or that might not occur on specified dates or*

(ii) *allow the issuer, or include a contractual obligation for the issuer, to settle the instrument by delivering its own equity instruments to the instrument holder.*

(c) *In addition, paragraph B5G of IFRS 7 specifies that both quantitative and qualitative information on debt-like and equity-like characteristics should be provided.*

108 Illustrative guidance is provided depicting one of the ways in which an entity might disclose the terms and conditions of financial instruments with both financial liability and equity characteristics, including terms and conditions that indicate priority on liquidation for such instruments (paragraphs IG14D–IG14E of the Illustrative Examples and Implementation Guidance on the ED).

Priority on liquidation

109 Users of financial statements have specifically asked for more information about the priority of financial instruments with both financial liability and equity characteristics in the event of issuing the entity's liquidation. Therefore, the IASB is proposing an entity to disclose the following (paragraph 30E of IFRS 7):

(a) *the terms and conditions of financial instruments that indicate their priority on liquidation, including those that could lead to a change in priority on liquidation;*

(b) *information about the contractual subordination of instruments in a class of financial instruments if it differs from the contractual subordination of the other instruments in that class;*

(c) *information about any significant uncertainty about how laws or regulations applicable to financial instruments could affect their priority on liquidation; and*

(d) *a description (including the nature and amount if such information is available) of any intra-group arrangements, such as guarantees, that might affect the priority of these financial instruments on liquidation of the entity that has issued them.*

Terms and conditions that become, or stop being, effective with the passage of time

110 Paragraph 30F of IFRS 7 proposes that an entity should disclose information about terms and conditions of financial liabilities (including all stand-alone derivatives) that become, or stop being, effective with the passage of time before the end of the instrument's contractual term.

111 As per the Basis for Conclusions on the ED (paragraph BC219), the IASB considered that this disclosure requirement would help users of financial statements understand the nature, amount, timing and uncertainty of cash flows and other features of these types of financial instruments.

The potential dilution of ordinary shares

112 The IASB is proposing to require an entity to provide information that enables users of financial statements to understand the potential dilution to the entity's ownership structure

resulting from financial instruments issued at the reporting date. To meet this objective, an entity shall disclose information about the maximum dilution of ordinary shares (paragraph 30G of IFRS 7 in the ED). This information is to be set out in a table (to the extent possible) for each class of ordinary shares (paragraph 30H of IFRS 7 in the ED).

113 As per the Basis for Conclusions on the ED, the proposed disclosure requirements in the ED are not intended to duplicate or replace information already required by IAS 33. The proposed requirements would serve a different purpose and would set out different calculations to IAS 33. Nonetheless, entities that apply IAS 33 would be able to use some of the information already collated when preparing the proposed disclosures on the maximum potential dilution of ordinary shares (paragraph BC221-BC222 of Basis of Conclusions on the ED).

114 In addition, illustrative guidance is provided depicting one of the ways that an entity might disclose information about the potential dilution of its ordinary shares resulting from financial instrument (paragraphs IG14F–IG14H of the Illustrative Examples and Implementation Guidance on the ED).

Instruments that include obligations to purchase the entity's own equity instruments

115 In order to enable users of financial statements to understand the accounting for financial instruments that include an obligation for an entity to purchase its own equity instruments, the IASB is proposing that an entity should provide certain disclosures, for example, the amount removed from equity and included in financial liabilities on initial recognition of the obligation as a financial liability and the component of equity from which that amount was removed (paragraph 30J of IFRS 7 in the ED).

116 In addition, illustrative guidance is provided depicting one of the ways that an entity might disclose information about instruments that include obligations to purchase own equity instruments (paragraph IG14I of the Illustrative Examples and Implementation Guidance on the ED).

Question 7 - Disclosure

The IASB proposes:

(a) to expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its ownership structure is, including potential dilution to the ownership structure from financial instruments issued at the reporting date (paragraph 1).

(b) to delete the reference to derivatives that meet the definition of an equity instrument in IAS 32 from paragraph 3(a) of IFRS 7.

(c) to move paragraphs 80A and 136A from IAS 1 to IFRS 7. These paragraphs set out requirements for disclosures relating to financial instruments classified as equity in accordance with paragraphs 16A–16B and/or paragraphs 16C–16D of IAS 32 (paragraphs 12E and 30I). The IASB also proposes to expand paragraph 80A to cover reclassifications if there are changes in the substance of the contractual arrangement from a change in circumstances external to the contractual arrangement.

(d) to amend paragraph 20(a)(i) of IFRS 7 to require an entity to disclose gains or losses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in its net assets, separately from gains or losses on other financial liabilities in each reporting period.

(e) to include disclosure requirements for compound financial instruments in IFRS 7 (paragraph 17A).

The IASB proposes to require an entity to disclose information about:

(a) the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments (paragraphs 30A–30B);

(b) the terms and conditions of financial instruments with both financial liability and equity characteristics (paragraphs 30C–30E and B5B–B5H);

(c) terms and conditions that become, or stop being, effective with the passage of time (paragraph 30F);

(d) the potential dilution of ordinary shares (paragraphs 30G–30H and B5I–B5L); and

(e) instruments that include obligations to purchase the entity's own equity instruments (paragraph 30J).

Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with the proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

General comments

117 EFRAG welcomes the IASB's efforts on disclosures on the priority of claims on liquidation, information about terms and conditions, potential dilution and instruments that include obligations to purchase the entity's own equity instruments.

118 EFRAG considers that it is important to test these new disclosure requirements to ensure that they are clear and can be implemented by entities. It is also important to ensure that there is an adequate balance between the benefits to users of financial statements and the costs for preparers.

Response to the first part of questions (a) to (e)

119 There are currently no specific disclosure requirements in IFRS 7 with regard to an entity's issued equity instruments or equity components of compound instruments, and some related disclosures are currently included in IAS 1. Therefore, EFRAG supports the expansion of the objective of IFRS 7 and the inclusion of disclosures for these instruments in one place, i.e., in IFRS 7.

120 With the expansion of the objective, EFRAG agrees to the changes proposed for paragraph 3(a) of IFRS 7 and moving paragraphs 80A and 136A from IAS 1 to IFRS 7, as these relate to equity instruments.

121 Furthermore, EFRAG agrees with the proposed disclosure requirements for compound financial instruments at initial recognition. This is because these disclosures would provide users with clarity on which components were part of a compound instrument before separation.

The nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments

122 EFRAG welcomes the IASB's proposals on the nature and priority of claims against the entity on liquidation, which arise from the entity's financial liabilities and equity instruments, as this would provide more transparency for users of financial statements. Also, as per EFRAG's comment letter on the 2018 DP, users indicated that they need information on the priority of claims in the event of liquidation.

123 However, there are challenges associated with providing disclosures on an entity's contractual nature and priority on liquidation related to distinguishing between subordinated and unsubordinated claims:

(a) entities may face challenges determining whether priority stems from the contract or from related law/regulation. For example, in many jurisdictions such as Sweden

payments to the government have a higher priority; therefore, all other liabilities are subordinated regardless of the terms of the contract; and

(b) there are also other areas of complexity such as the legal structure of international groups. Whether or not an instrument is secured or subordinated will depend on regulatory requirements and local legislation. The legal framework may change depending on the jurisdiction where the instruments have been issued. Therefore, even though the IASB's proposals reflect minimum disclosures that are to be provided, EFRAG considers that it may be useful to also provide information based on subgroups if they are located in different jurisdictions (with different local legal requirements) and to provide information on how the structure of the group affects the priority on liquidation.

The terms and conditions of financial instruments with both financial liability and equity characteristics

124 EFRAG welcomes disclosures on the terms and conditions that determine classification as financial liabilities or equity instruments.

125 Furthermore, EFRAG welcomes the disclosures of 'debt-like' and 'equity-like' characteristics, which will provide useful information to users of financial statements. For example, for compound instruments with a zero-value equity component, these disclosures would help users to understand why payments are recognised as dividends.

126 EFRAG compares the debt-like characteristics with a typical debt instrument, which usually comprises principal and interest payments. The cash flows are usually either fixed amounts or determinable amounts based on a market rate of interest, which are payable on specified dates. The amount and timing of this instrument is similar to an equity instrument with debt-like characteristics even if the entity can avoid or defer those payments before its liquidation.

127 In addition, EFRAG compares equity-like characteristics with equity instruments; for example, distributions to ordinary shareholders are subject to the entity's discretion, and payments may be variable.

128 EFRAG will consult with its stakeholders to ask whether they agree with the debt-like characteristics and equity-like characteristics and whether there are other characteristics which should be considered.

129 Nonetheless, EFRAG notes that an entity should include both quantitative and qualitative information in its disclosure of debt-like and equity-like characteristics. Regarding a

compound instrument, if an entity chooses the fair value option for the financial liability and there is a derivative against it, but the entity is not exposed to the derivative component in the instrument itself, we question whether quantitative disclosures on the derivative component would provide useful information and suggest not to provide quantitative disclosures for the derivative component.

130 Also, EFRAG notes that there are no additional disclosures proposed on legal requirements that could affect the timing and amount of future cash flows of issued financial instruments. EFRAG considers that, for example, if a financial instrument is classified as equity but the effects of law changes that financial instrument to be debt-like, e.g., being converted into a variable number of shares in specific circumstances, disclosures describing these changes by law would provide useful information to users of financial statements.

Terms and conditions related to priority on liquidation

131 The interaction between the contractual terms and the law (e.g., bail-in instruments) has raised many challenges. Therefore, EFRAG welcomes the IASB's efforts to address the challenges with improvements on disclosures related to terms and conditions about priority on liquidation.

132 As stated in our response to Question 4 above, EFRAG welcomes the IASB's clarifications on the term 'liquidation'. However, it would be helpful for the IASB to clearly explain the meaning of 'process of permanently ceasing operations'.

133 Furthermore, for financial institutions EFRAG is not clear in which order to provide the disclosures on terms and conditions about priority on liquidation, i.e., based on resolution or based on liquidation. EFRAG has heard from its stakeholders that if not based on resolution, then the information would not capture the true risk that users of financial statements should be aware of. EFRAG reads the proposals such that the terms and conditions are based on priority of liquidation, but if resolution may impact that priority, then the entity may provide a narrative description of the change in priority. Therefore, the disclosures are not based on resolution per se, but if resolution can change priority on liquidation, this can be disclosed when providing the disclosures about priority on liquidation.

134 In addition, some user stakeholders indicated that that priority on liquidation would be particularly useful if it showed the capital and funding structure of the group.

Terms and conditions that become, or stop being, effective with the passage of time

135 We refer to our response to Question 6 above, whereby EFRAG expresses concerns on the prohibition to reclassify 'passage-of-time changes' while requiring disclosures on terms and conditions that become, or stop being, effective with the passage of time.

The potential dilution of ordinary shares

136 EFRAG welcomes the refinements the IASB made to the disclosures, in particular having more disclosures on potential maximum dilution of ordinary shares, as this will provide useful information to users of financial statements. We have heard from users that it would also be useful for the IASB to develop proposals for the users to know the maximum value of what would be contributed to ordinary equity by the conversion to shares in order to calculate the enterprise value.

137 EFRAG highlights the importance of having additional information about dilution for both listed and non-listed entities and having a better definition of dilution compared to IAS 33, as in practice it is not always clear what dilution is.

Instruments that include obligations to purchase the entity's own equity instruments

138 EFRAG welcomes the IASB's proposals because users of financial statements will obtain information about the entity's exposure to and management of liquidity risk.

Questions to constituents

139 Are there any significant operational concerns in providing the disclosure requirements? Please explain.

Terms and conditions of financial instruments with both financial liability and equity characteristics

140 Do you agree with the guidance provided on debt-like characteristics and equity-like characteristics (in paragraphs B5B–B5G of IFRS 7), including providing both quantitative and qualitative information? Please explain.

141 Do you consider that there are other characteristics which should be considered? Please explain.

Question 8 – Presentation of amounts attributable to ordinary shareholders

Notes to constituents – Summary of proposals in the ED

142 Users of financial statements need transparency about whether an entity has issued instruments (other than ordinary shares) classified as equity, preferably without having to

go through multiple notes made to the financial statements to piece together the information needed to calculate ratios.

143 *To satisfy users' needs, in its 2018 Discussion Paper the IASB discussed the possibility of introducing presentation requirements related to the attribution of profit or loss, other comprehensive income and net assets between ordinary shareholders and other equity holders. These attribution proposals related to derivatives and non-derivatives. However, the respondents disagreed with proposed distribution approaches.*

144 *Then, the IASB considered but rejected a proposal to present in the statement of comprehensive income profit attributable to non-controlling interests and dividends attributable to preference and other equity holders as line-item deductions from net profit for the year to arrive at profit attributable to ordinary shareholders.*

145 *After that, the IASB considered whether the requirements in IAS 1 could be read as requiring separate presentation of amounts related to ordinary shareholders and amounts related to other equity holders, and it concluded that amendments are required to meet the needs of investors in ordinary shares for transparency's sake and to make a clearer distinction between returns attributable to ordinary shareholders and returns attributable to others. These proposed amendments explicitly require presentation of amounts attributable to ordinary shareholders separately from that of other equity holders.*

146 *The proposed amendments to IAS 1 affect the statement of financial position, the statement of changes in equity, the statement of comprehensive income and the notes to the financial statements. The proposals also include new illustrative examples in the Implementation Guidance that accompanies IAS 1, showing additional line items and the use of columns to provide additional information while still presenting suitable subtotals.*

147 *The presentation of equity attributable to ordinary shareholders and other equity holders in the draft illustrative example is based on the contractual terms applicable at the reporting date. Therefore, reserves attributed to other equity holders do not include amounts expected to become attributable to those equity holders upon the occurrence of future events.*

Question 8 - Presentation of amounts attributable to ordinary shareholders (paragraphs 54, 81B and 107–108 of IAS 1)

The IASB proposes to amend IAS 1 to require an entity to provide additional information about amounts attributable to ordinary shareholders. The proposed amendments are that:

(a) the statement of financial position shows issued share capital and reserves attributable to ordinary shareholders of the parent separately from issued share capital and reserves attributable to other owners of the parent (paragraph 54);

(b) the statement of comprehensive income shows an allocation of profit or loss and other comprehensive income attributable to owners of the parent between ordinary shareholders and other owners of the parent (paragraph 81B);

(c) the components of equity reconciled in the statement of changes in equity include each class of ordinary share capital and each class of other contributed equity (paragraph 108); and

(d) dividend amounts relating to ordinary shareholders are presented separately from amounts relating to other owners of the entity (paragraph 107).

Paragraphs BC246–BC256 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Would the proposed requirement to allocate issued share capital and reserves between ordinary shareholders and other owners of the parent give rise to any practical difficulties in determining the required amounts? If so, please describe the possible difficulties and specify areas in which further guidance would be helpful.

EFRAG's response

148 EFRAG acknowledges the inherent limitations of any binary debt-equity split and therefore welcomes the IASB's efforts to improve the presentation of equity instruments.

149 EFRAG supports the IASB's proposal to separately present the amounts attributable to ordinary shareholders from other owners of the parent in the primary financial statements. It is fundamental for the users of financial statements to have information about multiple equity providers and financial instruments not aggregated in a single line. This will help them better understand how the proceeds will be distributed on the sale of a business and evaluate the ordinary shareholders' value.

150 EFRAG suggests, however, replacing the term 'other owners of the parent' by 'other equity providers' to reflect the fact that other equity providers could not necessarily be owners of the business.

151 In addition, EFRAG highlights that the new disaggregation requirements in the forthcoming IFRS 18 *General Presentation and Disclosure* are likely to improve disaggregation, including within equity.

152 However, EFRAG raises questions on the practical application of the IASB's proposals, for example, how the allocation to issued capital and reserves attributable to ordinary shareholders of the parent and those attributable to other owners of the parent should be performed on the statement of financial position and the statement of financial performance.

153 EFRAG notes that it will not always be an easy split, as there could be several subcategories within issued capital (with multiple classes of shares) and reserves, and there is diversity in practice on the presentation of items within equity (e.g., share premiums, retained earnings, dividend pushers and translation differences). Therefore, EFRAG considers that additional application guidance and illustrative examples would be useful to ease implementation (such as more detailed examples, including on how to allocate profit or loss to other owners of the parent, and whether this allocation should be done in accordance with IAS 33). For example, it could be application guidance and illustrative examples for instruments that pay a fixed rate coupon but the issuer has the right to defer payment until its liquidation, whether or not profit or loss and comprehensive income should be attributed to other owners of equity only when dividends/coupons are declared, or whether any unpaid amounts are required to be accumulated and attributed.

154 In EFRAG's view, the IASB's proposals would put pressure on the term 'ordinary shareholders', as there are cases in which it is difficult to assess whether a specific class of shareholder is considered as ordinary shareholders.

155 Furthermore, EFRAG welcomes the IASB's decision not to change the classification of perpetual instruments (financial instruments that contain obligations that only arise on liquidation of the entity classified as equity), which would otherwise require a significant change to current requirements in IAS 32 and could cause a market disruption (e.g., may cause early redemption, make it less attractive for issuers and increase their cost of capital). However, EFRAG considers that it would be useful to require entities, where material, to issue perpetual instruments to present them as a separate line item within equity in the statement of financial position and in a separate column in the statement of changes in equity.

Question to constituents

156 Considering the guidance provided by the IASB, will you be able to allocate profit or loss to 'ordinary shareholders of the parent' and 'other owners of the parent'?

Question 9 – Transition

Notes to constituents – Summary of proposals in the ED

157 The IASB proposes ***retrospective application*** *of the proposed amendments, which, in the IASB's view, would maximise the consistency of financial information between periods and also facilitate analysis and understanding of comparative information.*

158 The IASB considers that the benefits of retrospective application outweigh the costs because

(a) *these are* ***clarifying amendments*** *to the underlying principles in IAS 32 which do not fundamentally change any existing requirements;*

(b) *comparative information would help users of financial statements identify and assess changes and trends in an entity's liquidity and solvency. In addition, to minimise costs the IASB proposes* ***not to require the restatement of information for more than one comparative period even if an entity chooses or is required to present more than one comparative period in its financial statements****; and*

(c) *most information* ***would be readily available*** *to preparers through their current information technology systems.*

159 The IASB nevertheless acknowledges that applying the proposed clarifying amendments would mean that some entities would have to change their accounting policies. As a result, a retrospective change in classification might be required for some of their issued financial instruments. Some instruments currently classified as financial liabilities might have to be accounted for as equity instruments, and vice versa.

160 The IASB further acknowledges the difficulties entities might have if their financial instruments change their classification from equity instruments to financial liabilities on initial application of the proposed amendments. For example, hindsight might be required to determine the effective interest rate or to apply the effective interest method in IFRS 9 retrospectively. The IASB is therefore proposing ***specific transition requirements for equity instruments required to be classified as financial liabilities****.* ***If it is impracticable (as defined in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors) to apply the effective interest method in IFRS 9 retrospectively, the fair value at the transition date***

would be treated as the amortised cost of the financial liability at that date *(paragraph 97X of the proposed amendments).*

161 In addition, the IASB proposes ***not to require separating a compound financial instrument with a contingent settlement provision into separate liability and equity components if the liability component is no longer outstanding at the date of initial application of the proposed amendments*** *(paragraph 97W of the proposed amendments). If the proposed amendments were applied retrospectively, a compound instrument with a contingent settlement provision that could require settlement on a specified date in the future would have to be separated into liability and equity components from the instrument's inception. For some instruments, the liability component might no longer be outstanding at the date of initial application of the proposed amendments and, consequently, separating these compound financial instruments would be of little benefit because retrospective application would involve separating two components of equity. Such an approach is similar to the transition requirements in IFRS 1 First-time Adoption of International Financial Reporting Standards and in paragraph 97C of IAS 32.*

162 The IASB proposes specific transition disclosures if there has been a change in classification resulting from initial application of the proposed requirements. The IASB concluded that ***information about the nature and amount of changes in the reporting period*** *would be particularly beneficial to users of financial statements (paragraph 97Z of the proposed amendments).*

163 The IASB also proposes that entities are ***not required to disclose the quantitative information that would otherwise be required by paragraph 28(f) of IAS 8*** *(paragraph 97Y of the proposed amendments). In the IASB's view, the cost of providing this disclosure would exceed the benefits, particularly because clarifying the underlying principles in IAS 32 could affect many line items in the financial statements due to the current diversity in how the requirements in IAS 32 are applied in practice to complex financial instruments.*

164 The IASB ***is not proposing any specific transition requirements in relation to IAS 34 Interim Financial Reporting for interim financial reports*** *issued within the annual period in which an entity first applies the proposed amendments. The entities will, therefore, be required to apply judgement on what information to disclose.*

165 The IASB is also ***not proposing additional transition requirements for first-time adopters****. Paragraph D18 of IFRS 1 allows for an exemption from the requirement to split a compound financial instrument into separate liability and equity components if the liability component is no longer outstanding at the date of transition to IFRS Accounting Standards.*

Furthermore, paragraph B8C of IFRS 1 contains a transition exemption if it is impracticable (as defined in IAS 8) for an entity to apply the effective interest method in IFRS 9 retrospectively. This exemption is similar to the transition requirements proposed for entities already applying IFRS Accounting Standards and, therefore, no further transition exemption is necessary for first-time adopters.

Question 9 - Transition (paragraphs 97U–97Z of IAS 32)

The IASB proposes to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information (a fully retrospective approach). However, to minimise costs, the IASB proposes not to require the restatement of information for more than one comparative period, even if the entity chooses or is required to present more than one comparative period in its financial statements.

For an entity already applying IFRS Accounting Standards, the IASB proposes:

(a) to require the entity to treat the fair value at the transition date as the amortised cost of the financial liability at that date if it is impracticable (as defined in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors) for the entity to apply the effective interest method in IFRS 9 Financial Instruments retrospectively (paragraph 97X);

(b) not to require the entity to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application (paragraph 97W);

(c) to require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments (paragraph 97Z);

(d) to provide transition relief from the quantitative disclosures in paragraph 28(f) of IAS 8[5] (paragraph 97Y); and

[5] Paragraph 28(f) of IAS 8 states: 'When initial application of an IFRS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose

> . . . (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment: (i) for each financial statement line item affected; and (ii) if IAS 33 Earnings per Share applies to the entity, for basic and diluted earnings per share . . .

(e) no specific transition requirements in relation to IAS 34 Interim Financial Reporting for interim financial statements issued within the annual period in which the entity first applies the amendments.

For first-time adopters, the IASB proposes to provide no additional transition requirements.

Paragraphs BC262–BC270 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Would the proposal to apply the proposed amendments retrospectively give rise to any other cases in which hindsight would be necessary? If so, please describe those cases and the circumstances in which the need for hindsight would arise.

EFRAG's response

166 EFRAG agrees that full retrospective application of the proposed amendments will enhance consistency and facilitate the analysis of the financial information by the users of financial statements.

167 Nevertheless, EFRAG considers that despite proposed amendments being clarifying amendments which do not fundamentally change the existing requirements, in practice they may require more changes to the classification of financial instruments than originally envisaged. As a result, the impact of the fully retrospective approach should be carefully assessed in terms of timing and cost-benefit analysis.

168 EFRAG welcomes the IASB's efforts in this respect aimed at minimising the costs for preparers by providing several reliefs and simplifications of transition requirements, such as

(a) not requiring the restatement of information for more than one comparative period;

(b) allowing to consider fair value at the transition date as the amortised cost of the financial liability if it is impracticable to apply the effective interest method in IFRS 9, respectively;

(c) not requiring separation of the liability and equity components if the liability component of a compound financial instrument was no longer outstanding at the date of initial application; and

(d) providing the exemption from quantitative disclosures in paragraph 28(f) of IAS 8.

169 In addition, EFRAG recommends the IASB to explore an optional transition relief to not apply the fully retrospective approach to instruments that do not exist at the time of initial application of the amendments, similar to the approach taken in other recent IFRS Accounting Standards. For example, paragraph 7.2.1 of IFRS 9 provides similar transitional relief whereby entities shall not apply IFRS 9 requirements to items that have already been derecognised at the date of initial application. Due to the fact that in practice the IFRS 9 transition relief had some operational challenges, EFRAG suggests that this relief could be optional.

170 Furthermore, EFRAG suggests that entities applying hedge accounting should not apply the fully retrospective approach because this could give rise to accounting mismatches, which would not reflect the performance of the entity. For example, for hybrid instruments that had been accounted as financial liabilities and whose interest rate risk has been hedged, if interest is recognised in equity upon transition, retrospective application would give rise to open derivatives with fair value changes that would impact profit or loss, thereby causing accounting mismatches. This situation will not result in useful information provided to the users of financial statements.

171 Upon transition, if reclassification occurs because of a change in circumstances external to the contractual arrangement (please refer to Question 6 for more details), EFRAG suggests providing information for the prior comparative period based on reclassified terms and conditions of a financial instrument.

172 EFRAG also notes that a full retrospective approach could have an impact on prior year coefficients linked to debt/equity ratios due to the reclassifications between financial liabilities and equity.

173 Therefore, EFRAG considers that the entities should be given sufficient time to implement the requirements of the ED, especially taking into account a full retrospective transition approach.

Question to constituents

174 Do constituents have any concerns on suggested retrospective transition requirements in addition to the ones described above? If so, please describe your concerns and provide suggested solutions.

Question 10 – Disclosure requirements for eligible subsidiaries

Notes to constituents – Summary of proposals in the ED

175 *The IASB is planning to issue the new IFRS Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures] before the amendments proposed in this Exposure Draft are finalised. This new IFRS Accounting Standard proposes reduced disclosure requirements for the eligible subsidiaries*[6] *without public accountability.*[7] *Therefore, the IASB applied the principles used to develop the reduced disclosure requirements to the proposed disclosure requirements in this ED. These principles (paragraph BC 34 of the Basis for Conclusions on the Exposure Draft Subsidiaries without Public Accountability: Disclosures) are listed below.*

(a) *Users of financial statements of [eligible subsidiaries] are particularly interested in information about cash flows and about obligations, commitments or contingencies, whether or not recognised as liabilities. Disclosures in full [IFRS Accounting Standards] that provide this sort of information are necessary for [eligible subsidiaries] as well.*

(b) *Users of financial statements of [eligible subsidiaries] are particularly interested in information about liquidity and solvency. Disclosures in full [IFRS Accounting Standards] that provide this sort of information are necessary for [eligible subsidiaries] as well.*

(c) *Information about measurement of uncertainties is important for [eligible subsidiaries].*

(d) *Information about an entity's accounting policy choices is important for [eligible subsidiaries].*

(e) *Disaggregation of amounts presented in an [eligible subsidiary's] financial statements is important for understanding those financial statements.*

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[6] An eligible subsidiary is not publicly accountable and has an ultimate or intermediate parent that produces consolidated financial statements available for public use that comply with IFRS Accounting Standards.

[7] An entity has public accountability if *(a)* its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or *(b)* it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (most banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks would meet this criterion).

(f) *Some disclosures in full [IFRS Accounting Standards] are more relevant to investment decisions in public capital markets than to the transactions and other events and conditions encountered by typical [eligible subsidiaries].*

176 Applying the principles for reducing disclosures involves exercising judgement. As a result, for example, not all disclosure requirements of IFRS 7 will be applicable to eligible subsidiaries.

177 In the IASB's view, the interest of users of eligible subsidiaries' financial statements in short-term cash flows means that ***disclosures are necessary on equity-like and debt-like features*** *(IFRS 7 paragraphs 30C, 30D, B5B-B5F and paragraphs BC203–BC215 of the BC on this ED)* ***and on passage-of-time changes*** *(IFRS 7 paragraphs 30F and paragraph BC219 of the BC on this ED). Proposed requirements for* ***instruments containing obligations to purchase own equity instruments*** *(IFRS 7, paragraph 30J and paragraph BC243 of the BC on this ED) and* ***financial liabilities with contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets*** *(IFRS 7, paragraph 20(a)(i) and paragraphs BC181–BC189 of the BC on this ED) address users' need for information on* ***disaggregation****, and the disclosure requirements on* ***significant judgements*** *(IFRS 7 paragraph B5A and paragraphs BC244–BC245 of the BC on this ED) provide information about an entity's accounting policies.*

178 The IASB concluded that the proposed disclosures on ***the nature and priority of claims against an entity on liquidation*** *(IFRS 7 paragraphs 30A, 30B and paragraphs BC191–BC201 of the BC on this ED) and* ***terms and conditions about priority on liquidation*** *(IFRS 7 paragraphs 30E, B5H and paragraphs BC216–BC218 of the BC on this ED) are both helpful to users of eligible subsidiaries' financial statements because they relate to an entity's liquidity and solvency.*

Question 10 - Disclosure requirements for eligible subsidiaries (paragraphs 54, 61A–61E and 124 of [IFRS XX])

The IASB proposes amendments to the draft Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures], which will be issued before the proposals in the Exposure Draft are finalised.

[IFRS XX] will permit eligible subsidiaries to apply the recognition, measurement and presentation requirements in IFRS Accounting Standards with reduced disclosures.

The IASB's proposals select appropriate disclosure requirements from those proposed for IFRS 7, based on the IASB's agreed principles for reducing disclosures.

Paragraphs BC257–BC261 explain the IASB's rationale for the selected disclosures.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why, taking into consideration the reduced disclosure principles described in BC258.

EFRAG's response

179 EFRAG notes that the consideration of reduced disclosure requirements for eligible subsidiaries in the scope of the forthcoming draft Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures] will be a part of any future amendments to existing IFRS Accounting Standards or a new IFRS Accounting Standard where disclosure requirements are amended, added or deleted.

180 Therefore, EFRAG welcomes the IASB's considering whether the reduction of the proposed disclosure requirements is warranted for eligible subsidiaries within the scope of the forthcoming draft Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures] applying the principles described in the paragraph BC 34 of the Basis for Conclusions on the Exposure Draft *Subsidiaries without Public Accountability: Disclosures*.

181 However, EFRAG highlights that IASB is requesting comments on consequential amendments to a future IFRS Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures] that had not yet been issued or endorsed in the EU. Therefore, the endorsement of the Amendments resulting from this ED, or at least a part of them related to the reduced disclosures, is conditional on the outcome of the EU endorsement process of the future IFRS Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures].

182 EFRAG further notes that financial institutions, including insurance companies, are out of the scope of the forthcoming IFRS Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures]. This means that their subsidiaries applying IFRS Accounting Standards would have to provide a comprehensive package of new disclosure requirements on financial liabilities and equity required by this ED without any reduction.

183 EFRAG notes that the user profile of the subsidiaries without public accountability is different from the one of publicly traded entities and agrees with the IASB that users of eligible subsidiaries' financial statements are first interested in the information about short-term cash flows, obligations, commitments and contingencies and about liquidity and solvency.

184 EFRAG agrees that disclosures of terms and conditions of the financial instruments with debt- and equity-like features, together with the nature and priority of claims on liquidation, provide necessary information about the short-term liquidity and solvency of the entity. EFRAG highlights that the above proposed disclosures are not reduced by the IASB (paragraphs 30A–30F of IFRS 7).

185 EFRAG also agrees that separate disclosure of gains or losses recognised on financial liabilities with contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets (IFRS 7, paragraph 20(a)(i)), together with disclosures on financial instruments containing obligations to purchase own equity instruments (IFRS 7, paragraph 30J), cover user needs on disaggregation of information for such instruments. EFRAG highlights that these disclosures are not reduced by the IASB.

186 The ED does not require eligible subsidiaries to disclose information about reclassification, compound financial instruments, potential dilution of ordinary shares and puttable instruments. EFRAG considers that such information is less relevant to the users of financial statements of eligible subsidiaries and agrees with the IASB's proposal.

187 EFRAG refers to its detailed comments and concerns expressed in the full set of the proposed disclosure requirements in Question 7 and notes that they remain valid for subsidiaries without public accountability.

188 EFRAG generally agrees with the IASB's proposals, which seem to be a fair balance between costs and benefits related to disclosing relevant information. Nonetheless, EFRAG is planning to make a cost-benefit analysis of the reduced disclosures during the consultation period, particularly on disclosures on the nature and priority of claims on liquidation.

Question to constituents

189 Do constituents consider that the proposed reduced disclosure requirements for subsidiaries without public accountability, and in particular disclosures on the nature and priority of claims on liquidation, strike a balance between costs for preparers and benefits for the users of financial statements?