EFRAG Financial reporting

Financial Instruments with Characteristics of Equity

Survey on the IASB's Exposure Draft ED/2023/5

Introduction and Objective

1 In close coordination with the European National Standard Setters, EFRAG will conduct field testing of the IASB's proposals included in the Exposure Draft ED/2023/5 *Financial Instruments with Characteristics of Equity* ('ED'), which was published in November 2023.

2 The purpose of the survey is to provide information on the expected effects of the application of the IASB's proposals on the classification, presentation, disclosures and transition of an entity's existing financial instruments to identify potential implementation and application concerns, to determine whether there is a need for additional guidance, and to estimate the efforts required to implement and apply the IASB's proposals.

3 This survey covers the IASB's proposals on classification, disclosures, presentation and transition.

Timeline

4 The deadline to fill out the survey is **8 March 2024**.

5 Results from this survey will be used as input for EFRAG's comment letter, and a summary report of the survey will be published on EFRAG's website. Any information included in the comment letter or summary report will not disclose to readers identifying data about individual participants. EFRAG currently has published its draft comment letter on 15 January 2024, with a comment period deadline of 20 March 2024.

What are participants expected to do?

6 Participants are asked to perform a qualitative assessment of the expected impacts of the IASB's proposals on classification, presentation, disclosures and transition and to identify any potential implementation and application concerns, including whether there is a need for additional guidance. The relevant questions for participants to answer are found in Appendix 1. In addition, should participants be ready to share any quantitative information, especially in the most material areas, such a contribution would be highly appreciated.

7 Participants are not required to respond to all questions of the survey. Whilst EFRAG would be eager to obtain feedback on as many elements as possible, participants are invited to focus on the issues which they find the most relevant. For information purposes, Appendix 2 provides a list of financial instruments that may be impacted by the IASB's proposals.

8 Participants may provide a technical analysis to support their view, to the extent possible.

EFRAG Secretariat availability

9 If you have any technical questions or would like to receive more information, please contact Sapna Heeralall (sapna.heeralall@efrag.org) and Sergey Vinogradov (sergey.vinogradov@efrag.org).

Appendix 1: Survey questions

Introduction and general description

1 Please provide the following details:

(a) the name of the entity you are responding on behalf of:

(b) the country where the head office is located:

(c) contact details, including e-mail address:

(d) the type of entity:

☐ Bank

☐ Insurer

☐ Financial conglomerate

☐ Corporate

☐ Other; please specify

Classification

Questions that relate to all IASB proposals on classification

The below questions relate to:

- The effects of relevant laws and regulations;
- Financial instruments settled in own equity instruments – the 'fixed-for-fixed' condition;
- Obligation to purchase an entity's own equity instruments (e.g., written put-options on non-controlling interests);
- Financial instruments with contingent settlement provisions;
- Shareholders' discretion; and
- Reclassification between financial liabilities and equity instruments.

2 Are the IASB's proposals understandable, i.e., whether the principles and the terminology of the ED are sufficiently clear and therefore no further guidance is needed from the IASB?

☐ Yes

☐ No

☐ Partly

Please explain.

3 Do you expect any classification changes? If so, please explain the impact of classification including the reasons for the change in classification and explain any challenges you expect, if any.

Type of instrument	Impact on classification including reasons for change in classification	Expected challenges, if any

4 Do you expect any unintended consequences? Please explain.

The effects of relevant laws and regulations (Question 1 of the ED)

5 Do you consider that the IASB should address Mandatory Tender Offers (MTOs)[1]? Please provide your reasons.

6 There are some loans or banking saving deposits in a jurisdiction where all key parameters are highly regulated by law or regulation. The IASB's proposals on the effects of laws and regulations indicate that only contractual rights and obligations that are *in addition* to those created by relevant laws or regulations are considered in classifying a financial instrument or its component part. Since, there are no contractual rights and obligations in addition to the law and regulation, some stakeholders consider that there may be unintended consequences whereby these products would be classified as equity in the entity's financial statements (instead of a financial liability) or being excluded from the scope of IFRS 9 / IAS 32.

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

☐ Yes

☐ No

☐ Not sure

Financial instruments settled in own equity instruments – the 'fixed-for-fixed' condition in IAS 32 (Question 2 of the ED)

In order to meet the fixed-for-fixed condition, in general, a derivative contract is required to include a fixed exchange ratio - the amount of consideration to be exchanged per equity instrument delivered does not vary. For example, if a derivative contract will be settled by delivering an amount of CU100 in exchange for 20 ordinary shares - in other words, the exchange ratio is fixed at CU5 per share (paragraph BC 35 of the Basis for Conclusions).

[1] An MTO is when an entity acquires a specified level of shareholding in another entity, laws in many jurisdictions require the acquirer to offer to purchase some or all outstanding shares of the acquiree held by the other shareholders

7 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 predetermined dates? If so, how pervasive would these classification changes be?

Obligation to purchase an entity's own equity instruments (e.g., written put-options on non-controlling interests) (Q3 of the ED)

An example is a variable number of the parent's shares which might be transferred to settle the group's obligation to purchase the subsidiary's shares from holders of non-controlling interests.

Initial recognition of the obligation to redeem an entity's own equity instruments

8 Currently, how are financial instruments with obligations to purchase an entity's own equity instruments accounted for, for e.g., written put options on non-controlling interests?

9 Do you support the IASB's proposals on gross presentation, 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 rights and returns associated with ownership of those equity instruments? Please explain.

☐ Yes

☐ No

(a) Are there other alternatives that the IASB should consider? For example:

(i) an entity initially recognising a financial liability for the redemption amount with the debit side going against non-controlling interests (instead of against parent's equity) if the NCI holder retains access to the rights and returns associated with ownership of the equity instruments; or

(ii) a net presentation resulting in the recognition of a stand-alone derivative measured at fair value.

Please explain your reasons.

(b) With reference to the alternative in Question 9 (a)(i), at initial recognition, if the redemption amount exceeds the NCI balance, where do you consider the difference between the redemption amount and the NCI balance to be recognised? Please explain.

10 What features do you consider in determining if an entity has access to the rights and returns associated with ownership of the equity instruments?

Subsequent measurement

11 Assuming that the gross presentation is retained, do you consider that changes to the carrying amount of the liability of written put options to non-controlling interest holders should be presented

☐ (a) in profit or loss (as proposed by the IASB). Please explain.

☐ (b) within equity (on the basis that it is a transaction with owners in their capacity as owners), for example split between NCI and other equity. Please explain.

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

12 Assuming that the net approach is adopted, 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 the derivative stems from a transaction with owners in their capacity as owners)?

Please explain your choice.

Financial instruments with contingent settlement provisions (Question 4 of the ED)

13 Do you consider whether measurement of a financial liability (or a liability component) arising from a contingent settlement provision should reflect the probability and estimated timing of occurrence of the contingent event on and after initial recognition?

☐ Yes

☐ No

Please explain.

14 What are your views on initial measurement of the financial liability (or a liability component) arising from a contingent settlement provision that does not take into account probability and estimated timing of occurrence of the contingent event and is greater than the consideration received?

15 Do you consider that existing risk management practices may be impacted by the IASB's proposals?

☐ Yes

☐ No

Please explain.

16 From the IASB's proposals, do you expect classification changes on how payments to holders (related to discretionary dividends/coupons) are recognised in the financial statements (in the statement of profit or loss or equity)? Will such changes affect your hedge accounting?

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

☐ Yes

☐ No

Shareholders' discretion (Question 5 of the ED)

18 Do you agree with the factors being proposed in paragraph AG28A of the ED?

☐ Yes

☐ Partially agree

☐ No – the IASB should mandate a particular accounting treatment, thereby not leaving room for judgment

☐ No – would prefer judgment based on different factors other than those proposed by the IASB

Please explain your reasons.

19 What other factors should be considered? Do you think some of the proposed factors should not be considered? If so, which ones? Explain your reasons.

Reclassification between financial liabilities and equity instruments (Question 6 of the ED)

An example of a change resulting from the passage of time is an entity issuing a put option in an instrument that allows the holder to put the instrument back to the entity for a fixed amount of cash during only the first three years of the instrument's life. If the put option expires unexercised at the end of the three years, there would be no reclassification as per the IASB's proposals.

An example of a change resulting from a change in circumstances external to the contractual arrangement is an entity issuing an instrument that will be settled by the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash denominated in the entity's functional currency. If the entity's functional currency changes, it would affect the substance of the contractual arrangement for that specific instrument (the instrument will now be settled in a foreign currency).

20 Are there reclassifications that you have currently or in the past made for passage of time changes that would no longer be allowed when applying the IASB's proposals?

21 Do you consider it clear whether and how to assess a change in circumstances external to the contractual arrangement for compound instruments and instruments currently classified as equity? Please explain your reasons.

☐ Yes

☐ No

22 Do you agree with the IASB's proposals not to reclassify a financial liability or an equity instrument 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? Please explain why.

Note that there are disclosure requirements for an entity to disclose information about terms and conditions that become, or stop being, effective with the passage of time.

(a) If you do not agree with the prohibition to reclassify 'passage-of-time changes', do you consider that it would be significantly costly to assess at each reporting date whether an instrument would be reclassified? Please explain why.

Disclosures of financial instruments (Question 7 of the ED)

Questions that relate to all IASB proposals on disclosures (except for disclosures on subsidiaries without public accountability)

The below questions are related to disclosures on:

- The nature and priority of claims against an entity on liquidation;
- Terms and conditions of financial instruments with both financial liability and equity characteristics;
- Terms and conditions for priority on liquidation;
- Potential dilution; and
- Obligations to redeem own equity instruments.

23 Are the proposed disclosure requirements understandable, i.e., whether the disclosure requirements are sufficiently clear and therefore no further guidance is needed from the IASB?

☐ Yes

☐ No

Please explain.

24 Do you expect significant operational issues when providing these disclosure requirements?

☐ Yes

☐ No

Please explain.

25 Do you have other significant concerns with providing these disclosure requirements? What additional guidance would be helpful (if any)? Please explain.

☐ Yes

☐ No

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

26 Do you agree with the guidance provided on debt-like characteristics and equity-like characteristics in paragraphs B5B–B5G of IFRS 7 in the ED, including providing both quantitative and qualitative information?

☐ Yes

☐ Partly agree

☐ No

Please explain.

27 Do you consider that there are other debt-like characteristics and equity-like characteristics that should be considered? Please explain.

Debt-like characteristics	
Equity-like characteristics	

Presentation (Question 8 of the ED)

Presentation of equity instruments, including obligations that arise only on liquidation (e.g., perpetual instruments)

28 Considering the guidance provided by the IASB, do you expect significant difficulties in making an allocation between 'ordinary shareholders of the parent' and 'other owners of the parent' in the statement of financial position, the statement of comprehensive income and statement of changes in equity? Please explain.

☐ Yes

☐ No

29 In your jurisdiction, do you anticipate any issues due to the interaction of the IASB's proposals with regulatory requirements on presentation of equity? Please explain.

Transition (Question 9 of the ED)

Fully retrospective approach

30 Do you agree with the retrospective application of the IASB's proposals with the restatement of information for one comparative period?

☐ Yes

☐ No

Please explain.

31 Are there other significant concerns on transition that need to be considered? Please explain.

Disclosures for subsidiaries without public accountability ('SWPA') (Question 10 of the ED)

32 Do you consider that the proposed reduced disclosure requirements for subsidiaries without public accountability (disclosure requirements in paragraphs 54, 61A–61E and 124 of Amendments to IFRS XX *Subsidiaries without Public Accountability: Disclosures* in the ED) and, in particular, the 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?

Appendix 2: List of financial instruments

1 Presented below are non-exhaustive lists of financial instruments that may be impacted by the IASB's proposals.

2 We have segregated the instruments into instruments where potential issues have already been identified in EFRAG's comment letter and other instruments.

Instruments that may be impacted

3 When completing the survey, please pay special attention to the instruments where potential issues have already been identified (e.g., please refer to EFRAG's draft comment letter), notably to the following instruments:

(a) written put options on non-controlling interests,

(b) bail-in instruments (AT1/RT1 instruments),

(c) instruments with legal obligations to pay dividends,

(d) mandatory tender offers and

(e) instruments with contingent settlement provisions.

4 Also, below is a more comprehensive list of instruments that may be in scope of the IASB's proposals:

(a) common share;

(b) perpetual preferred share;

(c) share issued by a limited life entity;

(d) general partnership interest;

(e) limited partnership interest;

(f) ownership instrument that is redeemable at the option of the holder (other than upon retirement or death);

(g) ownership instrument that is required to be redeemed if an uncertain event occurs;

(h) ordinary share with a required dividend;

(i) ordinary share with a substantive registration rights penalty;

(j) preferred share convertible into variable number of ordinary shares at the option of the holder;

(k) preferred share that is required to be converted into a variable number of ordinary shares on a specific date or event that is certain to occur (other than death or retirement);

(l) instrument issued by a cooperative that gives the holder the right to request redemption, but the cooperative can refuse that request;

(m) instrument issued by a cooperative that must be redeemed upon the holder's death, retirement or decreased participation;

(n) instrument that converts mandatorily on a specific date or event that is certain to occur (other than death or retirement) into a variable number of share instruments with a fixed monetary amount (for example, share-settled debt);

(o) physically (gross) settled written call option;

(p) net-share-settled written call option;

(q) physically (gross) settled employee stock option;

(r) physically (gross) settled instruments that give the holder the right to acquire a fixed number of the entity's own equity instruments at a fixed price (a rights issue) denominated in a currency that is not the entity's functional currency (for example, that assumes that the options were offered prorata to all existing shareholders);

(s) net-cash-settled written call option;

(t) net-cash- or net share-settled forward purchase contract at a fixed price;

(u) physically settled forward purchase contract;

(v) prepaid forward purchase contract for a fixed number of shares;

(w) net-cash- or net share-settled written put option;

(x) physically settled written put option;

(y) prepaid written put option for a fixed number of shares;

(z) convertible debt for fixed number of shares;

(aa) share redeemable at the option of the issuer (callable share);

(bb) preferred share convertible into a fixed number of ordinary shares at the option of the holder;

(cc) preferred share required to be converted into a fixed number of ordinary shares;

(dd) preferred share puttable, callable and convertible;

(ee) note receivable settled with cash or a variable number of shares; and

(ff) debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash).