This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG-CFSS. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG-CFSS. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Financial Instruments with Characteristics of Equity
Cover Note

Objective

1 The objective of the session is to provide EFRAG TEG-CFSS members an educational session on the IASB Discussion Paper *Financial Instruments with Characteristics of Equity* and inform EFRAG TEG-CFSS members that EFRAG is planning to develop outreach events during the consultation period.

Introduction

2 The IASB's discussions on the Financial Instruments with Characteristics of Equity (FICE) project started in May 2015 and lasted until January 2018. With the publication of the Discussion Paper, the IASB will need to decide whether to add a project to amend IAS 32 *Financial Instruments: Presentation* and whether any further changes are needed to the Conceptual Framework.

3 In the past, the IFRS Interpretations Committee ("IFRS IC") received several submissions related to the application challenges of IAS 32 and in many cases, it was unable to reach a conclusion. The IFRS IC referred these issues to the IASB as the challenges identified required discussion of fundamental concepts in IFRS Standards. The IASB initially tried to address the challenges related to the distinction between equity and liability within its Conceptual Framework project. The IASB finally decided to address these issues within the FICE research project, where both the conceptual and application issues can be addressed at the same time.

4 To address the IFRS IC issues, the IASB discussed potential improvements to the classification, presentation and disclosure requirements of financial instruments under the scope of IAS 32, including the possibility of making amendments to the definitions of liabilities and equity in the Conceptual Framework.

Summary of the IASB discussion paper

5 The IASB's Discussion Paper has 8 sections which address different topics:

Section 1: Objective, scope and challenges	The DP describes the objective of the project, its scope and the application challenges that arise with IAS 32. Subsequently, the IASB asks whether these challenges are pervasive enough to require standard-setting activity
Section 2: the IASB's preferred approach	The DP explains that under the IASB's preferred approach a claim would be classified as liability if an entity **has to transfer economic resources before liquidation** (timing) and/or the claim is for an **amount that is independent of the entity's available economic resources** (amount). Other features of claims (e.g. priority) would be

	provided through presentation and disclosures. This is the key principle that guides the classification of both non-derivatives and derivatives.
Section 3: Classification of non-derivative financial instruments	The DP explains how the new classification principle applies to non-derivative instruments. In particular, it provides guidance on when an amount is independent of the entity's available economic resources' and explains that the classification outcomes are broadly the same as in IAS 32. However, there will be classification changes that result from updating IAS 32 requirements, such as non-derivatives that have cumulative features (e.g. cumulative preference shares would be classified as liabilities under the IASB's preferred approach). The IASB also explains that the existing puttable exception would still apply.
Section 4: Classification of derivative financial instruments	Under the IASB's preferred approach, a derivative on own equity would be classified as a liability if it is **net-cash settled** (timing feature) and/or the **net amount is affected by a variable that is independent of the entity's available economic resources** (amount feature). Therefore, once IAS 32 is updated, derivatives settled in a foreign currency would be classified as a financial liability, including those that currently meet the foreign currency rights issue exception (strict form of the fixed-for-fixed condition). This also means that fixed-for-fixed net-share settled derivatives would be classified as equity. Finally, the DP provides guidance on when a net amount of a derivative is affected by a variable that is independent of the entity's available economic resources.
Section 5: Compound instruments and redemption obligation arrangements	The DP explains how the IASB's preferred approach would apply to compound instruments and instruments that have a redemption obligation (e.g. NCI written put). In particular, it explains the importance of recognising the redemption obligation amount. In addition, the IASB provides additional guidance on the accounting within equity, particularly when an entity issues NCI puts. For compound instruments and instruments that contain alternative settlement at the entity's option, the IASB generally retains current requirements but explores ways of providing additional information.
Section 6: Presentation	The DP proposes that financial liabilities and derivative assets/liabilities for which the amount is not independent of the entity's available economic resource (e.g. shares redeemable at fair value) should be separately presented in the statement of financial position and statement of financial performance (in other comprehensive income without recycling). The DP also discusses alternative approaches for derivatives for which the **net amount is partly independent of the entity's available economic resources** (e.g. foreign currency option on own shares). Finally, the DP discusses whether it should require separate presentation for all embedded derivatives. For financial instruments classified as equity, the DP proposes the attribution of comprehensive income to ordinary shares and equity instruments other than ordinary shares (statement of financial performance) and use of that attribution to update the carrying amount of equity instruments other than ordinary shares (statement of

	financial position). The DP provides different approaches for the attribution of non-derivatives and derivative financial instruments.
Section 7: Disclosures	The DP explores possible improvements to disclosure requirements for priority of claims on liquidation, potential dilution of ordinary shares and terms and conditions of financial instruments.
Section 8: Contractual terms	The DP proposes that economic incentives should not affect the classification of financial instruments, that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained and that the classification of claims should only be based on the contractual terms of a financial instrument (and not consider the law).

Next steps

6 EFRAG is planning to issue a Draft Comment Letter in Q3 of 2018 and subsequently start outreach activities with interested standard setters during the public consultation period. EFRAG Secretariat invites you to express interest in co-hosting an outreach event and would be happy to receive suggestions on topics that are the most relevant for discussion in the outreaches.

Questions for EFRAG TEG-CFSS members

7 Do EFRAG TEG-CFSS members have any overall comment on the IASB Discussion Paper?

Agenda Papers

8 In addition to this cover note, agenda paper *14-02 ASAF 00 FICE Ed session-July 2018 - TEG-CFSS 18-07-04* has been provided for the session.