Financial Instruments with Characteristics of Equity
Cover Note

Objective

1 The objective of the session is to:

(a) obtain the initial views of EFRAG CFSS members on IASB's Discussion Paper *Financial Instruments with Characteristics of Equity* (the Discussion Paper) issued in June 2018*;*

(b) provide a summary of EFRAG's Draft Comment Letter (DCL) to EFRAG CFSS members; and

(c) provide EFRAG TEG-CFSS members with an update about the planning and organisation of the outreach events.

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. In June 2018, the IASB issued the Discussion Paper on the distinction between liabilities and equity. After the end of the comment period, the IASB will consider whether to add a project to amend IAS 32 *Financial Instruments: Presentation* and whether any changes are needed to the Conceptual Framework.

3 EFRAG Secretariat last discussed this topic with EFRAG TEG-CFSS during an educational session on FICE held on 4 July.

4 EFRAG published its Draft Comment Letter on 28 August 2018, with a comment period that ends on 3 December 2018.

Summary of the IASB's Discussion Paper

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

Section 1: Objective, scope and challenges	This section 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. See slide 4 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 2: the IASB's preferred approach	This section discusses the IASB's preferred approach to the classification of financial instruments based on its analysis of various features of claims, including the proposed 'timing' and

	‘amount’ features. See slide 5 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 3: Classification of non-derivative financial instruments	This section explains how the IASB’s preferred approach for the classification of financial instruments applies to non-derivative instruments. See slide 6 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 4: Classification of derivative financial instruments	This section explains how the IASB’s preferred approach for the classification of financial instruments applies to derivatives on own equity. See slide 7 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 5: Compound instruments and redemption obligation arrangements	This section explains how the IASB’s preferred approach would apply to compound instruments and instruments that have a redemption obligation. See slide 8 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 6: Presentation	This section discusses potential improvements to presentation of financial instruments to address the existing limitations of a binary approach. In particular it discusses the presentation in OCI of gains/losses for particular subclasses of financial liabilities and the attribution of comprehensive income to subclasses of equity. See slides 9 and 10 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 7: Disclosures	This section explores possible improvements to disclosure requirements for priority of claims on liquidation, potential dilution of ordinary shares and terms and conditions of financial instruments. See slide 11 of agenda paper 11-02 *Debt and Equity Distinction* for more details.
Section 8: Contractual terms	This section discusses whether economic incentives and effects of law should affect the classification of financial instruments. See slide 12 of agenda paper 11-02 *Debt and Equity Distinction* for more details.

Summary of the main positions included in the EFRAG Draft Comment Letter

6 In its draft comment letter, EFRAG welcomes the Discussion Paper and the IASB’s efforts to address the application issues and other challenges related to IAS 32 and clarify its underlying principles in the process.

7 EFRAG considers that the application issues that arise with IAS 32 are pervasive enough to require standard-setting activity and welcomes the IASB’s efforts to respond to challenges in distinguishing financial liabilities from equity instruments.

8 EFRAG also welcomes the fact that the IASB’s preferred approach considers a number of EFRAG’s past requests. However, EFRAG has reservations over some of the proposals in the Discussion Paper, including:

(a) the balance of costs and benefits of the information provided by attributing comprehensive income to subclasses of equity;

(b) separate presentation in the statement of financial position and statement of financial performance for partly independent derivatives;

(c) accounting for standalone derivatives to extinguish an equity instrument on a basis consistent with accounting for a compound instrument;

(d) the proposed removal of the foreign currency rights issue exemption; and

(e) classification changes for financial instruments that, to EFRAG's knowledge, do not raise concerns in practice today.

9 More generally, EFRAG notes that the approach in the Discussion Paper introduces completely new terminology. EFRAG acknowledges that a better articulation of IAS 32's underlying principles could be an effective way to improve the consistency, clarity and completeness of the requirements and would require new terminology. However, new terminology would also require preparers and auditors to reconsider some past classification decisions. Accordingly, this approach, while addressing various interpretive issues, will also cause some disruption, create additional costs for preparers and risks of the emergence of new issues and uncertainties. In EFRAG's view a careful weighing of the potential benefits of a better articulation of the principles in IAS 32 against the potential risks of unnecessary disruption and unintended consequences is essential.

10 Finally, EFRAG considers that the IASB should further analyse the possibility of accounting for all standalone and embedded derivatives as derivative assets and liabilities under the scope of IFRS 9 *Financial Instruments.*

11 A more detailed presentation of EFRAG's views can be found in agenda paper 11-02 *Debt and Equity Distinction*.

Questions for EFRAG TEG-CFSS members

12 Do EFRAG TEG-CFSS members have any preliminary comments on the IASB's Discussion Paper?

13 Do EFRAG TEG-CFSS members have any preliminary comments on the main positions included in the EFRAG Draft Comment Letter?

Update on EFRAG outreach activities

14 During its consultation period, EFRAG will reach out to national standard setters, users of financial statements, preparers, regulators, business associations and other accounting experts to:

(a) raise awareness about the IASB's discussions on the FICE project and EFRAG's DCL;

(b) confirm whether the IASB has identified all the main challenges and problems with the requirements in IAS 32; and

(c) test whether the new (or newly articulated) principles can be applied in practice and will solve the issues that currently arise in practice.

15 During its consultation period, EFRAG will also reach out to constituents to obtain data for its early stage impact analysis of the proposals. The draft comment letter includes questions to constituents on the potential impact of the IASB's preferred approach. EFRAG will use this information to help develop an early stage impact analysis of the proposals, the outcome of which will be reflected in EFRAG's final comment letter.

16 During the outreach events, EFRAG is suggesting to discuss the main elements of the IASB's Discussion Paper and EFRAG's Draft Comment Letter. The discussion in the events could be guided by and focused on topics such as:

(a) What are the main challenges in distinguishing debt from equity?

(b) What is the best approach to this project: a fundamental review, a narrow scope amendment or something in between?

(c) What is your view on the trade-off between the benefits of a better articulation of the principles in IAS 32 against the risks of disruption of new terminology?

(d) Should both the 'timing' and the 'amount' features be used when distinguishing equity from debt?

(e) Is it relevant to classify financial instruments that are only settled on liquidation (e.g. cumulative preference shares) as debt?

(f) What are the most common types of equity instruments other than ordinary shares in your jurisdiction?

(g) What is the expected impact of the Discussion Paper on classification outcomes?

(h) To what extent is the puttable instruments exception used in practice? What are the application challenges that arise with this exception?

(i) Should all derivatives on own equity be classified at FVPL under IFRS 9 *Financial Instruments* together with disclosures on their maturity under IFRS 7 *Financial Instruments: Disclosures*?

(j) Is it useful to present income and expenses for instruments such as own shares and NCI redeemable at fair value in OCI? Without recycling?

(k) Do the benefits of the information provided by the attribution approaches described in the Discussion Paper exceed the related costs?

(l) Is there a need for additional guidance and/or disclosures on the distinction between contractual and legal obligations (e.g. for bail-in instruments)?

17 Each co-host of an outreach event can identify the topics that are most relevant for its constituency. In order to issue a ‘Save the Date’ document, the selected topics will be put in a more 'catchy’ and attractive language.

18 Several national standard setters and user organisations have already expressed their interest in hosting a joint outreach event with EFRAG. EFRAG has also received invitations to speak at conferences about its DCL on FICE proposals.

19 EFRAG Secretariat hopes that other national standard setters will be interested in co-organising an outreach with EFRAG.

Questions for EFRAG TEG-CFSS members

20 Are EFRAG TEG-CFSS members interested in co-hosting an outreach event with EFRAG?

Agenda Papers

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

(a) 11-02 *Debt and Equity Distinction* - TEG-CFSS 18-09-26; and

(b) 11-03 ASAF 01 *Financial Instruments with Characteristics of Equity* - TEG-CFSS 18-09-26 – for background only.

22 The IASB Discussion Paper *Financial Instruments with Characteristics of Equity* can be accessed here.

23 EFRAG Draft Comment Letter on the IASB Discussion Paper *Financial Instruments with Characteristics of Equity* can be accessed here.