Financial Instruments with Characteristics of Equity
Cover Note

Objective

1 The objective of the session is to discuss and approve EFRAG draft comment letter to the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity* (FICE), issued by the IASB on 28 June 2018 (the DP).

Background

2 On 30 May 2018, the EFRAG Board received an update on the objective and scope of the IASB's FICE project, the key challenges that arise with IAS 32 *Financial Instruments: Presentation*, the IASB's key tentative decisions at that date and a summary of EFRAG TEG discussions.

3 On 28 June 2018, the IASB published its DP focused on potential improvements to the classification, presentation and disclosure requirements of financial instruments with characteristics of equity.

4 On 22 July 2018, the EFRAG TEG started its discussions on the IASB's DP and on 8 August 2018 it agreed to recommend a draft comment letter to the EFRAG Board (agenda paper 06-02).

Summary of the main provisions contained in the IASB DP

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
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.
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.
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.

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.
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.
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.
Section 8: Contractual terms	This section discusses whether economic incentives and effects of law should affect the classification of financial instruments.

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

6 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 DP, 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 bases 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 DP 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 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.*

EFRAG's Project Plan

11 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:

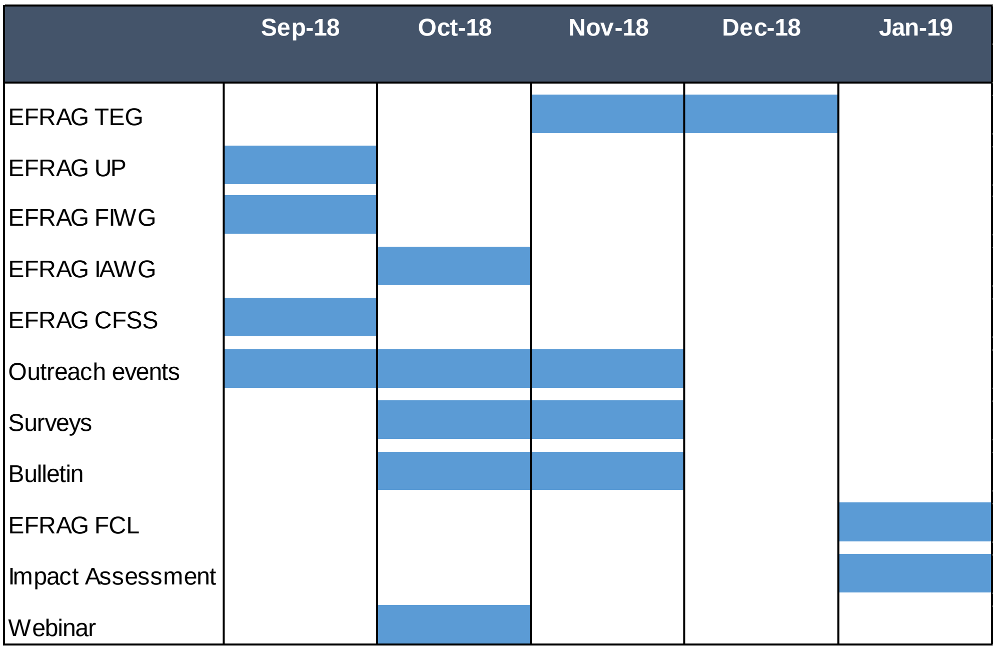
(a) raise awareness about the IASB's discus(sions on FICE and EFRAG's DCL;

(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.

12 EFRAG Secretariat expects to use a number of different tools for its outreach activities, including the use of webinars, outreach events, questionnaires/surveys, group meetings and bulletins. The EFRAG Secretariat also plans to discuss the interaction between the IASB's Discussion Paper and prudential requirements during its consultation period.

13 Finally, during its consultation period, EFRAG will also reach out to its constituents to obtain data for its early stage impact analysis of the proposals. EFRAG TEG has already included in the draft comment letter 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.



Questions for EFRAG Board

14 Does EFRAG Board approve EFRAG draft comment letter?

15 Does EFRAG Board have comments on EFRAG's project plan?

Agenda Papers

16 In addition to this cover note, agenda paper 06-02 – *EFRAG Draft Comment Letter* – has been provided for the session.