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## 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 open the relevant news item and click on the 'Comment publication' link at the end of the news item.**

**Comments should be submitted by [date].**

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United Kingdom

[XX Month 201X]

Dear Mr Hoogervorst,

### **Re: Discussion Paper Financial Instruments with Characteristics of Equity**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* ('FICE'), issued by the IASB on 30 June 2018 (the 'DP').

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

EFRAG welcomes the IASB' Discussion Paper and the IASB's efforts to address the current application and conceptual issues related to IAS 32 *Financial Instruments: Presentation* and clarify its principles in the process. EFRAG acknowledges that 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 IASB also tried to address the conceptual challenges related to the distinction between equity and liability within its Conceptual Framework project but decided to further explore how to distinguish between liabilities and equity in its FICE research project.

This is in line with **EFRAG's recommendation** in its comment letter to the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* that the IASB should undertake a comprehensive discussion on how to distinguish financial liabilities from equity instruments, from both conceptual and practical perspectives, including what this distinction means and is attempting to portray. In particular, EFRAG asked the IASB to:

- retain the binary split between liabilities and equity and define equity as the residual that is not directly measured;
- address issues that arise in practice such as the accounting for non-controlling interest written put options ('NCI puts'), application of the fixed-for-fixed condition, the role of economic compulsion when the entity has alternative settlement options, the counter-intuitive accounting that arises with financial instruments for which the amount depends on the entity's own performance, and implementation issues with paragraphs 16A to 16F of IAS 32; and
- provide more information about different classes of equity and potential dilution.

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 better articulate the principles for the classification of financial instruments as liabilities and equity instruments with the objective of improving the consistency, completeness and clarity of the requirements in IAS 32 and to respond to challenges in distinguishing financial liabilities from equity instruments.

In particular, EFRAG welcomes the fact that the IASB's preferred approach:

- retains the use of a binary split between liabilities and claims on equity;
- defines equity as 'the residual interest in the assets of the entity after deducting all of its liabilities';
- attempts to improve the presentation and disclosure requirements to address the challenges that arise from a binary approach, particularly on the equity side; and
- provides additional guidance related to the accounting for NCI puts, application of the fixed-for-fixed condition, the role of economic compulsion when the entity has alternative settlement options, the counterintuitive accounting that arises with instruments for which the amount depends on the entity's own performance.

However, EFRAG also has various reservations over some of the proposals in the DP, which are explained in detail in Appendix 1. In summary, these reservations relate to:

- the balance of costs and benefits of the information provided by the attribution approaches (i.e. attributing total income and expense to equity instruments other than ordinary shares and updating the carrying amounts of equity instruments based on that attribution);
- separate presentation in the statement of financial position and statement of financial performance derivatives, embedded derivatives and hybrids for which the net amount is affected by variables that are both independent and dependent on the entity's available economic resources ('partly independent derivatives');
- accounting for standalone derivatives to extinguish an equity instrument consistently with a compound instrument, in particular to account for the implicit equity conversion feature in a written put option on own shares in the same way as a written call option or conversion option in a convertible bond (currently an entity recognises the premium received as the equity component, which reflects the fair value of the written put option at the date of recognition);
- the proposed removal of the foreign currency rights issue exemption (the introduction of which arose from the strict manner in which IAS 32's 'fixed-for-fixed' criterion has been interpreted). EFRAG acknowledges that the exemption creates conceptual inconsistencies but considers that its removal or retention should be based on an evaluation of whether the concerns that led to its introduction remain relevant. The DP seems to suggest replacing a classification exception with a presentation exception. Alternatively, EFRAG considers that the IASB should

discuss whether the criteria in paragraph 6.34 of the DP for separate presentation in OCI could be used for these instruments to be classified as equity; and

- classification changes for financial instruments that currently, to EFRAG's knowledge, do not raise concerns in practice. If any new approach brings about such changes this should be justified by a clear explanation of why it leads to a better accounting outcome (e.g. net-share settled derivatives).

More generally, EFRAG notes that the preferred approach set out in the DP involves the introduction of completely new terminology. EFRAG understands that practices have developed over time in the application of IAS 32 in areas where detailed guidance is lacking (e.g. application of the 'fixed-for-fixed' criterion). If IAS 32's terminology is replaced with new terminology and/or new articulations of the underlying concepts, preparers and auditors would need to reconsider past practices in various areas including some that are not currently considered problematic. Accordingly, the DP's approach will cause some disruption and, while addressing various interpretive issues, creates a risk of new issues and uncertainties. In EFRAG's view a careful evaluation of the balance 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 therefore essential.

Finally, during the IASB's consultation period EFRAG will reach out to its constituents to better understand the impact of the DP's proposals. EFRAG will use this information to develop an early stage impact analysis of the proposals, the outcome of which will be reflected in EFRAG's final comment letter.

EFRAG's detailed comments and responses to the questions in the DP are set out in the Appendix 1. This letter also includes Appendix 2 *Glossary*, Appendix 3 *How the IASB proposals address the issues that arise in practice* and Appendix 4 *Preliminary impact assessment on the IASB's preferred approach*.

If you would like to discuss our comments further, please do not hesitate to contact Filipe Camilo Alves or me.

Yours sincerely,

Jean-Paul Gauzès  
**President of the EFRAG Board**

**Question to EFRAG TEG**

- 1 Does EFRAG TEG agree with the drafting of the cover letter of the Draft Comment Letter to the IASB Discussion Paper *Financial Instruments with Characteristics of Equity*?
- 2 Do EFRAG TEG members recommend this Draft Comment Letter to the Board?

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**Key messages for EFRAG TEG members**

<p><b>1. Objective, scope and challenges with IAS 32</b></p>	<ul style="list-style-type: none"> <li>• EFRAG welcomes the IASB project and highlights the importance of the project.</li> <li>• EFRAG considers that IAS 32 is not fundamentally broken and agrees that the IASB should not start from a blank sheet. EFRAG also welcomes the IASB intention to make a comprehensive review of IAS 32 without fundamentally changing the accounting outcomes of IAS 32.</li> <li>• 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 better articulate the principles for the classification of financial instruments as liabilities and equity instruments with the objective of improving the consistency, completeness and clarity of the requirements in IAS 32 and responding to challenges in distinguishing financial liabilities from equity instruments.</li> <li>• EFRAG welcomes the IASB discussions, particularly on presentation and disclosures. EFRAG considers that improvements to presentation and disclosures are currently needed and constitute a significant part, or even the most important part, of this project.</li> <li>• EFRAG lists a number of general concerns, including that FICE is an ambitious project (particularly when considering the attribution requirements; and the level of impact that the whole new model may have on a significant number of IFRS standards)</li> <li>• <i>Question to constituents: Are constituents aware of any other challenges with IAS 32 that have not been identified by EFRAG and the IASB?</i></li> </ul>
<p><b>2. The Board’s preferred approach to classification based on the various features</b></p>	<ul style="list-style-type: none"> <li>• EFRAG welcomes the IASB’s discussions on improving classification. In particular, welcomes the fact that the IASB retains a binary approach, defines equity as residual, identifies relevant features for classification and that the IASB has clarified that the classification is from an entity’s perspective.</li> <li>• However, EFRAG expresses a number of concerns on the IASB’s approach on the use of a complete new terminology and highlights the challenges that typically arise when setting a new terminology. In EFRAG’s view a careful evaluation of the balance 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. .</li> <li>• EFRAG agrees with reasons to reject the previous IASB’s approaches, including those in the DP on CF.</li> <li>• <i>No question to constituents</i></li> </ul>
<p><b>3. Classification of non-derivative financial instruments</b></p>	<p><i>Classification of a non-derivative financial instrument as a liability</i></p> <ul style="list-style-type: none"> <li>• EFRAG welcomes separate classification principles for derivatives and non-derivatives, similarly to what we have in IAS 32.</li> <li>• EFRAG refers to the application challenges with non-derivatives: puttable instruments, instruments that depend on entity’s own performance (e.g. shares redeemable at fair value) and non-derivatives with complex payoffs.</li> <li>• EFRAG notes that classification results are largely the same. Nonetheless, the classification outcomes for some instruments might differ from those applying IAS 32 because of the differences arising from clarifying the rationale and from the amount feature. The amount feature is partly an articulation of IAS 32’s ‘fixed number of shares’ criterion, and partly a new criterion. It will therefore affect some IAS 32 classification outcomes (e.g. cumulative preference shares, cumulative undated bonds) that, to EFRAG’s knowledge, are not considered problematic at present.</li> <li>• EFRAG considers that it would be useful to have separate guidance and explanations, similar to IAS 32, on how the IASB’s preferred approach should be applied when the financial instruments are settled with the issuer’s own equity instruments. In particular, when there is an obligation to deliver a variable number of equity instruments equal to a specified amount and to receive a variable number of shares equal to specified amount.</li> </ul>

	<ul style="list-style-type: none"> <li>• EFRAG welcomes the IASB’s preferred approach on non-derivative financial instruments with alternative outcomes and considers that the classification outcomes will remain largely the same for these types of non-derivative financial instruments.</li> <li>• EFRAG recommends the IASB to better clarify the meaning of <i>cannot exceed the entity’s available economic resources</i> and which types of instrument are subject to such guidance.</li> <li>• EFRAG recommends the IASB to discuss whether presentation and disclosures requirements could be improved based on the idea of subclasses of equity, which could be based on whether financial instruments will or may be settled in the issuer’s own equity instruments.</li> <li>• EFRAG has some specific concerns on the use of a new terminology, particularly on the notion of ‘an amount independent of the entity’s available economic resources’.</li> <li>• <i>Question to constituents: What are the most common non-derivative financial instruments other than ordinary shares in your jurisdiction?</i></li> </ul> <p><i>Puttables exception</i></p> <ul style="list-style-type: none"> <li>• EFRAG welcomes the IASB decision to retain the exception as the new IASB approach does not solve all the issues that gave rise to the exception.</li> <li>• EFRAG considers that the IASB should take the opportunity to understand to what extent the exception is used in practice, the application challenges and look for improvements.</li> <li>• <i>Question to constituents: To what extent the "puttable instruments and obligations arising on liquidation" exception in paragraph 16A-16D is being used in your jurisdiction?</i></li> <li>• <i>Question to constituents: What entity types are using this exception the most in your jurisdiction? (e.g. partnerships, limited life entities, co-operatives, etc)?</i></li> </ul>
<p><b>4. Classification of derivative financial instruments</b></p>	<p><i>Classification of derivatives on own equity other than those that include an obligation to extinguish an entity’s own equity instruments</i></p> <ul style="list-style-type: none"> <li>• EFRAG highlights that many of the application challenges are related to the classification of derivatives on own equity (fixed-for-fixed, redemption amounts, accounting within equity). Therefore, EFRAG welcomes the IASB efforts to provide guidance that would address these issues without fundamentally changing the classification outcomes.</li> <li>• The IASB discussed whether all (embedded) derivatives should be classified as derivative assets and liabilities under the scope of IFRS 9 <i>Financial Instruments</i>. Considering the benefits of such an approach (e.g. simplifying significantly the existing requirements in IAS 32 on derivatives on own equity) EFRAG considers that it is important to have stakeholders’ views on this issue and understand the impact of having all (embedded) derivatives classified as derivative assets and liabilities.</li> <li>• EFRAG agrees with the IASB analysis in the DP that a detailed componentisation of all derivatives on own equity would create many conceptual and operational challenges. It would also be a significant change to current requirements.</li> <li>• EFRAG generally supports the IASB’s efforts to better articulate the classification principles in IAS 32 for derivatives on own equity. However EFRAG is concerned that although the classification outcomes will not be significantly affected, the proposed guidance differs significantly from current guidance, particularly in terms of terminology (e.g. the identification of different types of derivatives such as asset/equity and liability/equity exchanges), which would have a significant impact on the existing application guidance and introduce new uncertainties, particularly around the notion of independent. Finally, the new guidance would still require significant judgement on whether a variable is independent or not and detailed application guidance on how the principles should be applied.</li> <li>• The DP provides specific guidance on whether the net amount of derivative, embedded derivative and hybrid is affected by a variable that is independent of the entity’s available economic resources (i.e. whether it meets the fixed-for-fixed condition). EFRAG notes that many of the submissions to IFRS IC on IAS 32 were related to whether the net amount is affected by a variable that is independent of the entity’s available economic resources (i.e. the fixed-for-fixed condition) and that currently there is diversity in practice. This is because</li> </ul>

	<p>currently IAS 32 provides limited guidance on this issue. Therefore, EFRAG welcomes the IASB’s preferred approach in the DP, particularly on foreign currency and anti-dilution provisions.</p> <ul style="list-style-type: none"> <li>• However, EFRAG would welcome more illustrative examples that would help entities to apply the principles described in the DP and considers that the IASB needs to further discuss the dependency on the entity’s economic resources before deducting all other claims, particularly on the use of EBIT as a proxy of a measure that reflects entity’s performance. Finally, on contingencies, EFRAG would welcome more guidance on whether the event specified is within the control of the entity, or beyond its control, and therefore whether the claim establishes a liability. This is particularly the case when the event relates to the entity’s future activities, financial performance, or financial position (e.g. bonds that are convertible into ordinary shares of the entity if the entity’s debt/equity ratio falls below a given percentage).</li> <li>• EFRAG acknowledges that applying the IASB’s preferred approach to financial instruments that currently meet the foreign currency rights issue exception in paragraph 16 of IAS 32 would have the conceptual benefit of removing exceptions to the fixed-for-fixed condition in IAS 32. Presenting separately the income and expenses that arise from such liabilities in other comprehensive income (OCI) would also alleviate the tension on the impact of fair value changes in profit or loss and related volatility. However, EFRAG is not convinced that such an approach solves the concerns that led to the amendments published in 2009. EFRAG notes that there are no application issues with the exception and that the IASB seems to be replacing a classification exception with a presentation exception (to the principle that only income and expenses that arise with liabilities that solely depend on the entity’s available economic resources should be separately presented in OCI).</li> <li>• Alternatively, EFRAG recommends the IASB to discuss whether the criteria in paragraph 6.34 of the DP for separate presentation in OCI could be used for classification purposes. That is, should discuss whether foreign currency rights issue (partly independent derivative) should be classified as equity if it meets similar criteria.</li> <li>• EFRAG notes that the classification change for fixed-for-fixed net-share settled derivatives (classified as equity and updated according to attribution mechanism) is a consequence of updating the IAS 32 requirements and not meant to address any specific issue that arise in practice. EFRAG however, considers that the IASB has not clearly explained the benefits of such classification, in terms of relevance, and would like to have stakeholder’s views on such classification change. Particularly, if the IASB decides to have an attribution approach other than full fair value. EFRAG also notes that liability/equity exchange contracts that are net-share settled fall under section 5 and therefore will require grossing up similarly to the gross share settled forwards contracts to buy and written puts over own equity.</li> <li>• <i>Question to constituents: To what extent the “foreign currency rights issues” is being used in your jurisdiction?</i></li> </ul>
<p><b>5. Compound instruments and redemption obligation arrangements</b></p>	<p><i>Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)</i></p> <ul style="list-style-type: none"> <li>• EFRAG acknowledges that many of <b>key challenges that arise in practice</b> with derivatives on own equity are related to whether it is appropriate that written put options and forward purchase contracts on an entity’s own equity instruments are presented grossed-up rather than on a net basis like other derivatives. There are also many questions on how to account for transactions within equity when an entity has an obligation to extinguish own instruments and how to subsequently measure them when the entity has to deliver the fair value of its own instruments (e.g. written puts with a fair value strike price)</li> <li>• EFRAG acknowledges that under the IASB’s preferred approach entities will continue to apply a requirement similar to the existing <b>redemption obligation requirement</b> in paragraph 23 of IAS 32. The IASB’s preferred approach clarifies that this accounting treatment ensures that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured. More specifically, it will ensure that the accounting for a convertible bond will be similar to the accounting for a written put option on own shares that is issued together with ordinary shares. Therefore, the new guidance on written puts will be closely related to the guidance on <b>compound instruments</b>.</li> </ul>

- EFRAG welcomes the fact that the requirements in IAS 32 on **compound instruments** would be carried forward largely unaltered under the IASB's preferred approach. EFRAG considers that it would be useful to require separate presentation in the statement of financial position of the equity components of compound instruments and derivatives on own equity (e.g. within a subclass) to help users better understand where the different components of complex financial instruments are.
- However, EFRAG is concerned that under the IASB's preferred approach the accounting for a written put option on own share that is issue together with ordinary shares would be same as for a convertible bond. In particular, EFRAG is concerned that the implicit equity conversion feature of the written put would be accounted for as a conversion option in a convertible bond (thus, the accounting of written puts and convertible bonds would be the same). Currently, the equity component reflects the premium received from the written put.
- EFRAG considers that such an outcome is complex for users and preparers to understand, does not reflect the substance of the instruments and will not provide useful information to users, regardless of whether the carrying amount is affected by an attribution requirement or not. EFRAG considers that this accounting becomes even less meaningful for any attribution method other than at fair value.
- Under the IASB's preferred approach the redemption obligation requirements should also apply to written put options where an entity repurchases equity instruments by transferring a variable amount of cash equal to the value of the underlying shares. The IASB's approach explains that the liability component would represent the redemption amount (the obligation to pay the fair value of the equity instrument) as if it were unconditional. The remaining obligation for the entity is to exchange that obligation for an equity instrument with the same value, which will have a nil value. Thus, all of the returns on the claim will be captured by the liability component. As the amount of the claim is not independent of the entity's available economic resources, then the separate presentation requirements will apply and the gains and losses that arise from the liability are presented in OCI. EFRAG considers that the DP's proposals have the benefit of clarifying and eliminating the diversity in practice on the accounting for derivatives on own equity in which the entity has to transfer a variable amount of cash equal to the value of the underlying shares, particularly when dealing with fair value non-controlling interest ('NCI') puts.
- EFRAG welcomes the IASB's discussion on accounting within equity for put options over NCI as this is an issue that creates diversity in practice. In the DP the IASB clarifies that for NCI puts, the accounting in the consolidated financial statements would be the same as for an ordinary written put option except that underlying equity instruments are shares that represent NCI. Therefore, the recognition of a liability component would be lead to the derecognition of the NCI. Regarding this derecognition of the NCI on which put options are written, EFRAG notes that while some consider it logical to derecognise the minority interest, current practice is mixed as some consider such derecognition as inappropriate. This could be the case when a put option is not at a fixed price which some interpret as that the NCI continue to have equity-type exposure and that the NCI should continue to be recognised. Neither approach is currently forbidden by IAS 32 paragraph 23 however EFRAG considers that the IASB should further discuss cases where the put option is not at a fixed strike price.
- Still, EFRAG expresses the same concerns as above in regard to recognising an equity component that represents an implicit call option as compared to the put option and subsequent remeasurement through an attribution system.
- The IASB approach is based on whether an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that has the feature(s) of a financial liability. Any conditionality would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability. EFRAG considers that the DP's proposals would not change significantly current requirements and would be aligned to the IFRS IC decisions up to date. In addition, EFRAG considers that it would bring clarity to current accounting, particularly on whether measurement of the liability should reflect the probability-weighting of the liability component based on the likelihood of the liability settlement outcome occurring.



	<p><i>Financial instruments with alternative settlement outcomes that are controlled by the entity</i></p> <ul style="list-style-type: none"> <li>• EFRAG notes that under IAS 32, if an entity has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of equity. Therefore, enhancing embedded derivative requirements and separating embedded derivatives would be a significant change to current requirements, and consequently to current practice. For example, it would change current practice on the accounting for the callable shares as entities would have to account for them as an equity host component and an embedded derivative asset component which represents the right to settle the claim in cash. Under IAS 32, shares callable by the issuer are classified as equity in their entirety and the right to settle by delivering cash does not play a role in classification.</li> <li>• Similarly, questions could arise with a reverse convertible bond. Such instrument could be seen differently as an equity component that represents the obligation to deliver a fixed number of shares and a derivative component that represent the issuer’s right to choose cash payment instead of the fixed number of shares if it is a cheaper alternative; or an instrument that includes an unconditional right of the entity to settle a claim either by transferring a fixed number of equity instruments (which would be an equity settlement) or a specified amount of cash (which would be a liability settlement). That is, it would include a liability host and an embedded derivative (i.e. purchased put option on own equity).</li> <li>• In addition, EFRAG notes that these instruments are often affected by multiple variables (e.g. foreign currency, market price of the shares, etc) and it will be difficult to provide information about all those different features through separation of embedded derivatives and recognition of fair value changes in profit or loss. In addition, such requirements will be costly for preparers. Finally, EFRAG notes that if the IASB decides to use the attribution requirements to help in providing information about financial instruments with alternative outcomes at the entity’s option, entities will still need to make the separation of the embedded derivative for attribution purposes as the attribution may be based on fair value changes of such embedded derivatives. This would also add costs and complexity to current requirements.</li> <li>• Therefore, EFRAG considers that information about the variability resulting from the different features included in these types of instruments could be provided through a better breakdown of equity and improved disclosures on the terms and conditions of such financial instruments. EFRAG also consider that improvements to the indirect obligation requirements as described in section 8 could also improve the classification in specific cases (e.g. an option does not have commercial substance).</li> <li>• <i>Question to constituents: To what extent are contingent convertible bonds (CoCo’s), cumulative preference shares and written puts on NCI being used in your jurisdiction?</i></li> </ul>
<p><b>6. Presentation of financial liabilities and equity on the face of the financial statements</b></p>	<p><i>Separate presentation of financial liabilities in the balance sheet and income and expenses in OCI</i></p> <ul style="list-style-type: none"> <li>• EFRAG acknowledges that a binary classification approach has its inherent limitations and welcomes the IASB discussion on improvements to presentation.</li> <li>• EFRAG notes that the DP’s proposals, when considered altogether will have a significant impact on presentation, including, separate presentation of three subclasses of liabilities (dependent, not dependent and partly dependent on the entity’s available economic resources), more use of OCI and claims arranged by priority on the face.</li> <li>• On the IASB’s proposed improvements to the statement of financial position: <ul style="list-style-type: none"> <li>○ there is lack of clarity of how separate classes of liability should be presented on the face of the statement of financial position and EFRAG struggles to see how the IASB’s approach would fit with current requirements of IAS 1 <i>Presentation of Financial Statements</i> (e.g. whether they would represent additional line items, subtotals or categories). EFRAG notes that presentation will depend on the use of disaggregation or criteria approach.</li> </ul> </li> </ul>

- EFRAG would recommend providing information on subclasses of liabilities in the notes instead, particularly on information on how changes in financial liabilities affect OCI and separate component of equity for OCI.
  - EFRAG is not convinced that the information about priority of financial liabilities and equity instruments on liquidation should be presented on the face of the statement of financial position. Such presentation would conflict with the current practice (particularly for financial institutions), going concern assumption, conflict with current-non-current presentation of the asset side and users would have additional difficulties in determining working capital. EFRAG recommends to provide the information on liquidation priority in the notes. Nonetheless, EFRAG considers that it would be important to further test the usefulness of these disclosures and all the other disclosure/presentation proposals with users.
  - Income statement
    - EFRAG agrees that it is important to clearly identify liabilities for which the amount depends on own performance. The IASB may use separate line items, OCI or disclosures. EFRAG considers that the use of OCI is an interesting approach to solve the issue of counterintuitive accounting and refers to the benefits of using OCI, including aligning it with previous thinking on own credit risk.
    - However, EFRAG notes that the use of OCI may be controversial, will raise discussion of what performance is and why recycling should not be used in this case.
    - EFRAG considers that it could be useful to not recycle such gains, however EFRAG considers that entities should provide disclosures relating the amounts recognise in OCI and the movements within equity when the instrument is settled. EFRAG also notes that the IASB does not address how this new category of OCI should be dealt within equity.
    - We also highlight that such approach would have a significant impact on IFRS 9 in terms of measurement (fair value through OCI category).
    - EFRAG recommend the IASB to use OCI on liabilities, derivatives and embedded derivatives that are solely dependent on entity's available economic resources (not to partly independent derivatives).
  - Partly independent derivatives
    - If derivative is partly dependent, then disaggregation approach is the most conceptual approach. However, it significantly raises complexity and application costs.
    - The criteria approach could be alternative from a cost-benefit perspective, however the criteria approach would be an exception to the key principle for separate presentation, raises complexity on presentation, level of judgement on applying criteria, derivatives and non-derivatives would be treated differently and would significantly impact IFRS 9
    - Apply OCI only to derivatives which the amount is affected by variables that are solely dependent on the entity's available economic resources, if to be applied.
- Separate presentation requirements to all embedded derivatives in hybrid instruments*
- EFRAG considers that such an approach would increase complexity and application costs of IFRS 9. EFRAG considers that separate presentation requirements should only apply to derivatives that are solely dependent on entity's available economic resources and do not require more separation than current requirements in IFRS 9.
  - If the IASB decides to proceed, EFRAG would recommend the IASB to make an impact assessment of such proposals in IFRS 9 before making any changes to it.
- Expand the attribution of income and expenses to some equity instruments other than ordinary shares*
- EFRAG notes that the concept of subclasses already exists in the conceptual framework (and in previous versions also) and that companies already present different subclasses of equity (issued capital, other equity instruments, etc)

- EFRAG welcomes the IASB discussion on presentation within equity but considers that the IASB will need to apply its definition of ordinary shares to more complex situations (partnerships puttable instruments, share-based payments) and clarify the interaction with definitions in IAS 33 *Earnings per Share*.
- EFRAG acknowledges that the attribution approach has some benefits but EFRAG questions whether the benefits of the information provided by the attribution approaches (i.e. attributing total income and expense to equity instruments other than ordinary shares and updating the carrying amounts of equity instruments based on that attribution) would exceed the related costs.
- EFRAG is concerned about related challenges such as complexity of requirements, costs and availability of the information, relevance of the information on the face of the statement of financial position and statement of financial performance, the need for a tabular presentation in equity within the statement of financial position (how different components of equity are attributed to different classes, including OCI), pervasive impact on many standards (particularly on the calculation of basic EPS), the fact that the approach does not include liabilities that will be settled with equity, lack of clarity when instruments are exercised, questions how it will apply to co-operatives and notes that the scope is wider than IAS 33, which make the requirements particularly difficult for non-listed entities.
- EFRAG recommends to improve presentation requirements without attribution (line items or categories on face) and provide information about dilution in the notes. If attribution is retained, EFRAG recommends the use of the method that is currently used for NCI and IAS 33 (based on relative position of existing and potential shareholders).

*Attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33*

- EFRAG considers that such an approach could be applied in practice but is concerned that the scope of attribution will be wider than IAS 33 (affecting non-listed subsidiaries).
- EFRAG recommends the IASB to clarify the scope of other than ordinary shareholders, provide more examples of non-derivatives instruments that would be considered other than ordinary shares and provide more guidance on how this guidance should be applied to more complex instruments and EFRAG is concerned about having different allocation methods for different types of instruments.

*Attribution approach for derivative equity instruments*

- EFRAG considers that the full fair value approach is the most understandable and useful approach from a cost-benefit perspective. Particularly, if applied to each individual instrument and not classes of instruments. Such an approach would align the measurement basis instruments classified as liabilities and equity and would should the same information as having a narrow equity approach.
- However, EFRAG considers that the IASB should continue to provide information about different subclasses of equity, including the effect of other equity instruments, through better disaggregation on the face, diluted earnings per share and related disclosures
- EFRAG considers that the IASB should thus discuss improvements to the presentation of line items within equity (additional disaggregation). EFRAG also considers that to provide users with the relevant information about the allocation of the results between different classes of equity instruments the IASB should concentrate its efforts on improving IAS 33. The DP acknowledges shortcomings within IAS 33 requirements, including the exclusion of out-of-the money financial instruments that could have dilutive impacts at future dates. Having developed principles for identifying liabilities and equity, it is appropriate and timely for the IASB to, in parallel, consider how to enhance IAS 33 requirements. As acknowledged in Paragraph 6.66, the DP's proposed attribution approach could lead to consequential rather than proactive amendments to the IAS 33 requirements. Due to EFRAG being in favour of the "disclosure only" option as far as the attribution of comprehensive income to equity instruments is concerned and with the concurrence that the EPS calculation has shortcomings, EFRAG proposes a parallel update to the IAS 33 requirements.

<p><b>7. Disclosure</b></p>	<ul style="list-style-type: none"> <li>• EFRAG considers that disclosures are a key part of the project and identifies a number of limitations to the current guidance. EFRAG also mentions the discussions with EFRAG User Panel members and welcomes the IASB discussion on disclosures.</li> <li>• EFRAG acknowledges that the proposed disclosures, as a whole, would represent a significant extension of disclosures on financial instruments on own equity. However, they would provide a greater level of detail about financial instruments classified as equity, making the level of disclosure more similar to those that are classified as liabilities.</li> <li>• In regard to disclosures on priority on liquidation, EFRAG notes that some considerations would have to be taken into account in terms of the reporting entity which is being considered. EFRAG highlights that it is the legal entity that has the capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and is ultimately held responsible for its actions. Therefore, providing information about priority of claims on liquidation for consolidated financial statements can be a challenging exercise and maybe be inconsistent with the individual entities of the group. Considering this, EFRAG recommends the IASB to improve disclosures on priority of claims on liquidation both on separate and consolidated financial statements and work on possible interactions between both.</li> <li>• Alternatively, if the IASB wants to proceed with an attribution system, EFRAG recommends the IASB to use the method that is currently used for NCI and IAS 33 (based on relative position of existing and potential shareholders and using the denominator numbers in the EPS calculation as defined in IAS 33).</li> <li>• EFRAG considers that the IASB should also discuss potential improvements to disclosures based on the limitations identified by ESMA (has recently publish a report which identified a number of deficiencies on disclosures related to financial instruments classified as equity, in particular for financial instruments that have many features as it is often difficult to understand what the key features are that lead to the classification of equity or liability) and information about restrictions to transfer funds to its shareholders and creditors (e.g. legal requirements, covenants, regulation, etc).</li> </ul>
<p><b>8. Contractual terms, relationship with law, economic compulsion and indirect obligations</b></p>	<p><i>Economic compulsion and indirect obligations</i></p> <ul style="list-style-type: none"> <li>• EFRAG welcomes the IASB's discussion on the role of economic incentives for classification purposes and agrees with the IASB's proposal to clarify that economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or equity instrument. EFRAG agrees that considering economic incentives on classification may raise more questions than answers (e.g. constant change in classification, need to define thresholds for classification changes, etc).</li> <li>• EFRAG also believes that retaining and improving the indirect obligations requirements in paragraph 20(b) of IAS 32 may alleviate some of the issues related to economic compulsion (to consider for example whether an entity is legally prohibited from exercising one of the settlement alternatives).</li> <li>• EFRAG considers that more bifurcation of financial instruments could be an alternative approach to solve the issues related to economic incentives. However, EFRAG notes that it would increase significantly the cost of application of IAS 32 and that new guidance would have to be developed for more bifurcation within IAS 32.</li> </ul> <p><i>Contractual terms, relationship with law</i></p> <ul style="list-style-type: none"> <li>• EFRAG notes that the interaction between law and contract is fundamental and mention the different approaches in IFRS 9 and IFRIC 2 <i>Members' Shares in Co-operative Entities and Similar Instruments</i>.</li> <li>• EFRAG agrees that the classification of instruments should be focused on the contractual terms of a financial instrument and that requiring entities to take into account law on classification may raise many challenges (constant changes in the law and entity required to follow them closely). However, EFRAG mentions the issues that arise in practice, in particular to what extent law needs to be reflected or included in the contract to affect the rights and obligations of an existing contract (e.g. bail-in instruments). Thus, would</li> </ul>

	<p>recommend the IASB to further discuss this issue with regulators to better understand the challenges that arise in practice and have a comprehensive discussion, beyond the standards IAS 32 and IFRS 9, on how the relationship between contracts and law should be dealt. EFRAG notes that the IASB has already taken a similar approach for IFRS 17.</p> <ul style="list-style-type: none"> <li>• EFRAG welcomes the fact that the IASB decided to retain IFRIC 2 which is the blueprint for the design of instruments and closely related to regulation. Nonetheless, recommend that IFRIC 2 is integrated in the revised version of IAS 32 or its replacement.</li> <li>• Finally, explain that the IASB's approach does not solve the issues that exist with mandatorily convertible bonds, particularly from the perspective of measurement and instruments that are mandatorily written down.</li> <li>• <i>Question to constituents: To what extent is the IFRIC 2 interpretation being used in your jurisdiction?</i></li> </ul>
<p><b>Other comments from EFRAG</b></p>	<ul style="list-style-type: none"> <li>• It would be undesirable to have conflicts between the newly revised Conceptual Framework for Financial Reporting and the distinction between liabilities and equity proposed in a new Standard. The IASB should therefore, as part of the project, explain how the Conceptual Framework for Financial Reporting could be amended to remove conflicts between the proposal and the guidance in the Conceptual Framework.</li> <li>• In regard to the interaction between the FICE project and IFRS 2 <i>Share-based Payment</i>, EFRAG recommends the IASB to be cautious in considering changes to IFRS 2. These would increase the complexity of that Standard, especially the attribution of comprehensive income to equity-settled plans.</li> </ul>

## Appendix 1 - EFRAG's responses to the questions raised in the DP

### Section 1 - Objective, scope and challenges

#### Notes to constituents – Summary of the IASB DP on the objective, scope and challenges

- 3 *In the past, the IFRS IC received several submissions related to the application challenges of IAS 32 Financial Instruments: Presentation, in particular when dealing with financial instruments with characteristics of equity (e.g. some types of convertible bonds). In many cases the IFRS IC was unable to reach a conclusion and referred those issues to the IASB as the challenges identified required discussion of fundamental concepts in IFRS Standards.*
- 4 *The IASB also discussed the distinction between liabilities and equity as part of its project to revise the Conceptual Framework for Financial Reporting (Conceptual Framework). However, in 2014 the IASB decided to further explore how to distinguish liabilities from equity as part of the Financial Instruments with Characteristics of Equity (FICE) project as it did not want to delay other much-needed improvements to the Conceptual Framework and wanted to address both the conceptual and application issues together.*
- 5 *To help the IASB's discussions in past on the distinction between debt and equity, EFRAG issued two discussions papers: Classification of Claims issued in 2014 and Distinguishing Between Liabilities and Equity issued in 2008.*

*What are the key challenges that arise with IAS 32?*

- 6 *The key challenges can in general be classified as:*
  - (a) **Conceptual issues:** *currently IAS 32, other IFRS Standards and the Conceptual Framework use various features to distinguish liabilities from equity, often without a clear rationale on the use of the distinguishing features. As a result, IAS 32 includes complex exceptions that override the definition of a liability in the Conceptual Framework, which make it inconsistent within itself and with other IFRS Standards;*
  - (b) **Application issues:** *the lack of clarity in the existing guidance and the absence of guidance on some issues leads to divergence in practice. For example, the application of the fixed-for-fixed condition to derivatives on own equity (e.g. written call option to deliver a fixed number of own shares in exchange for a fixed amount of cash when the number of shares changes as a result of an anti-dilution provision) and the accounting for instruments for which the form and/or amount of the settlement depends on events beyond the control of the entity and the counterparty (some types of contingent convertible bonds such as bail-in instruments).*

*What is the objective of the DP?*

- 7 *The IASB decided that the FICE project's objective is to articulate the principles for classifying financial liabilities and equity instruments with a clear rationale, without fundamentally changing the existing classification outcomes of IAS 32. This is because the requirements in IAS 32 have been applied to the classification of the majority of financial instruments without difficulty.*
- 8 *The feedback received on this DP will help the IASB to decide whether it should add a project to amend or replace IAS 32.*

What is the scope of the DP?

- 9 In the DP the IASB highlighted that claims against entities can have a wide variety of features and that classification can provide only some information about all the features of an instrument. In addition, users of financial statements have expressed concerns about the limited information provided through presentation and disclosure about various features of financial instruments with characteristics of equity.
- 10 Accordingly, the IASB decided that the FICE project should investigate not only improvements to the classification of financial instruments but also improvements to their presentation and disclosure requirements.
- 11 Nonetheless, the IASB will not consider changes to the recognition and measurement requirements that will apply to financial assets and financial liabilities as part of this project

Question 1

Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.

- a. Do you agree with this description of the problems and their causes? Why or why not? Do you think there are other factors contributing to the challenges?
- b. Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

EFRAG's response

**EFRAG considers that the application issues that arise with IAS 32 are pervasive enough to require standard-setting activity. EFRAG welcomes the IASB's efforts to better articulate the principles for the classification financial instruments as liabilities and equity instruments with the objective of improving the consistency, completeness and clarity of the requirements in IAS 32 and respond to challenges in distinguishing financial liabilities from equity instruments.**

**EFRAG welcomes the IASB discussions particularly on presentation and disclosures. EFRAG considers that improvements to presentation and disclosures are currently needed and constitute a significant part, or even the most important part, of this project.**

**However, EFRAG lists a number of general concerns, including that the DP's proposals are very ambitious.**

**Introduction**

- 12 The IASB's Discussion Paper *Financial Instruments with Characteristics of Equity* (FICE) is a new round in a long debate on how to distinguish liabilities from equity instruments. Based on the responses to the forthcoming Discussion Paper, the IASB will need to decide whether to add a project to amend IAS 32 and whether any further changes are needed to the Conceptual Framework or any other related standards such as IFRS 2.

**Challenges identified**

- 13 The last main revision of IAS 32 was in December 2003 when the IASB issued a revised version with the objective of reducing complexity, adding guidance, eliminating internal inconsistencies and incorporating elements of standing interpretations. Since then, IAS 32 was subject to a number of amendments and interpretations, which led to the introduction of a number of exceptions to the general principles of IAS 32.

- 14 The IFRS IC also received several submissions related to the application challenges of IAS 32 (please see Appendix 3) and in many cases it was unable to reach a conclusion. The lack of clarity in the existing guidance and the absence of guidance on some specific issues has led to divergence in practice. The IASB discussed the distinction between equity and liability within its Conceptual Framework project but in 2014 it decided to further explore how to distinguish liabilities from equity as part of the FICE project. This was in line with EFRAG's recommendation in its comment letter that the IASB should in parallel with the Conceptual Framework project undertake a more comprehensive discussion on how to distinguish financial liabilities from equity instruments, from both conceptual and practical perspectives, and on what this distinction means and is attempting to portray.
- 15 Therefore, EFRAG welcomes the IASB' Discussion Paper and the IASB's efforts to address the current application and conceptual issues related to IAS 32 and clarify its principles in the process. **EFRAG considers that the challenges identified in the DP are pervasive enough to require standard-setting activity in the future.**
- 16 EFRAG has highlighted many times the importance of this project, particularly for users of financial statements. Currently, the existing guidance in IAS 32 is complex and requires the assessment of each component of an instrument's contractual terms. The incorrect classification of financial instruments under IAS 32 can have a significant impact on:
- (a) *Statement of financial position*: the classification of financial instruments as equity or liability have a significant impact on gearing (leverage), liquidity and solvency ratios, which may result in a breach of debt covenants and may be important if the company is required by law to maintain a certain level of equity;
  - (b) *Statement of financial performance*: income and expenses are defined by reference to changes in assets and liabilities, other than those caused by contributions from equity participants or distributions to equity participants. Therefore, classification of financial instruments will determine whether interest, dividends, losses and gains on financial instruments are recognised in equity or included in profit for the year.

#### **Objective of the project**

- 17 EFRAG considers that notwithstanding the challenges identified, IAS 32 has worked well in practice for the majority of liabilities and equity. We recall that many respondents to and participants in the outreach meetings on the EFRAG Discussion Paper *Classification of Claims*, published in 2014, considered that IAS 32 is not fundamentally broken and that the IASB should not start from a blank sheet of paper.
- 18 To address the issues that currently arise in practice, EFRAG considers that the IASB should, as in 2003, take the opportunity to clarify existing guidance, refine the underlying rationale of the distinction between liabilities and equity if necessary, reduce complexity, eliminate internal inconsistencies to the extent possible, improve presentation and disclosure requirements, use previous tentative decisions from the IFRS IC and incorporate elements of existing Interpretations. EFRAG considers that this is possible without fundamentally changing the existing classification outcomes of IAS 32.
- 19 Finally, EFRAG notes that, as described in paragraph B9 of the DP, some other IFRS Standards contain requirements that depend on the requirements in IAS 32. Therefore, changes to IAS 32 can have a significant impact on the application of other standards including IFRS 3 *Business Combinations*, IFRS 9, IFRS 10 *Consolidated Financial Statements*, IAS 1 and IAS 33.



**Scope of the project**

- 20 EFRAG welcomes the IASB's efforts to solve the existing deficiencies in IAS 32, which are often related to classification issues, by clarifying existing guidance, adding new guidance and identifying the underlying rationale of the distinction between liabilities and equity in the process.
- 21 EFRAG also welcomes the fact that the IASB did not focus only on classification issues but also on presentation and disclosures of financial instruments under the scope of IAS 32.
- 22 Improvements to presentation and disclosure requirements are needed and constitute a significant part, or even the most important part, of this project. For example, EFRAG notes that ESMA has recently called for more transparency on the disclosures of fundamental characteristics of complex instruments such as puttable instruments, compound instruments and derivatives on own equity.
- 23 However, EFRAG expresses concerns on a number of areas related to the scope of this project:
- (a) EFRAG considers that the scope of the project and the DP's proposals are, when considered altogether, very ambitious, particularly when considering the attribution requirements and the level of impact that it may have on a significant number of IFRS standards such as IAS 1, IAS 32, IAS 33, IFRS 2, IFRS 9, IFRS 10 and the Conceptual Framework. We also consider that in many cases, the changes in other standards could have such a pervasive effect on them that the IASB might have to address them through a standalone separate project and not simply by proposing consequential amendments (e.g. IAS 33).
  - (b) EFRAG welcomes the fact that the IASB has clearly described the existing financial reporting challenges. However, EFRAG regrets that the IASB has not provided in a single section (as section 1 where the IASB describes the existing challenges) an explanation on how the IASB's preferred approach addresses all the challenges identified by the IASB and how the issues discussed by the IFRS IC would be resolved with the IASB's preferred approach. Similarly, it would have been useful to have a separate section that would explain the issues that remain unresolved (e.g. issues that arise with bonds that are contingently written-down at the entity or regulators' discretion and payments at the ultimate discretion of the issuer's shareholders). This information would help stakeholders understand whether they would be better off the IASB's preferred approach or with current requirements in IAS 32. EFRAG has included an Appendix 3 where it assesses whether and how the DP's proposals addresses the issues that arise in practice; and
  - (c) EFRAG also considers that the IASB should take the opportunity, during its outreach period, to ask stakeholders if there are any other improvements currently needed in IAS 32 which have not been discussed by the IASB. For example, whether the requirements in paragraph 16A and 16B on puttable instruments need be improved or clarified.

**Question to Constituents**

- 24 Are constituents aware of any other challenges with IAS 32 that have not been identified by EFRAG and the IASB?

**Question to EFRAG TEG**

- 25 Does EFRAG TEG agree with the drafting and key messages of section 1 of the appendix 1 of the Draft Comment Letter?
- 26 Does EFRAG TEG agree with question to constituents to obtain data for future impact assessment?

## Section 2 - The IASB's preferred approach

### Notes to constituents – Summary of the IASB DP on the IASB's preferred approach

27 When discussing possible ways of clarifying the underlying rationale of the distinction between liabilities and equity, the IASB considered what information is best provided through classification, and what is best provided through presentation and disclosures.

#### Classification

28 When forming its view on classification the IASB started by considering the needs of the users of financial statements, the different features of financial instruments and which features are the most relevant for classification purposes. The DP presents the preliminary view of the IASB that the best information to provide through the classification is information about the primary distinctions that are relevant to both the assessments of funding liquidity and balance-sheet solvency and returns. Accordingly, the IASB's preferred approach would classify a financial instrument as a financial liability if it contains:

- (a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (timing feature); and/or
- (b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources (amount feature).

29 The DP illustrates the IASB's preferred approach by this table:

<i>Distinction based on amount feature</i> <i>Distinction based on timing feature</i>	<i>Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)</i>	<i>No obligation for an amount independent of the entity's available economic resources (such as an amount indexed to the entity's own share price)</i>
<i>Obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as scheduled cash payments)</i>	<b>Liability</b> <i>(e.g. simple bonds)</i>	<b>Liability</b> <i>(e.g. shares redeemable at fair value)</i>
<i>No obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as settlement in an entity's own shares)</i>	<b>Liability</b> <i>(e.g. bonds with an obligation to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of cash)</i>	<b>Equity</b> <i>(e.g. ordinary shares)</i>

30 The IASB's preferred approach would define equity as 'the residual interest in the assets of the entity after deducting all of its liabilities', consistent with the definition in paragraph 4.63 of the Conceptual Framework. Thus, equity claims under the IASB's preferred approach could not contain either the timing or amount feature.

#### Presentation and disclosure

31 The DP identifies the following two broad assessments for which the financial statements should provide information:

- (a) Assessments of funding liquidity and cash flows; and
- (b) Assessments of balance-sheet solvency and returns.

- 32 *The DP states that in making assessments of finding liquidity and cash flows, users of financial statements typically consider:*
- (a) *whether the expected timing of cash generated by an entity's economic resources will precede the timing of required payments;*
  - (b) *to what extent the entity has financed long-term illiquid assets using claims with short-term liquidity demands (i.e. whether there is a potential liquidity shortfall);*
  - (c) *to what extent the entity is exposed to changes in the market liquidity of its assets (for example, if it needs to convert its assets to cash) and the liquidity of financial markets (for example, if it needs to obtain additional financing); and*
  - (d) *whether the entity manages its cash flows efficiently and effectively.*
- 33 *Similarly, the DP states that in making assessments of balance-sheet solvency and returns, users of financial statements typically consider:*
- (a) *whether an entity has sufficient economic resources to meet its obligations and the potential allocation of any shortfall in economic resources among the claims;*
  - (b) *the extent to which the entity has claims that respond to future changes in the entity's available economic resources. This assessment will show how resilient the entity's financial position is to reductions in the value of its economic resources. This assessment also identifies which claims participate in future reductions and appreciation of its available economic resources;*
  - (c) *the extent to which the entity has the ability to obtain new economic resources by issuing new claims, or to retain existing economic resources by refinancing existing claims. A shortfall in available economic resources would normally impair an entity's ability to access capital markets regardless of market liquidity.*
- 34 *In order to enable users of financial statements to make more detailed assessments on the issues, the DP suggests that additional information can be provided through presentation and disclosures. For example, the DP notes that:*
- (a) *Some claims would be classified as liabilities because they contain only one of the timing and amount two features, and hence information about them would be relevant for only one of the assessments. The DP therefore proposes to require separate presentation of liabilities that have only one of the two features.*
  - (b) *Additional sub-classifications of claims could be provided to show:*
    - (i) *The order of liquidity;*
    - (ii) *The order of priority; or*
    - (iii) *Current/non-current.*

**Question 2**

The IASB's preferred approach to classification would classify a claim as a liability if it contains:

- a. an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or
- b. an unavoidable obligation for an amount independent of the entity's available economic resources.

This is because information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50 of the DP.

The IASB's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

*EFRAG's response*

**EFRAG welcomes the IASB's discussions on improving classification. In particular, EFRAG welcomes the fact that the IASB proposes to retain a binary approach, define equity as a residual, identify relevant features for classification, and that the IASB has clarified that the classification is from an entity's perspective**

**However, EFRAG expresses a number of concerns on the IASB's approach on the use of a completely new terminology and highlights the challenges that typically arise when setting a new terminology. In EFRAG's view a careful evaluation of the balance 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 therefore essential.**

**Finally, EFRAG considers that presentation and disclosure constitute a significant part of this project.**

*The IASB's approach to improvements to classification*

- 35 A fundamental principle in IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument in accordance with the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. There are a number of exceptions from this principle, such as certain puttable instruments that meet specific criteria and certain obligations arising on liquidation.
- 36 In accordance with IAS 32, a financial instrument is an equity instrument only if the entity has no obligation under any circumstances to settle with cash or variable number of its own equity instruments. The entity must make the decision at the time the instrument is initially recognised and the classification is not subsequently changed based on changed circumstances (unless there is a modification of the terms of the contract).
- 37 EFRAG welcomes the IASB's efforts to improve IAS 32 requirements on classification of financial instruments as a way to address the lack of clarity in the existing guidance and the absence of guidance on some issues that leads to divergence in practice.
- 38 In particular, EFRAG acknowledges and welcomes the fact that the IASB:

- (a) has not started from a blank sheet of paper and that the IASB focused on an approach that is generally consistent with classification outcomes of IAS 32;
  - (b) retains the existing binary classification of financial instruments. Most respondents to and participants in the outreach meetings on the EFRAG Discussion Paper *Classification of Claims issued in 2014* considered that the current binary classification model in IAS 32 should be retained with a refinement of the liability definition. EFRAG continues to support explicitly splitting the claims side of the statement of financial position between liabilities and equity;
  - (c) EFRAG welcomes the fact that the IASB retains the existing notion of equity as a residual category;
  - (d) continues to rely on the substance of the contract, particularly when considering the proliferation of instruments and features in the last few years. Additional comments on the relation between contracts and the law are included in section 8;
  - (e) clarifies that the classification of financial instruments is made from an entity's perspective;
  - (f) EFRAG agrees with the DP that information provided in the financial states about an entity's claims should help users to assess the entity's liquidity and solvency. These information needs are also identified in the Conceptual Framework for Financial Reporting. The Conceptual Framework for Financial Reporting does not identify any key features of either liabilities or equity. EFRAG agrees with the DP that in relation to the assessment of liquidity and solvency, features such as 'timing' and 'amount' could be useful to consider. Accordingly, EFRAG welcomes the fact that the IASB:
    - (i) uses the 'timing' feature ('unconditional right to defer transferring cash or other financial assets until liquidation') for classification purposes. EFRAG agrees that claims classified as equity should not have a maturity, require ongoing payments or require repayments before liquidation that could lead to default.
    - (ii) uses the 'amount' feature ('an unavoidable obligation for an amount independent of the entity's available economic resources') for classification purposes as such feature reflects the notion that claims classified as equity are claims for an amount that is subordinated to all the companies liabilities and has a loss absorption feature as mentioned in the EFRAG Discussion Paper *Distinguishing Between Liabilities and Equity* issued in 2008 (as the amount is dependent on the entity's available economic resources, the holder participates in losses);
- 39 However, EFRAG is concerned about the introduction of a complete new terminology for classification purposes. EFRAG understands that the practices have developed over time in the application of IAS 32 in areas where the Standard lacks detailed guidance (e.g. application of the 'fixed-for-fixed' criterion). If IAS 32's terminology is replaced with new terminology and/or new articulations of the underlying concepts, preparers and auditors would need to reconsider past practices including some that are not currently problematic: the IASB's preferred approach will cause disruption and create the risk of new issues arising. In EFRAG's view a careful evaluation of the balance 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 therefore essential.
- 40 EFRAG is particularly concerned about:

- (a) the difficulties to assess the extent of the changes that the IASB will need to make to IAS 32 in order to reflect the new concepts in IAS 32, including changes to the application guidance which could be significant;
  - (b) the challenges that will arise with the new amount feature. For example, the notion 'an amount independent of the entity's available economic resources' and 'an amount that could exceed the entity's available economic resources' have been raising a lot of debate, particularly when both legs of a derivative are settled with entity's own shares. Other specific challenges on the new terminology 'amount independent of the entity's available economic resources' are further described in section 3.
  - (c) The challenges that will arise with the timing feature. For example:
    - (i) there are financial instruments which are settled, on maturity date, with the issuer's own equity instruments (e.g. options and forwards). In such cases, the **settlement date of the instrument** (a pre-determined date) is not the same as the **settlement date of the claim**, which is only at liquidation. Such distinction may raise confusion; and
    - (ii) 'for regulated financial entities, the issue is more related to "resolution" rather than "liquidation". From this perspective, the concept of resolution may need to be taken into account for classification of some financial instruments (e.g. additional tier 1 instruments).
- 41 Considering all these challenges, In EFRAG's view a careful evaluation of the balance 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 therefore essential.
- 42 EFRAG highlights the importance of testing extensively whether the IASB's preferred approach would solve the issues that currently arise in practice and apply them to a variety of financial instruments to avoid unintended consequences.

#### *Presentation and disclosure*

- 43 EFRAG acknowledges that a binary classification may not convey all of the similarities and differences between the different financial instruments, thus classifying claims as liabilities or equity may not provide satisfactory information to users. In addition, an approach based on a single distinction has resulted in various differences in disclosure and presentation requirements in IFRSs.
- 44 EFRAG also agrees that claims on an entity have numerous characteristics and there is no limit to how such characteristics could be combined in a single instrument. Accordingly, any split between equity and liabilities based on only some characteristics of an instrument portrays no more information on the nature of the claim than the chosen characteristics.
- 45 Thus, EFRAG welcomes the IASB's efforts to make improvements to the presentation and disclosure requirements to address the challenges that arise from a binary approach, particularly on the equity side. Improvements to presentation and disclosures are currently needed and constitute a significant part, or even the most important part, of this project.

#### ***Alternative classification approaches referred by the IASB***

- 46 EFRAG acknowledges that there are a number of alternatives, including those below, and on balance we consider that the IASB's approach deals with the critical features for classification. These alternative approaches include:
- (a) *narrow equity or basic ownership instrument approach*: In its comment letter on the IASB's Discussion Paper *A Review of the Conceptual Framework for*

*Financial Reporting*, EFRAG neither supported a strict obligation approach nor a narrow equity approach.

- (b) *rights approach*: EFRAG does not support an approach based on features such as rights that may affect how an entity uses its economic resources, such as voting or protective rights. Legal requirements and shareholders rights can change significantly from jurisdiction to jurisdiction.
- (c) *Those based only on one of the features used for classification*: EFRAG believes that the combination of the two features, and not each individually, leads to an appropriate classification of financial instruments. EFRAG highlights the importance of having an approach which is consistent with the existing definitions and classification outcomes in IAS 32 and that the use of a single characteristic would require entities to provide additional information through presentation and disclosures.
- (d) *Claims approach*: EFRAG is aware of suggestions that the statement of financial position should depict and describe these various claims as a continuum rather than a split between equities and liabilities (described variously as a ‘no-split’ or ‘claims’ approach). However, at least one type of claim cannot be remeasured directly without remeasuring the entire entity. If there were to be a class of claims that were not remeasured, then this would, implicitly, be accepting that some claims are different to others. It would be a liability/equity distinction, even if not called by that name. Given that at least one category of claims cannot be remeasured directly, EFRAG supports explicitly splitting the claims side of the statement of financial position between liabilities and equity, and the retention of a definition of equity as the residual (in this sense) being retained.

**Question to EFRAG TEG/Board**

- 47 Does EFRAG TEG agree with the drafting and key messages of section 2 of the appendix 1 of the Draft Comment Letter?



## Section 3 - Classification of non-derivative financial instruments

### Notes to constituents – Summary of the IASB DP on non-derivative financial instruments

- 48 *In the DP, the IASB developed separate classification principles for derivative and non-derivative instruments because of the particular classification challenges that arise from derivatives on own equity.*
- 49 *Section 3 of the DP is focused on the classification of non-derivative instruments that may be settled with cash, another financial asset or with the issuer's own equity. The classification of derivatives on own equity is considered in sections 4 and 5.*
- 50 *Under the IASB's preferred approach an entity classifies a non-derivative financial instrument as a financial liability if it contains:*
- (a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or*
  - (b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.*
- 51 *Under the IASB's preferred approach an equity instrument is any contract that evidences a residual interest in the assets of the entity, after deducting all of its liabilities. Consequently, a contract classified as an equity instrument would not contain:*
- (a) an unavoidable contractual obligation to transfer economic resources (including financial and non-financial assets) at a specified time other than at liquidation, nor*
  - (b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.*
- 52 *In paragraph 3.10 of the DP, the IASB highlights that a non-derivative financial instrument may contain alternative settlement outcomes that depend on future events, or on the holder or issuer exercising rights. For example, financial instrument that require the payment in cash of a fixed principal amount in four years and the payment of discretionary dividends. Under the IASB's preferred approach:*
- (a) if an entity does not have the unconditional right to avoid one or both of the features of a financial liability, then the entity classifies that obligation as a financial liability; and*
  - (b) if it also contains another possible outcome that does not have the feature(s) of a financial liability, then the entity considers whether the instrument is a compound instrument and applies the principles developed in section 5.*
- 53 *In paragraphs 3.11-3.13 of the DP, the IASB highlights that its preferred approach for the classification of non-derivative financial instruments has many similarities with the requirements in IAS 32 and that the classification outcomes will remain largely the same. However, it is noted that the classification outcomes for some instruments might change because of the differences that arise from clarifying the rationale and rearticulating the principles in IAS 32.*
- 54 *For example, one classification outcome that would change as a result of the articulation of the settlement amount feature is the classification of non-redeemable fixed-rate cumulative preference shares. Such non-derivative financial instruments would be classified as financial liabilities because the fixed-rate dividends accumulate over time and changes in the entity's available economic resources will not result in changes in the amount of the cumulative preference shares.*

- 55 *In regard to the classification of non-derivative financial instruments that are settled with the issuer's own equity instruments, currently their classification under IAS 32 depends on whether there is an obligation to deliver a variable number of the issuer's own equity instruments, regardless of how the number of shares to be transferred is determined.*
- 56 *Under the IASB's preferred approach, a non-derivative financial instrument that contains an obligation to deliver a variable number of equity instruments equal to a specified amount (e.g. CU100) would continue to be classified as a financial liability. However, it would do so because the obligation is for a fixed amount that is independent of the entity's available economic resources.*

*Additional guidance the notion of a claim for an amount that is independent of the entity's available economic resources*

- 57 *The notion of whether an amount is independent of the entity's available economic resources ('amount feature') is fundamental for the classification and presentation of financial instruments under the IASB's preferred approach.*
- 58 *In paragraph 3.17 of the DP, the IASB defines the entity's available economic resources as the total recognised and unrecognised assets of the entity that remain after deducting all other recognised and unrecognised claims against the entity.*
- 59 *In addition, the DP also states that an amount is independent of the entity's available economic resources if:*
- (a) the amount specified in the contract does not change as a result of changes in the entity's available economic resources; or*
  - (b) the amount changes as a result of changes in the entity's available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity.*
- 60 *In paragraph 3.20, the IASB further clarifies that a link to the entity's available economic resources does not automatically mean that the amount depends on the entity's available economic resources. The entity would be required to consider whether the amount could exceed the entity's available economic resources under any possible scenario based on the terms of the financial instrument at initial recognition. For example, if the amount of a financial instrument is indexed to twice the change in the fair value of the recognised and unrecognised net assets of the entity, then the amount of the financial instrument will increase twice as much as the available economic resources of the entity, and thus could potentially exceed the entity's available economic resources.*
- 61 *In addition, in paragraph 3.22 of the DP the IASB explains that while the amount of the financial instrument in isolation may not exceed the economic resources of the entity, when considered in combination with other claims against the entity it could result in an amount that exceeds the entity's available economic resources. Hence, if the amount does not take into account the effect of other claims against the entity (for example, if the amount is specified as a fixed percentage of a particular recognised or unrecognised asset) the amount is independent of the entity's available economic resources.*
- 62 *Finally, the IASB provides a number of examples:*

<i>Financial instrument with amount independent of the entity's available economic resources</i>	<i>Financial instrument with amounts that are not independent of the entity's available economic resources</i>
<i>Bond or other obligation for a fixed amount</i>	<i>Ordinary share</i>
<i>Obligation for an amount that is based on changes in an underlying variable, such as an interest rate or commodity index</i>	<i>An ordinary share in a subsidiary held by a NCI</i>
<i>Non-redeemable fixed-rate cumulative preference share, with a stated coupon or dividend amount that accumulates in the case of non-payment</i>	<i>Non-redeemable non-cumulative preference share with a stated coupon or dividend amount, but the coupon or dividend amount is cancelled if the coupon is not paid by the entity</i>
<i>Obligation for an amount specified by reference to a specific recognised or unrecognised asset the entity controls (e.g. property or a brand value)</i>	
<i>A share with a dividend feature that does not accumulate but is reset periodically when not paid</i>	

**Question 3**

The IASB's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

- a. an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or
- b. an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability.

Do you agree? Why, or why not?

EFRAG's response

**EFRAG acknowledges that although the classification results are largely the same, the classification outcomes for some instruments might differ from the effect of applying IAS 32 because of the differences arising from clarifying the rationale and rearticulating the amount feature (cumulative preference shares, cumulative undated bonds), even though such classification changes are not meant to address existing application issues.**

**Nonetheless, EFRAG considers that it would be useful to have separate guidance and explanations, similar to IAS 32, on how the IASB's preferred approach should be applied when financial instruments are settled with the issuer's own equity instruments. In particular, when there is an obligation to deliver a variable number of equity instruments equal to a specified amount and to receive a variable number of shares equal to specified amount.**

**Finally, EFRAG has some specific concerns on the use of a completely new terminology, particularly on the notion of 'an amount independent of the entity's available economic resources'.**

- 63 EFRAG welcomes the IASB approach to develop separate classification principles for derivative and non-derivative instruments. EFRAG notes that most of the classification issues that arise in IAS 32 are related to derivatives on own equity or embedded derivatives on own equity in compound instruments.
- 64 EFRAG highlights that in terms of non-derivative instruments, challenges have typically arisen with the classification of:
- (a) puttable instruments that include a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put (please see below paragraph 83);
  - (b) instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (please see below paragraph 83);
  - (c) instruments that are settled in the issuer's own equity instruments such as shares redeemable at fair value where the amount of the obligation changes in response to changes in the price of the entity's ordinary shares (please see below in section 6);
  - (d) non-derivative financial instruments with alternative settlement outcomes where the entity has the option for an equity or liability settlement (e.g. share with an embedded call option held by the issuer where the strike price is linked to a gold index and mandatorily convertible bonds where the entity has the option to exercise a cap); and
  - (e) a share with a dividend feature that does not accumulate but is reset periodically when not paid (please see below section 8).

**Classification of non-derivative financial instruments**

- 65 EFRAG notes that classification of non-derivative financial instruments under the IASB's preferred approach has many similarities with the requirements in IAS 32 and that the classification outcomes will remain largely the same for most types of non-derivative financial instruments.
- 66 However, EFRAG notes that the classification of some instruments might change. When comparing the IASB's preferred approach with current requirements in IAS 32, a key difference is the introduction of the 'amount' feature. This feature will affect the classification of instruments that do not require the transfer of economic

resources before liquidation but the claim is for a fixed amount that is independent of the entity's available economic resources. For example:

- (a) non-redeemable cumulative preference shares;
- (b) the classification of undated or perpetual cumulative hybrid securities that currently are classified as equity (vanilla, convertible and contingent convertible bonds) in their entirety where the issuer has the unconditional right to defer payment of any coupons or principal, including those that are contingent and can be exchanged for shares (fixed conversion price) if certain ratio is breached (e.g. Common Equity Tier 1 below a certain level).

67 Currently, these instruments are classified as equity in their entirety under IAS 32 as the entity has no contractual obligation to deliver cash or a variable number of its own shares under any circumstance.

68 However, under the IASB's preferred approach such instruments may be classified as financial liabilities. This is because, when a claim has optional deferral provisions, under the IASB's preferred approach there is a fundamental difference between financial instruments with cumulative payment features (which, when deferred, still accrue, and ultimately must be made up) and noncumulative payments features (where there is no obligation to address missed payments).

69 The introduction of the amount feature would also have the benefit of solving the issue that arises with shares that have a dividend feature that does not accumulate but is reset periodically when not paid. The fact that the dividend rate increases at a specified rate when it is not paid results in an amount that is independent of the entity's available economic resource. Therefore, it is classified as a liability.

70 In general, EFRAG welcomes the DP's proposals on non-derivative financial instruments and agrees that the classification outcomes will remain largely the same for most types of non-derivative financial instruments.

71 However, EFRAG considers that it would be useful to have separate guidance and explanations, similar to IAS 32, on how the IASB's preferred approach should be applied when the financial instruments are settled with the issuer's own equity instruments. In particular when there is an obligation:

- (a) to deliver a variable number of equity instruments equal to a specified amount (e.g. share settled bond); or
- (b) to receive a variable number of shares equal to specified amount (e.g. net-share settled written put option).

72 EFRAG also expresses concerns about the use of new terminology, which is mentioned in section 2 and in paragraph 77 below.

### **Non-derivative financial instruments with alternative settlement outcomes**

73 In regard to non-derivative financial instruments with alternative outcomes, the DP clarifies that under the IASB's preferred approach, if an entity has the unconditional contractual right to avoid a settlement outcome that has one or both of the features of a financial liability, then the instrument is classified as equity.

74 In addition, it explains that if an entity does not have the unconditional contractual right to avoid a settlement outcome that has one or both of the features of a financial liability, then the entity identifies that unavoidable obligation first and classifies that obligation as a financial liability. If the non-derivative financial instrument also contains another possible settlement outcome that does not have the feature(s) of a financial liability then the entity considers whether the instrument is a compound instrument.

- 75 In general, EFRAG welcomes the DP's proposals to non-derivative financial instruments with alternative outcomes and considers that the classification outcomes will remain largely the same for these types of non-derivative financial instruments.
- 76 In section 5, EFRAG provides its comments in regard to financial instruments in which the issuer has the option for a liability or equity settlement and related discussions on whether the IASB should enhance the embedded derivative requirements and separate embedded derivatives or use of the attribution requirements to help in providing information about these types of instruments. Such comments also apply to non-derivative financial instruments.

**Further guidance on an amount independent of the entity's available economic resources**

- 77 Paragraphs 3.17 to 3.24 of the DP, the IASB provide additional guidance on the meaning of an amount independent of the entity's available economic resources. As already mentioned in section 2, EFRAG has some specific concerns on the new terminology used by the IASB. In particular

- (a) '*amount independent of the entity's available economic resources*': The IASB uses this terminology when defining a financial liability and for separate presentation requirements. EFRAG considers that assessing whether an amount is independent of the entity's available economic resources will always involve significant judgement, particularly when considering non-listed companies and financial institutions that issue complex instruments with many different variables.

EFRAG understands that this would encompass fixed monetary amounts or amounts that vary in response to something other than the fair value of the entity's shares. However, EFRAG notes that financial instruments for which the amount is partly independent of the entity's available economic resources can also be classified as liabilities (e.g. foreign currency written call option).

Furthermore, when the IASB refers to equity, it states that equity claims could not contain either of the features that lead to a liability classification. That is, the amount cannot be '*independent of the entity's available economic resources*'. EFRAG considers that this could raise confusion because if a claim is partly independent of the entity's available economic resources (e.g. derivative that depends both on the value of the share and a foreign currency such as redeemable shares or puttable shares at fair value in a foreign currency or indexed to a commodity), then one may argue that the amount of the claim is not independent of the entity's available economic resources and classify the claim as equity (particularly when dealing with derivatives which the net amount partly depends on the entity's available economic resources).

- (b) '*economic resources*': Share-settled bonds are classified as a liability under the IASB's preferred approach as an entity has an obligation for a specified amount independent of the entity's economic resources. In this case, the type of economic resource required to be transferred to settle the claim on maturity date is a share. Thus, it seems that the entity's own shares are considered as an economic resource;
- (c) EFRAG considers that the IASB should clarify which types of instruments are subject to the following guidance:
- (i) Amount cannot exceed the entity's available economic resources; and
  - (ii) Amount cannot exceed the entity's available economic resources when considered in combination with other claims against the entity.

### Other potential improvements

- 78 EFRAG considers that the IASB should discuss whether the presentation proposals on subclasses of equity could be linked to the classification and disclosure requirements. For example, for the most residual class of claims (e.g. ordinary shares), the IASB could develop specific requirements in terms of classification, presentation and disclosure, which should be linked.
- 79 Considering this, EFRAG also considers that the IASB could discuss alternative approaches for the subclasses of equity, as described below in section 6. For example, the IASB could discuss whether the classification, presentation and disclosure requirements could be improved based on the idea of subclasses of equity which should be based on whether financial instruments will or may be settled in the issuer's own equity instruments (as already implicit in paragraph 16 of IAS 32-existing and potential shareholders).

#### Question to Constituents

- 80 What are the most common non-derivative financial instruments other than ordinary shares in your jurisdiction?

#### Question to EFRAG TEG

- 81 Does EFRAG TEG agree with the drafting and key messages of section 3 of the appendix 1 of the Draft Comment Letter on the issue related to non-derivative financial instruments?
- 82 Does EFRAG TEG agree with question to constituents to obtain data for EFRAG impact assessment?

## Section 3 – Puttable exception

### Notes to constituents – Summary of the IASB DP on the puttable exception

- 83 *A puttable financial instrument gives the holder the right to put the instrument back to the issuer for cash or another financial asset. Currently these instruments would meet the definition of a financial liability and should be classified as such, unless they meet the conditions of the puttable exception in paragraphs 16A-16B or 16C-16D of IAS 32.*
- 84 *In applying the IASB's preferred approach, a puttable instrument would still meet the definition of a financial liability. This is because the instrument contains an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation. The entity has the obligation to transfer cash or another financial asset in exchange for redeeming the financial instrument at the option of the holder or on the occurrence of an event other than liquidation.*
- 85 *For financial instruments that meet the requirements of the exception in paragraphs 16C-16D of IAS 32, the same conclusion would apply. These financial instruments are similar to puttable financial instruments that meet the exception in paragraphs 16A and 16B of IAS 32, however, instead of the condition in paragraph 16A(e), they impose on the entity an obligation to deliver a pro rata share of the net assets of the entity only on liquidation, if liquidation is at a specified time or at the option of the instrument holder. Therefore, the entity has a contractual obligation to transfer cash or another financial asset at a specified time, hence classification as a liability would*

*provide information that is relevant to assessments of an entity's funding liquidity and cash flows.*

- 86 *However, this does not address the challenge that arises when all of an entity's claims meet the definition of a liability and no claim qualifies for classification as equity. When all of the entity's claims meet the definition of liability:*
- (a) liabilities are recognised at no less than the amounts payable on demand which could result in the entire market capitalisation of the entity being recognised as liability;*
  - (b) depending on the basis for which the redemption value is calculated, it is possible that an entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value;*
  - (c) the entity would be depicted as wholly, or mostly, debt funded;*
  - (d) it raises questions as to what the difference between the assets and liabilities would represent, and how an entity would faithfully represent that difference in its financial statements, since equity is typically the element measured as a residual for the purposes of recognition and measurement; and*
  - (e) it raises other challenges because the definitions of income and expense assume the existence of equity (a change in an asset or a liability needs to result in a change in equity to meet the definition of income and expense).*
- 87 *Therefore, the IASB's preliminary view is that the puttable exception would continue to be required under the IASB's preferred approach, as:*
- (a) applying the IASB's preferred approach to financial instruments that meet the exception might address some, but not all, of the previous concerns that led to the exception. In particular, the incomplete recognition and measurement of assets and liabilities means that if at least one claim is not recognised and measured as a residual, the usefulness of the statement of comprehensive income is reduced;*
  - (b) the scope of the puttable exception is restricted to a narrow set of circumstances in which no other financial instrument or contract is more subordinated and holders of the puttable instruments represent the most residual interest in the entity's net assets; and*
  - (c) the IASB is not aware of any issues with the application of the puttable exception as set out in paragraphs 16A–16B or 16C–16D, of IAS 32.*

#### **Question 4**

The IASB's preliminary view is that the puttable exception would continue to be required under the IASB's preferred approach. Do you agree? Why, or why not?

#### *EFRAG's response*

**EFRAG welcomes the IASB decision to retain the puttable exception as the new IASB approach does not solve all the issues that gave rise to the exception.**

**EFRAG also welcomes the IASB proposal to retain the disclosure requirements in IAS 1 paragraph 136A for instruments that meet the exceptions in paragraphs 16A-16D.**

**EFRAG considers that the IASB should take the opportunity to understand the extent to which the exception is used in practice, the application challenges arising from it and whether potential improvements can be identified.**



- 88 EFRAG welcomes the IASB efforts to remove some of existing exceptions in IAS 32 that override the definition of a liability in the Conceptual Framework, which make it inconsistent within itself and with other standards.
- 89 In its endorsement advice issued in May 2008, EFRAG supported the amendment to IAS 32 to provide a limited exception to the existing requirements as a short-term solution pending the outcome of its longer-term projects. EFRAG considered that such an approach was reasonable in the circumstances. In the endorsement advice, EFRAG noted that IAS 32 already included some exceptions to the Conceptual Framework definitions of equity and liabilities in order to try to keep up with the increasing sophistication of financial instruments.
- 90 EFRAG still considers that the accounting treatment provided by paragraphs 16A to 16D of IAS 32 is relevant and should be retained until the IASB is able to find a solution that addresses all the issues that gave rise to the exception.
- 91 Nonetheless, this should not prevent the IASB from exploring improvements to the existing guidance in paragraphs 16A to 16D of IAS 32 and related disclosures. The requirements of paragraphs 16A to 16F of IAS 32 have led to significant implementation issues and confusion, as evidenced by requests to the IFRS IC. In particular, practical difficulties in identifying the most residual instrument.
- 92 EFRAG also notes that being equity classified, puttable instruments are not measured at fair value, as would be the case under liability classification. As a result, users do not have sufficient information to estimate the potential cash outflows from these claims. EFRAG acknowledges that for puttable instruments which meet the conditions this problem is mitigated by the current disclosure requirements in paragraph 136A of IAS 1. EFRAG considers that these disclosure requirements provide useful information for users about expected future cash flows from such claims (assuming that such instruments would be measured at fair value). Thus, EFRAG suggests that the disclosure requirements in paragraph 136 of IAS 1 should not only be retained but also clearly state that it applies to instruments as described in paragraphs 16C and 16D of IAS 32.
- 93 Finally, EFRAG considers that the IASB should take the opportunity to better understand how widely the exception is being applied in practice and how it can be improved.

#### **Questions to Constituents**

- 94 To what extent the “puttable instruments and obligations arising on liquidation” exception in paragraph 16A-16D is being used in your jurisdiction?
- 95 What entity types are using this exception the most in your jurisdiction? (E.g. partnerships, limited life entities, co-operatives, etc.)?

#### **Questions to EFRAG TEG**

- 96 Does EFRAG TEG agree with the drafting and key messages of section 3 of the appendix 1 of the Draft Comment Letter on the issue related to the puttable exception?
- 97 Does EFRAG TEG agree with questions to constituents to obtain data for future impact assessment?

## Section 4 - Classification of derivative financial instruments

### Notes to constituents – Summary of the IASB DP on classification of derivative financial instruments

- 98 *The classification of non-derivatives is addressed in section 3. The classification of derivatives on own equity is considered in sections 4 and 5.*
- 99 *The IASB discusses, for classification purposes, the following types of derivatives on own equity:*
- (a) **asset/equity exchanges:** *contracts to receive cash in exchange for delivering own equity instruments. For example, standalone derivatives such as written call option, purchase put option and forward contracts to sell own shares (section 4);*
  - (b) **liability/equity exchanges:** *includes contracts to:*
    - (i) *extinguish a financial liability in exchange for delivering own equity instruments (type 1). For example, standalone forward contract to convert financial liability to equity (section 4) and option embedded in a convertible bond to convert financial liability to equity (section 5); and*
    - (ii) *extinguish an entity's own equity in exchange for an obligation that has features of a financial liability (type 2). For example, written put option and forwards to acquire own shares (section 5);*
- 100 *For asset/equity exchanges (e.g. forward to sell shares), the DP further states that these types of exchanges increase financial assets (e.g. cash) and equity (e.g. issued capital) as the underlying financial assets are still to be received (e.g. cash) and the underlying equity to be delivered (e.g. own equity) does not exist before settlement. By contrast, for liability/equity exchanges the financial liabilities or equity instruments to be extinguished on settlement of the derivative are existing items of the entity.*
- 101 *In paragraph 4.26 the IASB explains that it considered how the classification principle developed in section 3 could be applied to derivatives on own equity in their entirety and concluded that a derivative on own equity would be:*
- (a) *classified in its entirety as either an equity instrument, or as a financial asset or a financial liability; the underlying legs of the exchange would not be separately classified; and*
  - (b) *classified as a financial asset or a financial liability if:*
    - (i) *the derivative could require the entity to deliver cash or another financial asset, and/or contains a right to receive cash, for the net amount at a specified time other than at liquidation; and/or - it is net-cash settled; and/or*
    - (ii) *the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.*
- 102 *Accordingly, for contracts to receive cash in exchange for delivering own equity instruments (asset/equity exchange) and contracts to extinguish a financial liability in exchange for delivering own equity instruments (liability/equity exchange type 1) would be classified as equity instruments if:*
- (a) *the derivative does not require a transfer of cash or another financial asset at a specified time other than at liquidation (i.e. they are either physically settled or net-share settled); and*
  - (b) *the net amount of the derivative is not affected by a variable that is independent of the entity's available economic resources (i.e. fixed-for-fixed);*

- 103 *It is worth noticing that in this section, the IASB discusses the classification of derivatives on own equity other than for those that include an obligation to extinguish an entity's own equity instruments and derivatives embedded in compound instruments. Effectively, section 5 deals with the gross share-settled liability/equity exchanges.*
- 104 *Under the IASB's preferred approach, the classification outcomes for some derivatives on own equity might differ from those under IAS 32 because of the differences arising from clarifying the rationale and rearticulating the amount feature. In particular, the classification of the following instruments would change:*
- (a) *net-share settled derivatives to deliver a fixed number of own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount; and*
  - (b) *foreign currency rights issues that meet the exception in IAS 32.*
- 105 *Finally, from paragraphs 4.45 to 4.66 the IASB discusses detailed guidance on variables that affect the net amount of derivatives on own equity (i.e. fixed-for-fixed condition). It mainly concludes that variables such as foreign currency and variables that depend on the entity's economic resources before deducting all other claims against the entity (e.g. EBITDA) would be independent variables in all circumstance and would preclude equity classification. For other variables such as time value of money, dilution and contingencies, the IASB concludes that they could be considered as dependent variables in some but not all circumstances.*

#### **Question 5**

The IASB's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows:

- a. a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and
- b. a derivative on own equity is classified as a financial asset or a financial liability if:
  - i. it is net-cash settled - the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or
  - ii. the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.

Do you agree? Why, or why not?

EFRAG's response

**EFRAG welcomes the IASB efforts to clarify the existing guidance on derivatives on own equity to address the issues that arise in practice without fundamentally changing the classification outcomes. EFRAG also welcomes the IASB proposal to classify derivatives on own equity in their entirety as an equity instrument.**

**However, EFRAG considers that the IASB should further analyse the option of accounting for all derivatives on own equity as derivative assets or liabilities under the scope of IFRS 9. EFRAG is also concerned that although the classification outcomes will not be significantly affected, the proposed guidance differs significantly from current guidance, particularly in terms of terminology (e.g. the identification of different types of derivatives such as asset/equity and liability/equity exchanges), which would have a significant impact on the existing application guidance and introduce new uncertainties.**

**Finally, EFRAG welcomes the additional guidance on whether the net amount of derivative, embedded derivative and hybrid is affected by a variable that is independent of the entity's available economic resources (i.e. whether it meets the fixed-for-fixed condition). However, EFRAG would welcome more illustrative examples that would help entities to apply the principles described in the DP.**

**The IASB's discussions on derivatives on own equity in general**

106 Currently, many of the application challenges with IAS 32 are related to the classification of derivatives on own equity. This is reflected in the number submissions to the IFRS IC related to derivatives on own equity - for a detailed list please see appendix 3. The IASB identified the following challenges in paragraph 4.14 of the DP:

- (a) the application of the fixed-for-fixed condition, particularly when they are impacted by variables such as foreign currency, anti-dilution provisions and conversion rates that change over time;
- (b) the appropriateness of the foreign currency rights issue exception compared to conversion options in foreign currency convertible bonds;
- (c) the recognition of a 'gross' liability for derivatives that include an obligation of the entity to purchase/redeem its own equity instruments (e.g. NCI puts)<sup>1</sup>; and
- (d) the accounting within equity for the premium received for an NCI put and the accounting for when the holder exercises the put or when it expires<sup>2</sup>.

107 In addition, EFRAG highlights the opacity of the current accounting treatment of derivatives on own equity under IAS 32 and the inability of users of financial statements to identify and assess these transactions in the financial statements.

108 Therefore, EFRAG welcomes the IASB's effort to better articulate the principles in IAS 32 and provide additional guidance with the objective of addressing the issues identified by the IFRS IC in the past. In particular, EFRAG acknowledges and welcomes the fact that the IASB:

- (a) continues to classify the derivative in its entirety rather than considering the individual legs under the derivative;

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<sup>1</sup> dealt in section 5

<sup>2</sup> dealt in section 5

- (b) has identified the main challenges in practical application of IAS 32; and developed additional guidance to clarify some complex areas such as:
  - (i) the fixed-for-fixed condition to derivatives on own equity;
  - (ii) the redemption obligation requirements;
  - (iii) the accounting within equity; and
  - (iv) the accounting for instruments with contingencies.
- (c) continues to focus on the substance of the transactions rather than the form; and
- (d) has not sought to change the accounting outcomes under IAS 32 significantly, but rather to improve the rationale of the existing requirements.

### **Different alternatives on accounting for standalone derivatives on own equity**

#### *Accounting for all derivatives on own equity as derivative assets or liabilities*

- 109 When discussing the accounting for all derivatives on own equity, the IASB considered whether it should simply scope out derivatives on own equity from IAS 32 and classify them as derivative assets or liabilities under IFRS 9 (a narrow approach on equity).
- 110 Such an approach would have the benefit of simplifying considerably the requirements in IAS 32 and would be in line with the view of many users of financial statements who argue that there are many complex instruments that are trying to be equity and are not common shares. Such an approach would also be in line with the feedback from some EFRAG members who see derivatives as executory contracts.
- 111 The IASB considered some of the challenges of such an approach (for example, the approach would be inconsistent with the classification of standalone obligations to issue a fixed number of ordinary shares as equity) and the fact that this approach would not meet the objectives of the IASB's preferred approach. Furthermore, the IASB considered that this would have similar limitations to the basic ownership approach considered in the predecessor project. Therefore, the IASB decided not to propose to classify all derivatives as derivative assets or liabilities under the scope of IFRS 9.
- 112 EFRAG also acknowledges that such an approach would mean that many standalone and embedded derivatives that are currently classified as equity would be reclassified and accounted for as liabilities.
- 113 Considering the benefits of simplifying such an approach and following discussions with users of financial statements, EFRAG considers that the IASB should further analyse the potential impact of having all derivatives on own equity classified as derivative assets and liability. In particular, EFRAG considers that it is important to understand the views of stakeholders on this issue and to measure the impact on the financial statements of such an approach.
- 114 Finally, EFRAG considers that the IASB discussions on such an approach should take into account the IASB's proposals for additional disclosures on potential dilution, priority on liquidation and terms and conditions of financial instruments which could compensate any loss of information on the face of the financial statements.

#### *Separate and classify separately the underlying legs of the derivative*

- 115 In the DP the IASB discusses whether it should require a detailed componentisation of all derivatives on own equity. For example, a warrant to deliver own shares in exchange for receiving cash may be classified as an equity component (i.e. the

obligation to deliver own shares) and an asset component (i.e. the right to receive cash).

- 116 EFRAG agrees with the IASB analysis in paragraph 4.20 of the DP that a detailed componentisation of all derivatives on own equity would create many conceptual and operational challenges. It would also be a significant change to current requirements. Therefore, EFRAG welcomes the IASB's preferred approach which is broadly similar to existing requirements in IAS 32 and IFRS 9 for derivatives, where the guidance is applied to contracts in their entirety.

#### **Classification of derivatives on own equity under the IASB's preferred approach**

- 117 For classification purposes, the IASB identified different types of derivatives on own equity, as described in paragraph 99 above. In particular, the IASB clearly distinguished those that could require the recognition of a liability for the redemption amount such as written puts or forward contracts, which are discussed separately in section 5.
- 118 Therefore, this section impacts mainly the guidance on the new amount feature replacing the fixed-for-fixed condition in IAS 32, as well as the foreign currency rights exception.

#### *The IASB's preferred approach in general for asset/equity and liability/equity exchanges*

- 119 As explained in paragraph 102 above, under the IASB's preferred approach, a derivative on own equity that is under the scope of section 4 would be classified as equity if the net amount of the derivative is not affected by a variable that is independent of the entity's available economic resources (i.e. fixed-for-fixed) and the entity is not required to deliver cash or other financial assets at a specified time other than liquidation (i.e. it is physically settled or net-share settled).
- 120 When comparing to IAS 32, this means that for derivatives on own equity the IASB's preferred approach retains the existing fixed-for-fixed requirement in IAS 32 with the net amount feature. In addition, the IASB proposes additional guidance on variables that affect the net amount of a derivative (i.e. fixed-for-fixed condition) in paragraphs 4.45 to 4.66 of the DP, which is further discussed in paragraphs below.
- 121 The IASB also proposes changes to current requirements in IAS 32 to reflect the features used under the IASB's preferred approach, this would result in some classification changes:
- (a) foreign currency rights issues that meet the exception in IAS 32 (from paragraph 124 onwards); and
  - (b) net-share settled derivatives to deliver a fixed number of own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount of the entity's functional currency (paragraphs 132 to 133 below).
- 122 Although EFRAG generally supports the IASB's efforts to better articulate the classification principles in IAS 32 for derivatives on own equity, EFRAG expresses the following concerns:
- (a) the IASB's preferred approach for the classification of derivatives on own equity will not fundamentally change the classification outcome, however the proposed guidance differs significantly from current requirements in IAS 32. For instance, the IASB uses a completely new terminology when referring to the classification of different types of derivatives (e.g. asset/equity exchanges, liability equity exchanges). EFRAG is concerned that the introduction of such terminology will introduce complexity to existing requirements and significantly impact the existing application guidance which would have to be updated to reflect the new concepts and wording;

- (b) even if the new terminology leads to accounting outcomes broadly similar to the requirements in IAS 32, the IASB's preferred approach affects the accounting for some financial instruments for which there are no concerns (e.g. net-share settled derivative instruments). In such cases EFRAG considers that the IASB should explain why such classification provides better information to users of financial statements;
- (c) for liability equity exchanges, it is hard to envisage an example of a basic (as opposed to highly bespoke), stand-alone derivative to extinguish a financial liability in exchange for delivering own equity instruments. In the context of embedded derivatives, the example of a convertible bond is easy to understand. It is not clear why this distinction is considered necessary or useful, except to place the current grossing up of certain derivatives under IAS 32 paragraph 23 on a more principled-based footing. However, this adds an unnecessary layer of complexity and creates an artificial distinction that inevitably fails in the case of purchased put contracts which are not grossed up as the entity can avoid payment;
- (d) the judgement in determining the impact of these may not be significantly simpler than the current fixed-for-fixed requirements; and
- (e) share price is considered to be a variable dependent on the entity's available economic resources, but other items that in many cases are used as proxies for share price (when shares are not actively traded) are considered to be independent variables.

123 Therefore, EFRAG considers that the IASB should further consider whether the end-result justifies this upheaval.

#### *Foreign currency rights exception*

- 124 EFRAG highlights that the DP's proposals on foreign currency would impact the classification of financial instruments that currently meet the foreign currency rights exception in paragraph 16 of IAS 32. This guidance addresses the accounting for rights, options and warrants to acquire a fixed number of additional shares pro rata to all existing shareholders of a class of non-derivative equity instruments in which entities fixes the exercise price of the rights in currencies other than their functional currency. These rights are commonly described as 'rights issues'.
- 125 Currently, rights issues offered for a fixed amount of foreign currency are classified as equity if such rights are issued pro-rata to all of an entity's existing shareholders in the same class for a fixed amount of currency, regardless of the currency in which the exercise price is denominated.
- 126 In accordance with the IASB's preferred approach, such instruments would be classified as a derivative liability with related returns presented in OCI if certain criteria are met. The reason offered is the inconsistency with similar embedded contracts such as foreign currency convertible bonds which do not qualify for equity classification under IAS 32 as it does not meet the fixed-for-fixed requirements (strict form of the fixed-for-fixed condition).
- 127 Applying such an approach to financial instruments that currently meet the foreign currency rights exception in paragraph 16 of IAS 32 would have the conceptual benefit of removing exceptions to the fixed-for-fixed condition in IAS 32 and presenting within comprehensive income the changes in the foreign currency and fair value of the shares to be deliverable. Presenting separately the income and expenses that arise from such liabilities in OCI would also alleviate the tension on the impact of fair value changes in profit or loss and related volatility. However, EFRAG:

- (a) is not convinced such an approach would solve the concerns that led to the amendments published in 2009;
- (b) is not aware of any issues with the application of such an exception;
- (c) considers that with the criteria in its preferred approach the IASB would be replacing the existing classification exception by a presentation exception; this is because such an approach represents an exception to the IASB's principle that the income and expenses that arise from liabilities that depend on the residual amount should be separately presented in OCI;
- (d) considers that the IASB would significantly increase the complexity of the requirements in IAS 32 if separate presentation requirements only applied to the portion of income and expenses that depends on the entity's available economic resources (disaggregation approach) as the entity would have to make the split between the changes in the foreign currency and value of the shares to be deliverable;
- (e) the DP's proposals would lead to an additional item presented in OCI and would raise the discussion whether there should be recycling;
- (f) contradicts the IASB conclusion that such transactions are transactions with owners in their capacity as owners which should be recognised in the statement of changes in equity rather than in the statement of comprehensive income in accordance with IAS 1; and
- (g) contradicts another IASB conclusion that classifying rights as derivative liabilities was not consistent with the substance of the transaction (paragraph BC4F).

128 Therefore, EFRAG considers that the for foreign currency rights issue is still relevant and should be retained until the IASB is able to find a solution that addresses all the issues that gave rise to the amendments in 2009.

#### *Partly independent variables*

- 129 To address the issue of foreign currency rights issue exception, EFRAG considers that the IASB could explore an alternative approach for partly independent derivatives, which encompass instruments that currently meet the foreign currency rights exception.
- 130 In paragraph 6.34 of the DP, the IASB establishes a criterion for separately presenting income and expenses in OCI when related financial instruments are partly independent derivatives. EFRAG considers that the IASB should discuss whether such criterion could be used for classification purposes. That is, the IASB should discuss whether a partly independent derivative could be classified as equity if it meets similar criterion.
- 131 EFRAG acknowledges the issues referred by the IASB in paragraph 4.33(c)<sup>3</sup> in regard to classifying partly independent derivatives in their entirety as equity instruments. However, we consider that the use of the criterion in paragraph 6.34 would mitigate the issue mentioned in paragraph 4.33(c).

#### *Net-share settled derivatives*

- 132 Currently, net-share settled derivatives are classified as liabilities and measured at fair value through profit or loss. Under the IASB's preferred approach, net-share settled derivatives to deliver a fixed number of own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount are

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<sup>3</sup> if only some partly independent derivatives were to be classified as equity instruments, whether some types of variables, such as foreign currency indexation, should have different treatment from other variables, such as commodity indexation.



classified as equity. Considering the IASB's attribution proposals, this would mean that the carrying amount of the derivative would have to be subsequently updated.

- 133 EFRAG notes that this classification change is a consequence of updating the IAS 32 requirements and not meant to address any specific concern that arises in practice. Although EFRAG considers that most derivatives are physically gross settled or net-cash settled, we consider that the IASB has not clearly explained the benefits of such classification, in terms of relevance, and would like to have stakeholders' views on such classification change. This is especially relevant if the IASB decides to have an attribution approach other than full fair value to update the carrying amount of the derivative.
- 134 EFRAG also notes that liability/equity exchange contracts that are net-share settled fall under section 5 and therefore will require grossing up similarly to the gross share-settled forward contracts to buy and written puts over own equity. This is not clear from the DP and could benefit from better description as well as examples.

**Information for EFRAG TEG:**

Under IAS 32, net share-settled contracts would fail the fixed-for-fixed requirement as the number of shares to be received or delivered could change depending on the fair value of the contract.

Under the IASB's preferred approach, these contracts can still meet equity classification if the net amount of the derivative is not affected by a variable independent of the entity's resources. Using the approach set out in the DP, it is as if under IAS 32 the share price of the entity's shares was considered to be an independent variable, although the starting points of these two differ completely in this respect.

*Additional specific guidance on variables that affect the net amount (i.e. fixed-for-fixed condition)*

- 135 In paragraph 4.45 to 4.66 of the DP, the IASB provides guidance on whether a specific variable that affects the net amount of the derivative precludes equity classification. That is, the IASB provides guidance on whether a derivative can be classified as equity when the net amount of a derivative is affected by variables such as foreign currency, time value of money, anti-dilution provisions and contingencies (i.e. whether a derivative meets the fixed-for-fixed condition)
- 136 EFRAG notes that many of the submissions to the IFRS IC on IAS 32 were related to the fixed-for-fixed condition. When analysing the issues, the IFRS IC also identified that there was diversity in practice in many issues related to the application of the fixed-for-fixed condition. This is due to the fact that currently IAS 32 provides limited guidance on how to interpret the fixed-for-fixed condition. As a result, the IFRS IC either reported the issues to the IASB and/or requested the IASB to better explain the requirements in IAS 32.
- 137 EFRAG considers that such guidance is fundamental to promote consistency in practice. In particular, we consider that it is useful to have a key principle that is supported by practical application guidance. Therefore, EFRAG generally supports the direction of the IASB proposals in the DP.
- 138 In regard to the variables analysed by the IASB in paragraphs 4.45 to 4.66, in general EFRAG would welcome more illustrative examples that would help entities to apply the principles described in the DP.

Foreign currency<sup>4</sup>

- 139 This section is focused on whether the net amount of a derivative is impacted by foreign currency, resulting in a financial liability classification, similarly to the position under IAS 32.
- 140 EFRAG considers that the issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency as very important. Entities often issue financial instruments that are denominated in a currency other than its functional currency. A common example is the issuance of convertible bonds by a parent or subsidiary which are denominated in a currency (e.g. euros) other than its functional currency (e.g. Norwegian krone) for ease of access to investors.
- 141 As currently IAS 32 does not make a specific reference to this issue, entities have an accounting policy choice which impairs comparability. Generally, entities have considered guidance in IAS 39 *Financial Instruments: Recognition and Measurement* (now replaced by IFRS 9). In these standards, a contract in the functional currency of either counterparty would be closely related which reflects the bargaining power of both parties to the contract.
- 142 In addition, in November 2006 the IFRS IC discussed the issue of which functional currency should be the reference point in determining whether a derivative is denominated in a foreign currency but did not take the matter onto its agenda. Considering the lack of guidance and clarity on this issue, EFRAG welcomes guidance on this topic.
- 143 Paragraph 4.49 explains that foreign currency would introduce an independent variable and the derivative would be classified as a financial asset or a financial liability. The DP then continues in paragraph 4.50 to explain what happens if an entity enters into a derivative contract on equity instruments of another entity within the same group. To determine whether the derivative could meet equity classification, the IASB also explains that the functional currency of the entity whose equity instruments form the underlying of the derivative should be the reference point.
- 144 EFRAG agrees with the principle included in paragraph 4.50 of the DP as the relevant determination for the separate/individual accounts would be whether the derivative is over its equity (or another group entity's) and its functional currency.
- 145 Challenges arise when considering consolidated financial statements, including situations where an entity issues derivatives over equity instruments of another entity within the group. Considering the notions of "reporting entity" and "functional currency" that exist in IFRS Standards, ideally the principle in paragraph 4.50 of the DP should also apply to consolidated financial statements (as a single entity). However, we acknowledge that a group does not have a functional currency and such discussion is beyond the scope of this project. Therefore, we agree with the outcome proposed.
- 146 However, EFRAG considers that the IASB should consider developing illustrative examples of derivative contracts on equity instruments of another entity within the same group to better explain how these principles would apply in practice considering different perspectives. For example, the classification in the separate financial statements of the subsidiary and parent and the consolidated financial statements of the group. Including examples where the shares of the subsidiary are denominated in a different currency (e.g. US Dollars) when compared to the

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<sup>4</sup> referred to as 'Currency or fixed units of financial assets in the DP'

currency used to settle the derivative and subsidiary's functional currency (e.g. EURO).

- 147 EFRAG also thinks that the sections on foreign currency (paragraph 4.50) and NCI (paragraph 4.62) should be cross reference or situated closely together, as the first section settles the principle and the second better explains how this principle is applied to NCI. The same holds true for any conversion option identified in written puts as discussed in section 5.
- 148 EFRAG also notes that the foreign currency variable is also important for the separate presentation requirements of derivatives that have been classified as liabilities. More specifically, it affects the assessment of whether income and expenses that arise from partly independent derivatives should be recognised in OCI (e.g. foreign currency denominated written call option).

Dependency on the entity's economic resources before deducting all other claims

- 149 EFRAG welcomes specific guidance on this topic in this section given the complexity of the model and the new terminology. However, EFRAG considers that this may still be the subject of significant debates between preparers and auditors and will require significant judgement, therefore further examples may also be useful in this area.
- 150 Paragraph 4.52 of the DP clearly considers that a derivative contract gross or net-share settled based on EBIT is different in nature than a contract based on the fair value of shares settled in shares. The DP seems to suggest that as interest and tax are excluded, EBIT only reflects changes in assets; however this would not be a problem where the entity has low debt. Furthermore, earnings include capitalised interest in some cases as well as other working capital type liabilities.
- 151 Some would argue that in many cases EBIT or a multiple thereof (or other similar metrics) are considered to be proxies for the fair value of the entity's economic resources and that for purposes of consistency, these should also be classified as equity. The example in paragraph 4.52 of the DP is not clear whether the derivative is gross or net-settled in shares or whether it is cash-settled. Where EBIT is used as a proxy for the fair value of shares (e.g. in the case of unlisted shares), it is not clear why equity classification is not considered to be appropriate. Therefore, we consider that the IASB should consider this aspect in more depth and provide further explanations as to the rationale for the final approach taken. EFRAG considers that whilst the guidance may be clear and simple to apply in practice, the scope of instruments to be classified as equity could be narrower than economic reality would suggest.

Time value of money

- 152 EFRAG notes that the impact of time value of money and the potential impact on the amount feature could pose interpretation problems and therefore welcomes the additional guidance. EFRAG agrees with the basic consideration that time value of money impacts all financial instruments whether it be directly or indirectly. Any final definitions and guidance on this topic needs to be consistent as far as possible to the explanation and guidance in IFRS 9.
- 153 EFRAG notes that the additional guidance creates the scope for more uncertainty and judgement as time value of money can be both a dependent and independent variable. EFRAG considers that further guidance is required to assist preparers and advisors in the exercise of judgement in this area. For example, what is considered to be 'leveraged', i.e. does this mean anything other than a one for one relationship? In the example provided in paragraph 4.54, both instruments seem to qualify for equity treatment, but it is not clear whether the strike price is comparable

irrespective of the method used. Further examples of when the time value of money is an independent variable would support practical application.

- 154 Considering the discussion above on the use of different currencies, EFRAG considers that additional guidance on the notion of “benchmark interest rate of an unrelated currency” would be welcomed. For example, when an entity issues a foreign currency Bermuda option for NCI, it is possible that entities that belong to the group have different functional currencies and work in different markets. Therefore, it would be important to link this guidance to paragraph 4.50 of the DP.
- 155 EFRAG does not consider that there is currently sufficient guidance or examples in the DP to conclude that this should solve most practical application problems, especially as time value of money can be both a dependent and independent variable.

#### Dilution and distributions to holders of equity instruments

- 156 Option contracts by unrelated parties (i.e. A sells a call option on the shares of C to B) generally does not include anti-dilutive provisions or provisions for distributions. On a theoretical basis, therefore, it is not clear why contracts where the issuer is involved need to include these adjustments.
- 157 However, given that in practice these clauses give rise to considerable efforts to determine whether fixed-for-fixed-requirements have been met, additional guidance is welcome and the examples in paragraph 4.58 even more so. EFRAG considers that the guidance provided will go a long way towards solving most problems around practical application in this area.

#### Non-controlling interests

- 158 EFRAG welcomes that the DP confirms the principles in IAS 1 on NCI when considering derivatives over own shares.
- 159 However, for the avoidance of doubt, the examples should clarify who are the parties to the contract (parent, subsidiary and/or other parties); explain the treatment in the accounts of the parent and/or subsidiary and then conclude on the position on consolidation. Currently, the guidance is not always clear whether the contract meets equity classification in the financial statements of the subsidiary and/or parent before concluding on the treatment in the consolidated financial statements.

#### Contingencies

- 160 Examples of contingencies outside of the control of both parties currently included in various contracts include:
- (a) Changes in indices (stock markets or consumer price)
  - (b) Changes in other financial variables such as interest or exchange rates;
  - (c) Changes in tax laws or other regulatory requirements such as capital requirements;
  - (d) Changes in key performance indicators such as turnover, net income or leverage ratio;
  - (e) Changes in control;
  - (f) Changes in listing status (such as successfully completing an IPO); or
  - (g) Cross-default settlement clauses.
- 161 EFRAG agrees with the basic principle that contingencies outside the control of the entity is considered unavoidable and therefore precludes equity classification. The example in paragraph 4.66 explains when such an event does not impact either the

timing or amount features, but more examples showing where either is impacted may also be useful.

- 162 EFRAG also urges the IASB to consider issuing further guidance on what constitutes in the control of the entity which can be complex in practice. For instance, when determining 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). This is also relevant for interpretation of clauses relating to initiation of IPOs or successful completion of IPOs etc.

**Question to EFRAG TEG**

- 163 Does EFRAG TEG agree with the drafting and key messages of section 4 of the appendix 1 of the Draft Comment Letter?

## Section 5 - Compound instruments and redemption obligation arrangements

### Notes to constituents – Summary of the IASB DP on compound instruments and redemption obligation arrangements

- 164 *In section 5 of the DP, the IASB discusses potential improvements to the existing guidance on derivatives that include an obligation to extinguish an entity's own equity instruments (e.g. written put options, purchased call option or forward contracts to buy own equity instruments) and embedded derivatives in compound instruments (e.g. convertible bonds).*
- 165 *In the IASB's preferred approach an entity would:*
- (a) *for a standalone derivative to extinguish an equity instrument (e.g. written put option), consider the package of contractual rights and obligations arising from the derivative and the underlying non-derivative equity instrument that will, or may, be extinguished (together referred to as a 'redemption obligation arrangement'). Once identified, the package of the contractual rights and obligations would be analysed for classification purposes in a similar way as a compound instrument.*
  - (b) *for a compound instrument (e.g. convertible bond) or a redemption obligation arrangement (as described in (a) above), separate the financial liability and equity components. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:*
    - (i) *classify that unavoidable obligation as a non-derivative financial liability, applying the non-derivative classification principle of the IASB's preferred approach; and*
    - (ii) *classify any remaining rights and obligations as equity or as a financial asset or a financial liability, applying the derivative classification principle of the IASB's preferred approach.*
  - (c) *if an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that has the feature(s) of a financial liability, the financial instrument does not contain a financial liability component.*
- 166 *Finally, in paragraph 5.45 the IASB considered financial instruments with alternative settlement outcomes that are controlled by the entity (fixed-for-fixed reverse convertible bond which is accounted for as equity in its entirety under IAS 32) and discussed whether, and if so, how the information about the entity's right to choose the alternative settlement outcome should be provided in the financial statements. Possible alternatives include:*
- (a) *separation of embedded derivatives from the equity host instrument (i.e. for the reverse convertible bond, separate the embedded purchased call option on own shares); and*
  - (b) *presentation and disclosure, such as attribution within equity.*

**Question 6**

Do you agree with the IASB's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the IASB considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

- a. Do you think the IASB should seek to address the issue? Why, or why not?
- b. If so which approach do you think would be most effective in providing the information, and why?

*EFRAG's response*

**EFRAG welcomes the fact that under the IASB's preferred approach entities will continue to apply a requirement similar to the existing redemption obligation requirement in paragraph 23 of IAS 32 and that the requirements in IAS 32 on compound instruments would be carried forward largely unaltered. However, EFRAG is concerned that the accounting for a convertible bond would be same as for the accounting for a written put option on own shares that is issued together with ordinary shares. EFRAG does not consider that such transactions are similar and is concerned about the final outcome.**

**EFRAG considers that the DP's proposals have the benefit of clarifying and eliminating the diversity in practice on the accounting for derivatives on own equity in which the entity has to transfer a variable amount of cash equal to the value of the underlying shares, particularly when dealing with fair value NCI puts and clarifying the accounting within equity for put options over NCI as this is an issue that creates diversity in practice.**

**Finally, for financial instruments with alternative settlement outcomes that are controlled by the entity, EFRAG considers that information about the variability resulting from the different features included in these types of instruments could be provided through a better breakdown of equity on the face of statement of financial position, together with improved disclosures on the terms and conditions of such financial instruments. EFRAG also considers that improvements to the indirect obligation requirements as described in section 8 could also improve the classification in specific cases.**

**Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)**

*Key challenges*

167 EFRAG acknowledges that many of key challenges that arise in practice with derivatives on own equity are related to:

- (a) whether it is appropriate that written put options and forward purchase contracts on an entity's own equity instruments are presented grossed-up rather than on a net basis like other derivatives (i.e. redemption obligation requirements);

- (b) how to account for transactions within equity when an entity has an obligation to extinguish its own instruments (e.g. NCI puts);
- (c) how to subsequently measure the redemption amount when the entity has to deliver the fair value of its own instruments (e.g. written puts with a fair value strike price);
- (d) whether the liability component should include the effect of any conditionality (e.g. probability-weighting the liability component based on the likelihood of the liability settlement outcome occurring); and
- (e) how to account for a financial instrument that gives the issuer the option for a liability or equity settlement.

168 In this section, the IASB explains how the IASB's preferred approach addresses these issues. EFRAG has provided its comments accordingly, however as under the IASB's preferred approach the redemption obligation requirements are closely related to the compound instruments guidance, EFRAG starts by providing its comments on compound instruments.

#### *Compound instruments*

- 169 Under the IASB's preferred approach, an issuer would need to determine whether an instrument contains both a liability and an equity component similar to the approach under IAS 32. Based on the classification principle in the DP, where an entity is unable to avoid a settlement outcome that has feature(s) of a financial liability, the entity identifies this obligation first and classifies it as a non-derivative financial liability. Similarly to IAS 32, the entity would need to consider whether remaining rights and obligations would be classified as an equity component if it was in a separate contract.
- 170 EFRAG welcomes the fact that the requirements in IAS 32 on compound instruments would be carried forward largely unaltered under the IASB's preferred approach. EFRAG considers that the current approach under IAS 32 to be well understood and giving rise to few problems in practice.
- 171 However, EFRAG considers that it would be useful to require separate presentation in the statement of financial position of the equity components of compound instruments and derivatives on own equity (e.g. within a subclass) to help users better understand where the different components of complex financial instruments are presented.

#### *Redemption obligation requirements*

- 172 EFRAG acknowledges that under the IASB's preferred approach (paragraph 165 above) entities will continue to apply a requirement similar to the existing redemption obligation requirement in paragraph 23 of IAS 32. More specifically, under the IASB's preferred approach a financial instrument that includes an obligation to acquire own equity for cash (e.g. written put option physically gross settled) will give rise to a financial liability for the present value of the redemption amount, even when there is an obligation that is conditional.
- 173 The IASB's preferred approach clarifies that this accounting treatment ensures that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured. More specifically, it will ensure that the accounting for a convertible bond will be similar to the accounting for a written put option on own shares that is issued together with ordinary shares.
- 174 EFRAG agrees with the IASB's proposal to have the same settlement outcomes for instruments that are structured differently as this ensures the focus on economic substance rather than legal form. EFRAG welcomes the IASB proposal to retain the redemption obligation requirements that already exist in IAS 32 for financial



instruments that contain an obligation for the entity to acquire own equity for cash or another financial asset. EFRAG considers that it is important to recognise the redemption amount because the entity does not have the unconditional right to avoid a settlement outcome that as the feature(s) of a financial liability.

- 175 However, EFRAG does not consider that the accounting for a written put option on own shares that is issued together with ordinary shares is similar to the accounting for a convertible bond and EFRAG is concerned with the final outcome.
- 176 Any similarity observed between a written put and a convertible bond, is a direct consequence of the decision to recognise a liability for a *possible* obligation. To then conclude that the accounting for a written put is the same as a convertible bond ignores economic reality: In one case the entity has issued shares and may acquire them back, while in the other case an entity might have to issue shares in the future to settle the claim. The similarity between a convertible bond and a written put from the perspective of the holder assumes that the holder of the put also holds the underlying shares which is not necessarily the case.
- 177 EFRAG is particularly concerned with the outcome of the accounting within equity, which is described below.

*Accounting within equity for written put options*

- 178 As a second step, and to achieve consistency in the accounting for convertible bonds and written puts issued together with the issue of shares, the IASB proposes changes to the existing requirements on accounting within equity. More specifically, the IASB proposes the following accounting:
- (a) the redemption amount is the present value of the strike price of the option (in accordance with IAS 32);
  - (b) the related equity is derecognised at the fair value of the ordinary shares at the issue date of the written put (change to IAS 32);
  - (c) the equity component representing the remaining rights in the arrangement, (i.e. representing a written call or conversion option in a convertible bond) is recognised as the sum of the premium received and the difference between the two amounts calculated above (change to IAS 32). Under IAS 32, the cash received for the written put was accounted for as the equity component. The identification and classification of such an exchange obligation represents a significant change from the current IAS 32 requirements.
- 179 As already mentioned above, EFRAG does not consider that such transactions are similar and is concerned about the final outcome. In particular, EFRAG considers that such an outcome is complex for users and preparers to understand, does not reflect the substance of the instruments and will not provide useful information to users, regardless of whether the carrying amount is affected by an attribution requirement or not. EFRAG considers that this accounting becomes even less meaningful for any attribution method other than at fair value.
- 180 EFRAG notes that the DP introduces a new concept as derecognition of equity is not considered to be ‘true derecognition’ but merely a reflection of the change in characteristics of equity instruments. It is not clear what this means and what, if any, practical implications of such a new category of derecognition could be. Furthermore, the DP indicates that equity is the residual of the amounts recognised for the liability, the conversion option and cash received, however, it is not clear whether this includes the impact of valuation adjustments such as credit or debit valuation adjustments or funding valuation adjustments.
- 181 In summary, EFRAG considers that the DP’s proposals for the accounting within equity:

- (a) will increase significantly the complexity of the requirements on date of recognition as the equity component is changed from a written put to a written call or conversion option in a convertible bond. EFRAG also considers will be difficult for users to understand the outcome of such accounting treatment;
- (b) the carrying amount of the equity component will be subsequently updated in accordance with the attribution method selected by the IASB. EFRAG considers that it will be difficult for users to understand the outcome of such accounting treatment even if the attribution is at full fair value. If the IASB decides to use other attribution mechanism, EFRAG considers that users will not be able to understand the final outcome;
- (c) may increase confusion due to the new concept that derecognition of equity is not ‘true derecognition’ and what that means; and
- (d) the principles stated in paragraph 5.8 of the DP will be difficult to incorporate in IAS 32 as it would need detailed guidance and examples, as EFRAG does not consider that it is intuitive that a written put option (and other similar derivatives) should be analysed from classification purposes in a similar way as a compound instrument.

*Subsequent measurement of fair value written puts*

- 182 Another important issue is how to subsequently measure written puts when the entity has to deliver the fair value of its own instruments. Currently, the subsequent measure changes in the redemption are recognised in profit or loss. However, some argue that subsequent measure changes in the redemption recognised in profit or loss result in counter-intuitive accounting.
- 183 Under the IASB's preferred approach, the same principles are followed irrespective of whether the strike price is at fair value or for a fixed amount. Therefore, the liability component would represent the redemption amount - the obligation to pay the fair value of the equity instrument - as if it were unconditional. The remaining obligation for the entity is to exchange that obligation for an equity instrument with the same value, which will have a nil value. Thus, all of the returns on the claim will be captured by the liability component. As the amount of the claim is not independent of the entity's available economic resources, the separate presentation requirements will apply and the gains and losses that arise from the liability will be presented in OCI.
- 184 EFRAG considers that the DP's proposals have the benefit of clarifying the accounting for fair value puts and will ensure consistency with the accounting for shares redeemable at fair value (except those that fall under the puttable exception).

*Accounting for NCI puts*

- 185 In the consolidated financial statements, put options over NCI follow the same basic accounting per IAS 32 paragraph 23 discussed above in paragraph 170.
- 186 The challenges of applying IAS 32 on written puts in general continues when applying the requirements to written puts of NCI. The challenges include whether:
- (a) The NCI is derecognised, or a contra-equity account is recognised within the consolidated equity when recognising the liability for the redemption amount; and
  - (b) The subsequent measurement changes in the redemption amount is recognised in profit or loss or in equity, similarly to other transactions between equity holders.
- 187 In the DP the IASB clarifies that its proposals for the accounting within equity for a written put option would also apply to NCI. Thus, applying the IASB's preferred

approach, the accounting for put options over NCI in the consolidated financial statements would involve:

- (a) recognition of a liability component at the redemption amount, which will be subsequently remeasured in accordance with IFRS 9;
- (b) derecognition of the NCI on which put options are written, at the fair value of the ordinary shares of the subsidiary at the date the put options are issued; and
- (c) recognition of the residual as an equity component for the implicit written call option on the subsidiary's shares.

188 The carrying amount of the equity component is updated over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns. At maturity, the carrying amounts of the equity component and the liability, are transferred to ordinary shares. If the put option expires unexercised, then the carrying amounts of the redemption amount and the conversion option would be reclassified to NCI.

189 For fair value NCI puts, the IASB clarifies that the treatment as described in paragraph 183 would also apply to NCI puts with a strike price at fair value, where the equity component will be nil and all of the returns on the claim will be captured by the liability component and related returns recognised in OCI as described.

190 EFRAG considers that the DP's proposals have the benefit of clarifying the accounting for NCI puts including those with a strike price at fair value and will ensure consistency with the accounting for shares redeemable at fair value.

191 EFRAG welcomes the IASB's discussion on accounting within equity for put options over NCI as this is an issue that creates diversity in practice. Regarding the derecognition of the NCIs on which put options are written, EFRAG notes that current practice is mixed as some consider it logical to derecognise the minority interest while others consider such derecognition as inappropriate. This could be the case when a put option is not at a fixed price which some interpret as that the NCI continue to have equity-type exposure and that the NCI should continue to be recognised. Neither approach is currently forbidden by IAS 32 paragraph 23. Nonetheless, EFRAG expresses the same concerns as in paragraph 179 above in regard to recognising an equity component that represents an implicit call option as compared to the put option.

192 Whilst the DP clarifies that the component of equity (whether shares issued or NCI) is derecognised, it does not deal with the ancillary issues this creates:

- (a) Why changes to the redemption amount (especially for written puts at fair value) should fall under the principles in IFRS 9 around recognition in profit or loss rather than those in IFRS 10 and IAS 1 around transactions between equity holders;
- (b) The treatment of profit allocation and dividends paid to NCI under IFRS 10 when the NCI have been derecognised;
- (c) The impact of the changes on other topics such as earnings per share, i.e. derecognised shares means that subsidiary's income is fully included, but derecognised shares may need to be considered for fully diluted EPS. This may be different from the current situation;
- (d) Whether the accounting should differ based on whether the written put forms part of a business combination or whether it was entered separately; and
- (e) The DP does not provide guidance on the treatment when there is uncertainty around how many shareholders would exercise a cash option in allocation rights as per ESMA's enforcement decision EECS/0214-03.

- 193 Therefore, EFRAG concludes that there are various conflicts that have to be resolved on the basis of derecognition of the equity component. Furthermore, as noted, EFRAG has serious concerns about both the recognition of a conversion option as well as an attribution process to components of equity.

*Financial instruments with alternative settlement outcomes that are contingent on uncertain event*

- 194 In accordance with paragraph 19 of IAS 32 if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. Similarly, an obligation dependent on a counterparty exercising its right to redeem is a financial liability as the entity does not have the unconditional right to avoid delivering cash or another financial asset.
- 195 Paragraph 25 of IAS 32 also 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.
- 196 The IASB's preferred approach is similarly based on whether an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that has the feature(s) of a financial liability. Any conditionality would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability.
- 197 It is worth noting that in regard to automatic mandatorily convertible bonds with a cap, on the IASB's preferred approach the entity would first classify the obligation to deliver a variable number of its own shares with a total value equal to a fixed amount as a non-derivative liability component. In identifying the liability component, the entity would not consider the uncertainty that arises from conditionality, i.e. the likelihood of the share price falling below the cap. Once the liability component is identified, the entity would classify the remaining rights and obligations applying the classification principle of the IASB's preferred approach for derivative financial instruments.
- 198 EFRAG considers that the IASB's preferred approach for contingencies, such as mandatorily convertible bonds with a cap that is triggered automatically, would not change significantly current requirements and would be aligned to the IFRS IC decisions up to date. In addition, EFRAG considers that it would bring clarity to current accounting, particularly on whether measurement of the liability should reflect the probability-weighting of the liability component based on the likelihood of the liability settlement outcome occurring. Such guidance is particularly important to clarify the accounting for financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event, which have been raising concerns around the measurement of the liability component. EFRAG notes that according to the IASB's approach, the liability component must be measured at the full amount that the issuer could be required to pay immediately.

**Financial instruments with alternative settlement outcomes that are controlled by the entity**

- 199 Some financial instruments have alternative settlement outcomes and give the entity an unconditional right to choose the settlement outcome, such as a reverse convertible bond that gives the issuer the option to settle with fixed number of own shares or deliver cash.

- 200 Under IAS 32, this financial instrument would be classified as equity in its entirety as the entity has the unconditional right to avoid delivering cash. Also, the entity has no contractual obligation to deliver a variable number of its own equity instruments.
- 201 Under the IASB's preferred approach, this instrument would also be classified as equity in its entirety as the entity has the unconditional right to avoid the liability settlement. In the absence of further specific requirements, these instruments will be classified in their entirety even if the alternative settlement outcome may be affected by variables that are independent of the entity's available economic resources (e.g. gold indexed callable share). As a result, information about the variability resulting from such variables will not be provided.
- 202 The IASB discussed potential ways to provide information about the alternative settlement outcomes, including separation of embedded derivatives from the equity host instrument and presentation and disclosure, such as attribution within equity.
- 203 EFRAG notes that, under IAS 32, if an entity has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of equity. Therefore, enhancing embedded derivative requirements and separating embedded derivatives would be a significant change to current requirements, and consequently to current practice.
- 204 Similarly, questions could arise with a reverse convertible bond. Such an instrument could be seen differently as an equity component that represents the obligation to deliver a fixed number of shares and a derivative component that represent the issuer's right to choose cash payment instead of the fixed number of shares if it is a cheaper alternative; or an instrument that includes an unconditional right of the entity to settle a claim either by transferring a fixed number of equity instruments (which would be an equity settlement) or a specified amount of cash (which would be a liability settlement). That is, it would include a liability host and an embedded derivative (i.e. purchased put option on own equity).
- 205 In addition, EFRAG notes that these instruments are often affected by multiple variables (e.g. foreign currency, market price of the shares, etc.) and it will be difficult to provide information about all those different features through separation of embedded derivatives and recognition of fair value changes in profit or loss. In addition, such requirements will be costly for preparers. Finally, EFRAG notes that if the IASB decides to use the attribution requirements to help in providing information about financial instruments with alternative outcomes at the entity's option, entities will still need to make the separation of the embedded derivative for attribution purposes as the attribution may be based on fair value changes of such embedded derivatives. This would also add costs and complexity to current requirements.
- 206 Therefore, EFRAG considers that information about the variability resulting from the different features included in these types of instruments could be provided through a better breakdown of equity and improved disclosures on the terms and conditions of such financial instruments, especially where economic compulsion may play a role in the entity's exercise of its discretion.
- 207 EFRAG also consider that improvements to the indirect obligation requirements as described in section 8 could also improve the classification in specific cases (e.g. where an option does not have commercial substance). Also the issues related to economic compulsion are addressed in section 8.

**Questions to Constituents**

- 208 To what extent contingent convertible bonds (CoCo's), cumulative preference shares and written puts on NCI are being used by the entities in your jurisdiction?
- 209 What types of entities are using them the most?

**Question to EFRAG TEG**

- 210 Does EFRAG TEG agree with the drafting and key messages of section 5 of the appendix 1 of the Draft Comment Letter?
- 211 Does EFRAG TEG agree with question to constituents to obtain data for future impact assessment?

## Section 6 - Presentation

### Notes to constituents – Summary of the IASB DP

- 212 *In section 6, the IASB proposes potential improvements to presentation of financial instruments with characteristics of equity. More specifically, it discusses the creation of subclasses of equity and subclasses of liabilities and develops specific proposals that should apply to them.*
- 213 *These proposals are intended to address the limitations of a binary classification system under which instruments must be classified as either liabilities, equity (or as compound instruments), but may have characteristics of both.*

### Notes to constituents – Summary of the IASB DP on separate presentation of financial liabilities

- 214 *As already discussed in section 2 under the IASB's preferred approach, a claim is classified as a liability if it contains:*
- (a) *an unavoidable contractual obligation to transfer economic resources at a specified time other than at liquidation; and/or*
  - (b) *an unavoidable contractual obligation for an amount independent of the entity's available economic resources.*
- 215 *For financial liabilities and derivative financial assets and liabilities that have only one of these two liability features, the IASB discussed potential improvements to the presentation requirements with the objective of providing additional information when there is an:*
- (a) *obligation to transfer cash or other financial assets prior to liquidation **but** the amount of the claim is not independent of the entity's available economic resources (e.g. shares redeemable at fair value). Such improvements are focused on helping users making their assessment of entity's balance sheet solvency and returns; and*
  - (b) *obligation for an amount that is independent of the entity's available economic resources **but** no obligation to transfer cash or other financial assets prior to liquidation (e.g. share settled bonds). Such improvements are focused on helping users making their assessment of the entity's liquidity and cash flows.*

#### *Statement of financial position: assessment of balance sheet solvency*

- 216 *To facilitate assessments of balance sheet solvency, under the IASB's preferred approach an entity should present separately in the statement of financial position (e.g. using additional line items or sub-classifications) financial liabilities and derivative financial assets and liabilities that depend on the entity's available economic resources and partly independent derivatives that meet certain criteria. This would encompass:*
- (a) **financial liabilities** *that contain no obligation for an amount that is independent of the entity's available economic resources but are classified as financial liabilities due to their timing feature (e.g. shares redeemable at fair value that do not meet the puttable exception);*
  - (b) **derivative financial assets and derivative financial liabilities** *that have net amounts unaffected by any independent variable but are classified as financial assets or liabilities due to their timing feature (e.g. fair value written put options and fair value NCI puts); and*
  - (c) **partly independent derivatives** *that meet specific criteria (e.g. foreign currency written call option).*

- 217 *This would also encompass embedded derivatives that are separated from the non-derivative host contract and hybrid instruments that are under the scope of IFRS 9 and are measured currently at fair value through profit or loss.*
- 218 *In addition, to help users of financial statements assess how any potential shortfall or surplus in economic resources is allocated among claim holders an entity should, under the IASB's preferred approach, present financial liabilities and equity in order of priority on the face of the statement of financial position, or disclose it in the notes to the financial statements. If the statement of financial position is presented using a current or non-current presentation, classes of financial liabilities and equity can be arranged by order of priority within those subtotals.*

#### **Statement of financial performance: assessment of returns**

- 219 *Under the IASB's preferred approach, an entity should separately present in OCI, without subsequent reclassification ('recycling'), income and expenses arising from financial liabilities and derivative financial assets and liabilities that depend on the entity's available economic resources and partly independent derivatives that meet certain criteria so that users of financial statements are able to distinguish these financial instruments to make assessment of an entity financial performance.*
- 220 *The IASB considered that such approach would have the benefit of addressing the concerns regarding the counterintuitive effects on the income statement that apply to all financial instruments that contain an obligation for an amount that is affected by changes in the entity's available economic resources. That is, when an entity performs well, the carrying amount of the liabilities increases and a loss is recognised and when an entity performs poorly, the carrying amount of the liability decreases and a gain is recognised.*

#### Derivatives and hybrid instruments

- 221 *As referred above, under the IASB's preferred approach, an entity should separately present in OCI, without subsequent reclassification ('recycling'), income and expenses arising from financial liabilities and derivative financial assets and liabilities that contain an obligation for an amount that is not fully independent of the entity's available economic resources. This would also include standalone derivatives, hybrid instruments and embedded derivatives<sup>5</sup>.*
- 222 *When discussing partly independent derivatives (foreign currency written call option), the IASB considered two approaches:*
- (a) **disaggregation approach:** *the portion of income and expenses that result from the effect of dependent variables (e.g. share price) would be subject to separate presentation in OCI while the portion of income and expenses that result from the effect of independent variables (e.g. foreign currency) would be recognised in profit or loss; and*
  - (b) **criteria-based approach:** *applying the criteria-based approach, an entity would present the total income and expenses arising from a partly independent derivative in OCI (including the portion that results from the effect of independent variables) if the derivative meets particular criteria.*
- 223 *In the IASB's preliminary view, the criteria-based approach better achieves the objective of the presentation requirement as the income and expenses would reflect the effects of all variables in the instrument, would be less complex and less costly. It also considered that the disadvantage of presenting separately in OCI the income*

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<sup>5</sup> Currently, these instruments are under the scope of IFRS 9 and are measured at fair value through profit or loss both when accounted for at fair value as a whole and when separated from the non-derivative host instrument.



and expenses that include the effect of some independent variables could be mitigated by the criteria selected.

- 224 In terms of the criteria, the IASB considered the existing requirements for assessing whether an embedded derivative is ‘closely related’ to the host in a hybrid instrument, in particular paragraph B4.3.8(d) of IFRS 9. Therefore, in the IASB’s preliminary view, an entity should separately present all income and expenses arising from a partly independent derivative, if the following criteria are met:
- (a) the derivative has a net amount that is otherwise not affected by any other independent variable, except for it being denominated in a currency other than the entity’s functional currency;
  - (b) the foreign currency exposure is not leveraged;
  - (c) the foreign currency exposure does not contain an option feature; and
  - (d) the denomination in the foreign currency is imposed by an external factor. For example, the currency denomination is imposed by law or regulation, or market forces are such that denominating the derivative in the entity’s functional currency would not have been practically possible.
- 225 If a derivative that is partly independent does not meet the criteria, an entity would present all income and expenses from that derivative in profit or loss without separate presentation in OCI.
- 226 In addition, for presentation in the statement of financial position, an entity would present separately the carrying amount of the partly independent derivatives that meet the criteria. Specifically, such derivatives should be presented as a separate line item on the face of the statement of financial position.
- 227 Finally, when discussing **hybrid instruments**, the IASB noted that if an embedded derivative in a hybrid instrument is separated from the host contract and the amount is partially or not affected by an independent variable, the IASB’s criteria and separate presentation requirements would apply. However, for a hybrid instrument for which an embedded derivative is not separated, the IASB considered two possibilities without presenting a preferred view:
- (a) **Alternative A** - presentation requirements would apply only to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, depend on the entity’s available economic resources (e.g. shares redeemable at fair value); or
  - (b) **Alternative B** - apply the separate presentation requirements to all embedded derivatives. This approach would require entities to separate all embedded derivatives for the purpose of applying the presentation requirements even if the hybrid contract as a whole is measured at fair value through profit or loss.

#### **Statement of financial position: assessment of liquidity and cash flows**

- 228 The IASB considered whether separate presentation of financial liabilities and derivative financial assets and liabilities using additional line items or sub-classifications would be helpful in providing further disaggregated information about the timing feature. Such distinction could help users of financial statements to make more detailed assessments of funding liquidity and cash flows.
- 229 In the IASB’s preliminary view, presentation requirements do not need to be developed to provide additional information about the timing feature because existing presentation and disclosures required by other IFRS Standards, such as IFRS 7 Financial Instruments: Disclosures, are sufficient to facilitate assessments of funding liquidity and cash flows.

**Question 7**

Do you agree with the IASB's preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The IASB also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

*EFRAG's response*

**EFRAG agrees that it is important to clearly identify liabilities whose amount depends on own performance and considers that the use of OCI is an interesting approach to solving the issue of counterintuitive accounting. However, EFRAG notes that the use of OCI may be controversial, will raise discussion of what performance is and why recycling should not be used in this case. EFRAG also considers if OCI is not to be recycled, then entities should provide disclosures reconciling the amounts recognised in OCI and the movements within equity.**

**EFRAG considers that if the requirements for separate presentation of financial liabilities in OCI are to be implemented, then these requirements should apply only to liabilities, derivatives and embedded derivatives that are solely dependent on entity's available economic resources. Similarly, EFRAG considers that the requirements should apply only to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, are solely depend on the entity's available economic resources.**

***Separate presentation of financial liabilities in the balance sheet and income and expenses in OCI***

- 230 As already mentioned above in section 1, EFRAG acknowledges that a binary classification may not convey all of the similarities and differences between the different financial instruments, thus classifying claims as liabilities or equity may not provide sufficient information to users.
- 231 Therefore, EFRAG welcomes the IASB discussion on how the creation of subclasses of liabilities could help in providing additional information to users, particularly about liabilities that have only one of the two liability features (i.e. either the amount or timing feature). We consider that improvements to presentation are important even if stakeholders disagree on the best classification approach.
- 232 Currently, IAS 1 sets out the overall requirements for financial statements, including how they should be structured, the minimum requirements for their content and the current/non-current or liquidity distinction.
- 233 In terms of statement of financial position, an entity must separate current and non-current assets and liabilities (unless presentation based on liquidity provides information that is reliable and more relevant); must include a number of line items on the face of the statement of financial position; and present additional line items, headings and subtotals if necessary to fairly present the entity's financial position.
- 234 In terms of the statement of financial performance, a number of line items and subtotals are specified for both in profit or loss and OCI. In addition, expenses recognised in profit or loss should be analysed either by nature (raw materials, staffing costs, depreciation, etc.) or by function (cost of sales, selling, administrative, etc.).

- 235 EFRAG notes that the IASB's proposal, when considered as a whole (i.e. creation of subclasses of liabilities, separate presentation requirements within the statement of financial position and statement of financial performance and arranging claims by priority), represents a significant change to existing requirements in IAS 1 and IFRS 9 as it would change current presentation and measurement of liabilities and derivatives (use of OCI) within the statement of financial position and statement of financial performance.
- 236 In particular, EFRAG highlights that the DP's proposals would:
- (a) give rise to separate presentation requirements for three classes of financial liabilities which would affect both the statement of financial position and statement of financial performance:
    - (i) financial liabilities and derivatives for an (net) amount that is dependent on the entity's available economic resources;
    - (ii) financial liabilities and derivatives for an (net) amount that is independent of the entity's available economic resources;
    - (iii) partly independent derivatives for which the net amount that is neither completely independent nor solely dependent on entity's available economic resources.
  - (b) increase the use of OCI in the statement of financial performance; and
  - (c) if the IASB requires entities to present financial liabilities and equity in order of priority on the face of the statement of financial position, as in paragraph 218 above, elements in the statement of financial position would be arranged by both liquidity (current and non-current) and by priority on liquidation for the claims side.
- 237 Therefore, as explained below, EFRAG welcomes some of the DP's proposals on presentation of financial liabilities, but not all.

*Statement of financial position*

- 238 In regard to the statement of financial position, the IASB is proposing the use of additional lines items or sub-classifications for the presentation of liabilities and derivatives for which the (net) amount fully or partly depends on the entity's own performance (e.g. share price).
- 239 EFRAG considers that at this stage is not clear how separate presentation would be reflected on the face of the financial statements, particularly on how these presentation requirements would interact with the existing requirements in IAS 1 (e.g. in terms of minimum line items). More specifically, whether these will be reflected as simply a separate line item, a new subtotal or a separate category.
- 240 The presentation may also depend on the IASB's final decision on disaggregation and criteria-based approach. If the disaggregation approach is used, only two subclasses of instrument will exist (solely dependent or not dependent). If the IASB opts for the criteria-based approach, then the IASB will need to develop three categories (solely dependent, partially dependent and not dependent).
- 241 Therefore, EFRAG struggles to see how the separate presentation requirements would fit within the overall presentation requirements in IAS 1. Considering this, EFRAG would suggest that such information is presented within the notes of the financial statements, linking directly the changes in liabilities with the gains or losses recognised in OCI and the movements within equity.
- 242 EFRAG notes that currently most non-financial entities make the distinction between current and non-current assets/liabilities and organise the line items within each category typically by liquidity.

- 243 EFRAG also notes that currently many financial institutions use the exception described in paragraph 60 of IAS 1 which states that an entity shall present all assets and liabilities in order of liquidity when a presentation based on **liquidity** provides information that is reliable and more relevant than separately presenting current and non-current assets, and current and non-current liabilities.
- 244 Considering this, EFRAG considers that requiring entities to arrange the claims by priority on liquidation on the face (paragraph 218 above) would:
- (a) be inconsistent with current practice and would introduce a different organisation between assets (liquidity) and liabilities (priority);
  - (b) would raise questions on how to arrange liabilities that have a high priority on liquidation but have to be liquidated in the short term, particularly for consolidated financial statements;
  - (c) mean that users could face additional difficulties in determining the working capital of an entity;
  - (d) raise the same issues described in paragraph 352 below (i.e. defining priority within consolidated financial statements can be challenging)
- 245 EFRAG would prefer to have information related to priority on liquidation reflected in the disclosures and not on the face of the statement of financial position (please see section on disclosures). Such an approach would be less disruptive than presentation on the face, while providing the same information.

*Statement of financial performance*

- 246 Some obligations of an entity to transfer economic resources depend on an entity's performance. Remeasuring these obligations through profit or loss results in reduced relevance of reported financial performance as expectations of changed future performance of the entity are immediately recognised in a counter-intuitive way:
- (a) increased expectations result in the recognition of an expense; and
  - (b) reduced expectations result in the recognition of income.
- 247 Similar concerns regarding portraying in profit or loss the changes in financial liabilities measured at fair value caused by changes in the credit risk of an entity resulted in the 'own credit risk' amendments to IFRS 9.
- 248 Therefore, EFRAG considers that it is important to clearly identify financial liabilities and derivatives for which the (net) amount is dependent on the entity's own performance. EFRAG notes that such distinction could be done either by using a separate line item within profit or loss, using OCI or through disclosures.
- 249 In the DP, the IASB refers to the possibility of presenting income and expenses that arise from financial liabilities which the amount depends on the entity's own performance **separately in OCI or using a separate line item within profit or loss**.
- 250 Under the IASB's preferred approach an entity should separately present in OCI, without subsequent reclassification ('recycling'), income and expenses arising from financial liabilities and derivative financial assets and liabilities that depend on the entity's available economic resources.
- 251 EFRAG can see arguments both in favour and against presenting income and expenses in OCI that arise from financial liabilities and derivative financial assets and liabilities that depend on the entity's available economic resources.
- 252 On the one hand EFRAG can see some similarities between this issue and the issue about own credit risks in IFRS 9. This similarity would be an argument in favour of

the IASB's preferred approach. In addition, EFRAG considers that the IASB proposals have the benefit of providing a conceptual solution to what some see as counter-intuitive accounting for puttable instruments, including NCI puts.

- 253 On the other hand, EFRAG acknowledges that many believe that an increase (decrease) in a financial liability should be reflected as performance, even its amount depends on the entity's available economic resources. This is because, when an entity enters into a contract that generates a loss (gain) if the entity performs well (poorly), the recognition of that loss (gain) reflects management's decision to enter into that contract and provides useful information for users' assessment of management's accountability. In addition to this:
- (a) The use of OCI is a controversial issue which interacts with the revised *Conceptual Framework for Financial Reporting*. EFRAG notes that if the IASB decides to expand the use of OCI, there is likely to be a call for a new debate on the notion of performance and for the IASB to further clarify the dividing line between profit or loss and OCI;
  - (b) Under the IASB's preferred approach gains and losses would not be recycled to profit or loss, because the nature of these income and expenses will not be different in the future and will therefore not be relevant to assessments of performance at a future date. If, the gains and losses were to be reported in OCI, then EFRAG considers that it would be useful to not recycle such gains or losses, however we believe that entities should provide disclosures relating the amounts recognised in OCI and the movements within equity when the instrument is settled;
  - (c) The IASB is silent on whether an entity would be required to present the amounts recognised in OCI as a separate component within equity in the statement of financial position and whether there should be a subsequent transfer within equity. Current requirements in IFRS 9 do not permit an entity to recycle the amounts in OCI that are related to changes in the entity's own credit risk. However, the IASB permits their subsequent transfer within equity.
  - (d) This would represent a significant change to the existing requirements in IFRS 9 as it would affect all financial liabilities and derivatives not only in terms of OCI but also on separation of hybrids. We also note that in IFRS 9, only the fair value changes attributable to changes in the entity's own credit risk can be recognised in OCI. That is, only a part of the fair value change of the instrument is recognised in OCI. The DP's proposals would mean that the entire change in the entity's available economic resources (e.g. fair value change of own share price) would be reflected in OCI. Considering the significant impact on the requirements of IFRS 9, EFRAG would recommend that the IASB assess the impact of its proposed changes to IFRS 9 before proceeding.
  - (e) Similarly, this would also impact significantly the guidance in IFRS 3 *Business Combinations* on contingent consideration (e.g. contingent consideration in a business combination may be closely linked to the entity's own performance);
  - (f) Entities may try to structure claims to meet the description of this new class in order to avoid reporting changes in the carrying amount of claims within profit or loss; and
  - (g) EFRAG expresses below a number of concerns with the IASB's approach for partly independent derivatives.
- 254 Notwithstanding these challenges, EFRAG considers that the IASB should continue to explore separate presentation requirements for financial liabilities based on the use of OCI. Nonetheless, EFRAG considers that they should only be applied:

- (a) To financial liabilities (including derivatives) for which the amount is **solely** dependent on the entity's available economic resources; and
- (b) to financial instruments in their entirety or to their different components when the entity has chosen or is required, under current IFRS Standards, to split the financial instrument into different components.

*Partly independent derivatives*

- 255 If a liability or derivative is partially independent of the entity's available economic resources, EFRAG agrees that the most conceptually sound approach would be the **disaggregation approach**. That is, an entity would be required to separate the effects of the variables that affect the amount of an instrument into profit or loss (e.g. foreign currency) and OCI (e.g. value of share). This is because splitting the different components would provide a better reflection of the effect of the entity's own performance in comprehensive income.
- 256 However, EFRAG considers that such model would increase significantly the complexity of the requirements in IAS 32, would be costly to apply and would always generate an artificial split as preparers will not be able to eliminate the effects of the interrelation between the different variables such as share price and foreign currency changes. EFRAG also notes that this approach would widen significantly the scope of use of OCI.
- 257 EFRAG acknowledges that the **criteria-based approach** would address the cost issue of the disaggregation approach. However, EFRAG considers that the 'criteria-based approach' (all in or all out):
- (a) constitutes an exception to the principle that only gains or losses that arise from liabilities and derivatives that depend on the entity's available economic resources should be presented in OCI. This would result in variables that are independent of the entity's available economic resources being reflected in OCI, even if restricted to a number of instruments;
  - (b) would increase complexity in terms of presentation in the statement of financial position as the IASB would need to identify separately within profit or loss and OCI those liabilities that are fully dependent, those that are partially dependent and those that are not;
  - (c) would involve judgement about the facts and circumstances when applying the criteria, particularly when assessing whether the 'foreign currency is imposed by an external factor' as in paragraph 6.34(d) of the DP (e.g. use of the wording 'practically possible');
  - (d) would lead to dissimilar accounting for derivatives and non-derivatives. This is because non-derivative financial liabilities would only be separately presented if the amount of the claim is solely dependent on the entity's available economic resources (e.g. shares redeemable at fair value). It is not clear whether the separate presentation requirements are also applied to non-derivatives that are partly dependent on the entity's available economic resources (e.g. shares redeemable at fair value in a foreign currency); and
  - (e) would widen the scope of changes to the existing requirements in IFRS 9 to allow the use of OCI for both 'not independent' and 'partly independent' derivatives.
- 258 Therefore, EFRAG does not support the IASB's proposal to present separately in the statement of financial performance (in OCI) derivatives, embedded derivatives and hybrids which the net amount is affected by variables that are both independent and dependent on the entity's available economic resources. EFRAG considers that if the IASB decides to further explore the requirements for separate presentation of financial liabilities in OCI, then they should be applied only to financial liabilities and

derivatives for which the amount is solely dependent on or affected by the entity's own performance.

***Separate presentation requirements to all embedded derivatives in hybrid instruments***

- 259 EFRAG considers that if the requirements for separate presentation of financial liabilities in OCI are to be implemented, then these requirements should apply only to embedded derivatives that are separated from the host (but not required) and hybrid instruments that, as a whole, are **solely** depend on the entity's available economic resources (e.g. shares redeemable at fair value);
- 260 EFRAG considers that separate presentation of all embedded derivatives in hybrid instruments would maximise the benefits of the separate presentation requirements. However, EFRAG is concerned about the costs and complexity of always requiring the split of hybrids instruments just for the purpose of using OCI. If the IASB decides to proceed, before proceeding, EFRAG would then recommend that the IASB assess the impact of such proposals.

**Question to EFRAG TEG**

- 261 Does EFRAG TEG agree with the drafting and key messages of section 6 "Summary of proposals in the DP on separate presentation of financial liabilities" of the appendix 1 of the Draft Comment Letter?

## Notes to constituents – Summary of the IASB DP on separate presentation of equity instruments

- 262 *Applying the IASB's preferred approach, financial instruments classified as equity instruments would not contain an obligation for the entity to transfer economic resources before liquidation nor an obligation for an amount independent of the entity's available economic resources.*
- 263 *However, different equity instruments may contain rights and obligations for the issuer and holder of that instrument. These differences may result in the allocation of different amounts of the residual return to different classes of equity instruments based on features that are not reflected by their classification as equity.*
- 264 *In paragraphs 6.56-6.57 of the DP, the IASB notes that information about the different features of equity instruments would be useful for users of financial statements in assessing the distribution of returns between those different classes of equity instruments. These different features could include differences in:*
- (a) the priority of the claim on liquidation (e.g. non-cumulative preference shares and ordinary shares);*
  - (b) pay-offs (e.g. warrants) and contingencies (e.g. options); or*
  - (c) restrictions on dividends, buy-backs or other distributions.*
- 265 *In order to address this, the IASB considered enhancing the presentation requirements for different classes of equity through the statement of changes in equity and providing information about the distribution of returns by expanding the attribution of total comprehensive income to equity instruments other than ordinary shares<sup>6</sup> (including NCI). The attribution of total comprehensive income to all equity instruments should be presented on the face of the statement of financial performance.*
- 266 *In the IASB's view, the advantage of expanding attribution to other equity instruments is that such attribution would present, in a single place, the effect on ordinary shares of having other classes of equity instruments outstanding. As a result, the attribution of returns to all equity instruments provides a complete picture of how equity instruments affect each other's returns.*
- 267 *It would also result in the carrying amounts for each class of equity being updated for the amount of total comprehensive income attributed to it, and presenting such changes in carrying amounts in the statement of changes in equity. Such a requirement, together with the improvements to the identification of different equity components would improve the information provided about equity instruments and the consistency, completeness and clarity of those requirements.*
- 268 *When discussing attribution methods, the IASB provided the following approaches without reaching preliminary view about which approach would best balance the costs and benefits of improving information provided to users of financial statements:*
- (a) **non-derivative equity instruments other than ordinary shares:** the attribution of total comprehensive income to non-derivative equity instruments (e.g. non-cumulative preference shares and participating equity instruments) should follow the existing calculation for basic earnings per share in IAS 33. Doing so will align the attribution requirements with the calculation of basic*

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<sup>6</sup> An ordinary share is the class of equity that is the most subordinate claim and requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred at liquidation is equal to a pro rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.



*earnings per share, which would reduce the costs of applying these attribution requirements.*

- (b) **derivative equity instruments:** *the IASB discussed three approaches for calculating the attribution of total comprehensive income to derivative equity instruments:*
- (i) *full fair value approach - total comprehensive income would be attributed to derivative equity instruments based on changes in their fair value, with the residual being attributed to ordinary shares;*
  - (ii) *An average-of-period approach - total comprehensive income would be attributed to derivative equity instruments using relative average fair values through the period; and*
  - (iii) *An end-of-period approach - total comprehensive income would be attributed to derivative equity instruments indirectly. This would be calculated by first using relative fair values at the end of the period to attribute the carrying amounts of derivative equity instruments and ordinary shares at the end of the period. The attribution amount would then be based on the changes in the carrying amounts attributed from one period to another.*

269 *The IASB acknowledges that any approach to attribution would entail additional costs to prepare the information. In particular, all three approaches would require the entity to measure the fair value of equity derivatives, which could be difficult if those fair values are not observable. Therefore, the IASB also considered whether a better balance between the benefits and costs would be achieved if preparers were required to provide information about such equity instruments only through disclosure and the requirements of IAS 33.*

#### **Question 8**

The IASB's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

The IASB's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

The IASB did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the IASB considered various approaches, including:

- a. a full fair value approach (paragraphs 6.74–6.78);
- b. the average-of-period approach (paragraphs 6.79–6.82);
- c. the end-of-period approach (paragraphs 6.83–6.86); and
- d. not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

EFRAG's response

EFRAG acknowledges that the attribution approach has some benefits, such as providing information about distribution of returns among the different types of classes of equity and reflecting the same information as the 'narrow equity' approach. However, EFRAG questions whether the benefits of the information provided by the attribution approaches (i.e. attributing total comprehensive income to equity instruments (other than ordinary shares including NCI) and updating the carrying amounts of those equity instruments based on that attribution) would exceed the related costs.

EFRAG recommends the IASB to discuss improvements to existing presentation requirements without the attribution mechanism (e.g. more disaggregation on the face of the financial statements) and provide information about dilution through improvements to IAS 33 and disclosures. If attribution is retained, EFRAG recommends the IASB to use the method that is similar to the currently used for NCI and IAS 33. That is, based on the relative position of existing and potential shareholders at the year end.

***Expand the attribution of income and expenses to some equity instruments other than ordinary shares***

*Use of subclasses of equity*

- 270 The IASB discussed the use of subclasses of equity and how the use of subclasses could help in providing additional information about financial instruments with characteristics of equity. For example, information about priority and contingencies.
- 271 EFRAG notes that the presentation of subclasses of equity is not an entirely new concept. Currently, the Conceptual Framework already mentions (previous versions also) that equity may be sub-classified in the statement of financial position and that such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity (paragraph 4.20 of the 2010 Conceptual Framework and paragraph 65 of the 1989 Framework).
- 272 EFRAG also notes that many entities, particularly financial institutions, already show different sub-classifications of equity. For example:
- (a) *issued capital / called up share capital* that includes for example ordinary shares and preference shares;
  - (b) *other equity instruments* such as perpetual bonds, equity components of compound instruments and derivatives on own equity;
  - (c) *reserves*;
  - (d) *retained earnings*;
  - (e) *other comprehensive income*;
  - (f) *profit of the year attributable to the shareholders of the parent*; and
  - (g) *non-controlling interest*.
- 273 The use of subclasses of equity is also aligned with EFRAG's views included in the EFRAG comment letter on the IASB DP *Conceptual Framework for Financial Reporting*, where EFRAG considered that primary and secondary equity claims were fundamentally different and that IFRS Standards should reflect those differences.
- 274 Therefore, EFRAG welcomes the IASB's discussion on potential improvements to the presentation of subclasses of equity instruments and how they could provide

additional information to users, even though it will create the need for the IASB to develop new definitions for the new subclasses of equity.

*Definition and scope of each subclass of equity*

- 275 The IASB's preferred approach would require total equity, and changes in equity, to be disaggregated between *ordinary shares* and *equity instruments other than ordinary shares*.
- 276 In the DP the IASB states that an *ordinary share* is the class of equity that is the most subordinate claim and requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred at liquidation is equal to a pro-rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.
- 277 EFRAG notes that *equity instruments other than ordinary shares* would encompass non-derivative instruments (e.g. non-cumulative preference shares, non-cumulative perpetual bonds and participating equity instruments) and derivative instruments (e.g. warrants).
- 278 However, EFRAG considers that if the IASB is to differentiate a subclass of *equity instruments other than ordinary shares*, then EFRAG considers that there is a need for the IASB to provide additional guidance on its scope:
- (a) EFRAG notes that there are many different types of ordinary shares with different rights and that determining the most residual class of financial instrument has proven to be difficult in the past, particularly with the application of the puttable exception. In its letter to the IASB DP *Conceptual Framework for Financial Reporting*, EFRAG also identified a number of challenges related to an approach based on the most residual instrument;
  - (b) EFRAG considers that the IASB needs to discuss how its proposal would fit in non-corporate structures, such as partnerships, and cooperatives.
  - (c) whether perpetual bonds would be considered as *equity instruments other than ordinary shares*, even if they share similar characteristics to ordinary shares, and how the attribution would be made to such instruments. EFRAG notes that such instruments will not be converted into ordinary shares;
  - (d) the interaction between IAS 1 and IAS 33 in terms of definitions of 'ordinary equity shareholders' and 'potential equity shareholders'.
  - (e) the IASB should clarify whether equity-settled share-based payments would be within the scope of the attribution requirements.

*Assessment of the attribution requirement proposals*

- 279 EFRAG considers that attributing total comprehensive income to some equity instruments other than ordinary shares and using such an attribution mechanism to update the carrying amounts of some equity instruments has some potential benefits:
- (a) showing the 'wealth transfer' or 'distribution of returns' among the different type of equity instruments;
  - (b) reflecting the same information as the 'narrow equity' approach (with the narrow equity approach, changes in value of the financial instruments with characteristics of equity classified as liability would impact retained earnings. With the IASB's preferred approach the carrying amount of equity instruments other than ordinary shares would also be updated against retained earnings); and

- (c) limiting the accounting differences between liability and equity treatments, thereby limiting the incentives to structure instruments to achieve a particular accounting outcome.
- 280 EFRAG considers that such information could be particularly useful if it reflected the full fair value changes of each individual equity instrument. For example, information about fair value changes of each individual forward or option would provide useful information about the wealth transfer between the ordinary shareholders and potential shareholders.
- 281 However, EFRAG is concerned that the introduction of subclasses of equity and attribution mechanism will introduce significant complexity, increases the costs for preparers and may even be impracticable. EFRAG also questions whether the benefits of the information provided by the attribution approaches (i.e. attributing total income and expense to equity instruments other than ordinary shares and updating the carrying amounts of those equity instruments based on that attribution) would exceed the related costs.
- 282 Considering all the challenges identified below, in paragraph 311 EFRAG suggests an alternative approach to the IASB.

#### **Attribution requirements and their impact on primary financial statements**

- 283 In this section, EFRAG identifies general concerns that affect the primary financial statements (concerns related to each primary financial statement are described in the following sections).
- 284 Overall , EFRAG has the following concerns:
- (a) EFRAG is concerned about the increased complexity and costs of the IASB's proposal requirements, particularly when considering that the IASB would require entities to remeasure their derivatives on own equity, which may be challenging if those fair values are not observable. EFRAG notes that entities will have to, even if not listed, determine the fair value of their equity instruments other than ordinary shares, compute an attribution method for derivatives and non-derivatives, present the results in the statement of financial position and statement of financial performance and keep track of these movements in the statement of changes in equity;
  - (b) EFRAG observed mixed views on the usefulness of expanding the attribution requirements to ordinary shares and equity instruments other than ordinary shareholders;
  - (c) EFRAG questions how equity instruments other than ordinary shares should be presented in the statement of financial position within equity and in the statement of financial performance in the attribution section. EFRAG notes that in the DP the IASB does not specifically mention the impact of the introduction of subclasses of equity on the presentation requirements in the statement of financial position and statement of financial performance. That is, the DP does not specify whether equity instruments other than ordinary shares represent a new category, subtotal, one line item within equity or many new line items (e.g. split between derivatives and non-derivatives or by key classes of instruments such as options, forwards, etc.);
  - (d) EFRAG considers that it will be difficult to obtain a relevant attribution requirement for equity instruments other than ordinary shares in the statement of financial performance while, at the same time, reaching a meaningful update of the carrying amount within equity, particularly when considering that different elements of equity instruments other than ordinary shares may have different attribution methods;

- (e) EFRAG considers that it is difficult to assess what would have to be changed in IAS 32, and other standards to encompass the proposed guidance on the attribution of comprehensive income in the statement of financial performance and statement of financial position. It is EFRAG's understanding that the IASB would have at least to consider amendments to the requirements in IAS 1, IAS 32 and IAS 33. EFRAG also considers that it could also affect IFRS 7 and IFRS 13 *Fair Value Measurement*;
- (f) expanding the attribution requirements and updating the carrying amount of equity instruments other than ordinary shares would not, by itself, reflect the entire effect of the wealth transfer between existing shareholders and potential shares. This is because there are financial instruments that are settled with own equity but are accounted for as liabilities in their entirety. Such wealth transfer would not be seen so clearly within equity as gains or losses that arise from such instruments go through comprehensive income;
- (g) the IASB would have to evaluate whether an attribution method can be applied to partnerships, cooperatives and organisational structures other than corporate. In particular, EFRAG considers that the IASB should make clear whether financial instruments that meet the puttable exception would be classified as ordinary shares.
- (h) currently the scope of IAS 33 is applicable only to listed companies (parent or consolidated). As the scope of attribution would be wider than the scope of IAS 33, subsidiaries would have to apply concepts from IAS 33 even if they are scoped out of IAS 33.

*Attribution requirements in the statement of financial performance and EPS*

- 285 Under IAS 1, an entity is required to attribute total comprehensive income to owners of the parent and non-controlling interest. In the DP the IASB is considering expanding the attribution of total comprehensive income to *equity instruments other than ordinary shares*.
- 286 EFRAG notes that the IASB's approach is focused on the attribution of total comprehensive income to equity instruments other than ordinary shares (i.e. a change to paragraph 81B(b) of IAS 1) However, EFRAG considers that it is not clear whether the IASB's attribution proposal would encompass changes to existing attributing requirements on profit or loss (i.e. a change paragraph 81B(a) of IAS 1).
- 287 If the attribution mechanism is also to be applied to profit or loss, EFRAG considers that such a split will affect the calculation of basic EPS, as currently the starting point for the numerator of the EPS is profit or loss related to the owners of the parent company (subject to adjustments), ignoring income and expenses included in OCI. This would mean, that Basic EPS would also ignore the financial liabilities for which the amount depends on the entity's available economic resources.
- 288 EFRAG notes that Basic EPS is a fundamental measure of an entity's performance and that the IASB should carefully consider the impact of its preferred approach on the calculation of Basic EPS.
- 289 Finally, if the calculation method of Basic EPS is going to be actually changed, EFRAG is concerned about changing it simply through a consequential amendment.

*Attribution requirements in the statement of financial position*

- 290 Under current IFRS Standards, once a financial instrument is classified as an equity instrument, its carrying amount is not subsequently directly remeasured or updated.
- 291 In regard to non-controlling interest, IFRS 10 requires that a parent shall present non-controlling interests in the consolidated statement of financial position within

equity, separately from the equity of the owners of the parent, which reflects the relative interests of non-controlling equity holders in subsidiaries.

- 292 Additionally, it states that an entity shall attribute the profit or loss and comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.
- 293 In regard to the carrying amount of NCI, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests (in accordance to IFRS 10).
- 294 In paragraph 6.63 the DP states that the attribution of comprehensive income to equity instruments other than ordinary shares and subsequent update would be similar to the presentation of NCI. However, in EFRAG's view the attribution of comprehensive income to equity instruments other than ordinary shares has a different nature.
- 295 Its objective is not to reflect the relative interests of holders of equity instruments other than ordinary shares. Although the carrying amount of NCI is currently updated, it simply reflects changes in the part of the residual (assets less liabilities) owned by non-controlling interests or changes in the proportion held by NCI. The allocation of profit or loss and comprehensive income to NCI and owners of the parent are currently required by IAS 1 and follows the consolidation method set out in IFRS 10. It is not a separate measurement method for the equity instruments. This method currently requires that 'when potential voting rights or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and NCI is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives'. Therefore, EFRAG considers that the objective of showing 'how the equity instruments affect each other's returns' is conceptually and economically different from existing guidance on attribution.
- 296 EFRAG also notes that in practice preparers use several equity components (reserves, retained earnings, OCI, etc.) which would increase the complexity in terms of attribution when compared to NCI. For example, entities would have to analyse how the allocation of comprehensive income to ordinary shares and equity instruments other than ordinary shares would affect the allocation of comprehensive income to reserves, retained earnings and particularly to separate components of OCI. To ensure the understandability of the attribution requirements on the face of the statement of financial position, the IASB may need to reconsider the format of the statement of financial position. In particular, the use of tabular format for the equity section may be required, where all line items are either attributed to ordinary shares or classes of equity other than ordinary shares.
- 297 Furthermore, if the attribution mechanism is applied to equity component recognised as an *equity instrument other than ordinary shares* and the IASB uses an attribution other than full fair value, EFRAG questions the relevance of the information provided on the face of the statement of financial position.
- 298 Although it is not clear from the DP, EFRAG would expect that any amount recognised as equity instrument other than ordinary shares would not be subsequently derecognised when the instrument is exercised, cancelled or expires. Therefore, when presenting equity instruments other than ordinary shares, the carrying amounts on the face would reflect both instruments that have been already settled and instruments that will be settled in the future. Arguably, new ordinary

shareholders will only be interested in information regarding instruments that will be settled in the future.

*Statement of changes in equity*

299 EFRAG is also concerned that an attribution approach would increase significantly the complexity and movements within the statement of changes in equity, blurring its usefulness.

***Attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33***

300 The fact that the IASB is discussing different attribution methods for different equity instruments other than ordinary shares indicates that it will be difficult to achieve a meaningful result for both the statement of financial performance and statement of financial position.

301 EFRAG is concerned that the result of using different methods may lead to an artificial allocation of total comprehensive income to different subclasses of equity, without adding significant value to users.

302 EFRAG considers that if the IASB uses different methods to update the carrying amount of equity instruments other than ordinary shares and NCI, then users will have difficulties in understanding how each component has been updated, which could lead to the misinterpretation of the resulting information.

303 Finally, although EFRAG is not in favour of an attribution mechanism, :

- (a) EFRAG considers that an attribution based on the existing requirements of IAS 33 for non-derivative equity instruments could be applied in practice. We note however that the scope of the attribution requirements is wider than the scope of IAS 33 and that entities that are not currently applying the concepts of IAS 33 would be required to use the Standard for attribution purposes; and
- (b) EFRAG would welcome more examples of non-derivatives instruments that would be considered other than ordinary shares.

***Attribution approach for derivative equity instruments***

304 Although EFRAG is not in favour of an attribution mechanism, it prefers the IASB's full fair value approach for relevance and cost-benefit purposes, even if this may result in ordinary shares or equity subclasses other than ordinary shares having a deficit balance.

305 EFRAG considers that the use of the full fair value approach results in an understandable 'measurement' basis for the carrying amount of equity instruments other than ordinary shares (particularly, for equity components of convertible bonds and derivatives on own equity) and that such information would be particularly useful if it reflected the full fair value changes of each individual equity instrument (not by grouped by type or other). Such an approach would also have the benefit of aligning the 'measurement' basis for derivatives on own equity that have been classified as financial liabilities. The full fair value approach would also produce information that would be similar to the information that would result as if only ordinary shares were considered as equity instruments (depending on how non-derivative, non-ordinary share equity instruments would be accounted for if there were to be considered as liabilities).

306 EFRAG considers that the average-of-period and end-of-period approaches would be complex and costly to apply as the entity would have, for example, to calculate the relative fair value of its own equity instruments. It is also difficult for EFRAG to see the relevance of the information provided by these methods for the purposes of updating the carrying amount of equity instruments other than ordinary shares,

particularly when updating the carrying amount of each individual equity component of convertible bonds and options.

***Disclosures only approach***

- 307 In paragraph 6.87 of the DP the IASB acknowledges the costs and complexity of any approach to attribute total comprehensive income to equity derivatives and discusses a 'disclosure only' approach as a way to provide information about the effect of derivative equity instruments on ordinary shares.
- 308 Such an approach would encompass additional disclosures about potential dilution (section 7) and extending the existing disclosure requirements related to the fair value of financial liabilities in IFRS 7 to equity instruments other than ordinary shares. The IASB argues that this would result in similar information being provided about derivatives on own equity regardless of whether they are classified as financial assets, financial liabilities or equity instruments.
- 309 EFRAG welcomes the IASB's proposal to provide more information about the effect of derivative equity instruments on ordinary shares through diluted earnings per share and other disclosures. However, EFRAG is concerned about the related costs of extending the existing disclosure requirements related to the fair value of financial liabilities in IFRS 7 to equity instruments other than ordinary shares, particularly if Level 1 inputs (i.e. quoted prices in active markets) are not available.
- 310 Alternatively, EFRAG considers that the IASB could discuss a number of additional improvements other than simply additional disclosures. This is discussed in the section below.

***EFRAG's alternative approach***

- 311 To provide more information about the effect of equity instruments other than ordinary shares, EFRAG considers that the IASB could combine a number of different improvements:
- (a) improve presentation by requiring further disaggregation of equity on the face of the statement of financial position;
  - (b) improve current requirements in IAS 33 based on the shortcomings that the IASB identified in the Discussion Paper; and/or
  - (c) improve current disclosures in IAS 33 on dilution, including the distribution of returns when there is full dilution (section 7).
- 312 Finally, if expanding the attribution requirements to equity instruments other than ordinary shares is deemed necessary and retained, EFRAG recommends the use of the method that is currently used for NCI and IAS 33, based on the relative position of existing and potential shareholders, but without updating the carrying amounts within equity.

***Improvements to presentation within equity***

- 313 Currently, IAS 1 only requires the presentation of 'issued capital and reserves attributable to owners of the parent' and 'non-controlling interests'. From its initial research, EFRAG observed that when entities present their equity within the statement of financial position, there is often a lack of disaggregation and consistency on the presentation of categories, subtotals and lines items.
- 314 Therefore, EFRAG considers that the IASB should discuss potential improvements to the content and structure of the statement of financial position within equity. For example, currently financial institutions often refer to 'issued capital' and 'other equity instruments' within the equity section of the statement of financial position. Thus, the IASB could consider the introduction of additional line items, subtotals and categories to separately present, for example, financial instruments that will or may



be settled in the issuer's own equity instruments (distinguishing existing vs potential shareholders).

*Improvements to current requirements in IAS 33*

- 315 The DP acknowledges shortcomings within IAS 33 requirements including the exclusion of out-of-the money financial instruments that could have dilutive impacts at future dates (paragraph 332 below for more details). Having developed principles for identifying liabilities and equity, it is appropriate and timely for the IASB to, in parallel, consider how to enhance IAS 33. For example, to help users to better assess the allocation of returns amongst different classes of equity, the IASB could start by improving the requirements in IAS 33 by addressing the shortcomings identified in the DP, aligning the requirements in IAS 33 with the requirements in IAS 32 and IAS 1 (e.g. definitions) and addressing the issues that arise in practice (e.g. lack of transparency around the calculation of the weighted average number of ordinary shares).
- 316 EFRAG's support for an IAS 33 update is consistent with its response to the 2008 IASB Exposure Draft *Simplifying Earnings Per Share* which reflected feedback from stakeholders, including users of financial statements, on some of the principles that could be adopted to enhance the calculation of both the basic and diluted EPS.
- 317 One of the 2008 ED proposals was that for instruments that are remeasured at fair value through profit or loss, the related potential ordinary shares should not be included in the EPS calculations (this was then described as the "fair value method"). EFRAG supported the "fair value method" alongside the need for additional disclosures that could inform users on future potential dilution effects related to instruments that were recognised at fair value through profit or loss.
- 318 The DP proposes to align the attribution to classes of non-derivative equity instruments other than ordinary shares to the requirements in IAS 33. At the same time, the attribution to classes of derivative equity instruments aims to enhance the information available for users beyond that provided by IAS 33. The ideas within the attribution approaches are aligned with some of the ideas for improving the EPS calculation that were made in the 2008 ED proposals. For instance, in the arguments for the full fair value attribution approach, Paragraph 6.75(b) observes that, unlike IAS 33, where dilution is based on the intrinsic value, an attribution approach that is based on the fair value of an option contract reflects the probability that the ordinary shares will be issued.
- 319 However, as noted in various places in this comment letter, there is a concern about the complexity and costs associated with any of the three attribution approaches. Hence, as an alternative to the attribution approaches, EFRAG proposes the revision of IAS 33 requirements together with the enhancement of disclosures of equity instruments.
- 320 EFRAG acknowledges that the review of IAS 33 is considered to be challenging; however, EFRAG considers that the challenges that will arise with the attribution mechanism will be greater than reviewing IAS 33. The existing shortcomings could be addressed more efficiently through disclosure of potential dilution instead of an attribution system of equity claims. However, using an enhance IAS 33 instead of attribution raises the question issue as to whether IS 33 should be extended to all entities or whether attribution should be limited to the scope of IAS 33.

*Alternative attribution mechanism with updating carrying amounts*

- 321 If the IASB decides to proceed with an attribution approach, EFRAG considers that the IASB could consider the possibility of an attribution approach that would take into account the relative position of existing shareholders and possible exercise or conversion of potential ordinary shares (similar to IAS 33 approach).

**Question to EFRAG TEG**

322 Does EFRAG TEG agree with the drafting and key messages of section 6 “Summary of proposals in the DP on separate presentation of equity instruments” of the appendix 1 of the Draft Comment Letter?

## Section 7 - Disclosure

### Notes to constituents – Summary of the IASB DP on Disclosures

323 *In the DP, the IASB proposes potential improvements to the disclosure requirements on priority of claims on liquidation, potential dilution of ordinary shares and contractual terms and conditions.*

#### *Disclosures about priority on liquidation*

324 *In the DP, the IASB emphasises that users of financial statements have often asked for more information about the priority of financial liabilities and equity instruments on liquidation of an entity. In particular, information about an entity's capital structure in a single place), which alleviates the need for users of financial statements to compile this information from multiple sources.*

325 *In addition, in paragraph 2.30 of the DP, the IASB highlights that information about the priority of financial liabilities and equity instruments on liquidation is also fundamental to help users of financial statements to make detailed assessments of balance sheet solvency and returns.*

326 *Considering that currently IFRS Standards do not require any disclosures about the priority of financial liabilities and equity instruments, the IASB preliminary view is that it would be useful to present financial liabilities and equity instruments in their order of priority either on the face of the statement of financial position or in the notes to the financial statements.*

327 *An entity would be permitted to group financial instruments together if the contractual terms and conditions of the financial instruments indicate that the instruments have the same level of priority. The objective would be to provide information to users of financial statements about the relative ranking of financial liabilities and equity instruments. The objective would not be to depict the value of those financial liabilities and equity instruments in a hypothetical liquidation.*

328 *The information provided might include a list of all financial liabilities and equity instruments in the order of their priority and for each group or category of financial liability and equity instrument, information about:*

- (a) terms and conditions that indicate the priority within the entity's capital structure (e.g. liquidation preference, the existence of guarantees and collateral, and other payment conditions that might establish a priority between contracts);*
- (b) terms and conditions that could lead to changes in priority (e.g. conversion features and contingent features);*
- (c) terms and conditions that indicate any promised returns and/or rights to dividends or other distributions; and*
- (d) any other contractual features that could affect holders' rights to share in an entity's economic resources and returns.*
- (e) if there is any change in the priority of any group of financial instruments, information about the reason(s) for the change; for example, any changes in relevant terms and conditions or circumstances.*

329 *In order to provide the information described above entities would need to analyse the terms and conditions of their financial instruments to determine each instrument's priority relative to other financial instruments.*

330 *In paragraph 7.10 of the DP, the IASB identified a number of challenges in determining the priority of financial instruments. Despite these challenges, the IASB observed that, in the absence of information about the priority of financial liabilities*

*and equity instruments, users of financial statements would need to perform their own assessments, which would require making assumptions based on limited information. Information about the priority of an entity's financial liabilities and equity instruments would be useful to users of financial statements, even if such information is prepared with some limitations. Those limitations could include simplifying assumptions or requiring the provision of this information only for a particular set of financial instruments (such as limiting it to financial liabilities and equity instruments of, or against, the parent entity).*

- 331 *The IASB did not reach a preliminary view on whether the amounts included should be the carrying amounts presented in the statement of financial position, the fair value amounts required by IFRS 7, or both.*

*Disclosures about potential dilution of ordinary shares*

- 332 *In the DP, the IASB argues that the information that is currently provided about dilution in IAS 33 and IAS 1 has many limitations. In particular, both the IASB and users of financial statements note that:*

- (a) the definition of dilution in IAS 33 is incomplete as potential ordinary shares are considered dilutive only if they decrease earnings (or increase loss) per share from continuing operations;*
- (b) IAS 33 only considers the effect of equity instruments that are in-the-money;*
- (c) lack of information around the calculation of the weighted average number of ordinary shares;*
- (d) lack of information about potential changes in the number of shares outstanding at the end of the period arising from existing rights and obligations of the entity; and*
- (e) lack of information about the effect of new issuances of ordinary shares on the voting rights of existing shareholders.*

- 333 *Given these limitations, in the IASB's preliminary view more information about the potential dilution of ordinary shares should be provided to meet the needs of users of financial statements. The objective would be for an entity to provide information to help users of financial statements assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares.*

- 334 *To address the limitations of IAS 33, these disclosures in the notes to the financial statements would provide information about dilution that could arise from any potential increase in the number of issued ordinary shares. Such information would help users of financial statements understand the distribution of returns to ordinary shares, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future. Information about such potential dilution is important for both existing and potential investors in the entity's ordinary shares.*

- 335 *As noted in paragraph 7.17 of the DP, disclosures about dilution could complement, or be a substitute of potential improvements on the face of the financial statements. That is, the DP's proposals on potential attribution for equity instruments other than ordinary shares and its impact on the statement of financial performance (attribution of comprehensive income), statement of financial position (updating carrying amount) and statement to changes in equity (distribution returns within equity). Information about potential dilution would be even more important if the IASB does not proceed with those attribution requirements.*

- 336 *In the IASB's view, the information to meet the disclosure objective might include:*

- (a) a list at the end of each reporting period of all financial instruments, that could dilute the ordinary shares;*

- (b) *the following information for each group of potentially dilutive financial instruments:*
  - (i) *terms and conditions, including how the number of ordinary shares required for settlement is determined;*
  - (ii) *dates of share settlement; and*
  - (iii) *number of shares to be delivered at settlement, based on the current conditions at the end of reporting period;*
- (c) *a reconciliation of the movement in the number of ordinary shares outstanding, and in the maximum number of additional potential ordinary shares, during the period, including:*
  - (i) *the total number of ordinary shares and additional potential ordinary shares outstanding at the beginning and end of the reporting period;*
  - (ii) *sources of changes in the number of ordinary shares, and additional potential ordinary shares (e.g. rights issue, stock splits, warrant issues etc.);*
  - (iii) *settlement dates, which led to changes in the number of ordinary shares outstanding; and*
  - (iv) *the details of any share repurchase plans.*

337 *In the DP the IASB noted that most of this information is already required for calculating earnings per share (for entities applying IAS 33). Additionally, the IASB thinks that the disclosures could be integrated with existing disclosures, for example, with the disclosures regarding outstanding shares required by IAS 1.*

*Disclosures about the contractual terms and conditions.*

338 *In paragraph 7.26 of the DP the IASB explains that information about the terms and conditions of financial liabilities and equity instruments would help users of financial statements make both assessments identified in Section 2 as well as with making other assessments such as assessing the distribution of returns under different future scenarios*

339 *In the IASB’s preliminary view additional information should be provided about the terms and conditions of financial liabilities and equity instruments that affect the amount and timing of cash flows. Such information might include:*

- (a) *terms and conditions that are relevant to determining the settlement amount. Such terms and conditions might include information about the financial instrument’s principal amount, interest rate, indices and whether and how the settlement amount depends on the entity’s available economic resources (such as indexation to share price) and the effect of any options and contingencies; and*
- (b) *the timing of settlement including the effect of any options and contingencies.*

340 *Users’ feedback also indicates that disclosures about terms and conditions should be provided in a single place in the notes to the financial statements.*

341 *The IASB acknowledges that aggregating this information could be challenging when an entity has a large number of financial instruments that fall within the scope of the disclosure. The IASB notes possible approaches to arranging this information, such as stratifying the set of financial instruments depending on their prospects for future cash flows and requiring different disclosures based on the significance of those prospects.*

<b>Question 9</b>
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The IASB's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial statements:

- a. information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).
- b. information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).
- c. information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the IASB's preliminary view? Why or why not?

How would you improve the IASB's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

*EFRAG's response*

**EFRAG considers that disclosures are a key part of the project and welcome the IASB proposals. We acknowledge that the proposed disclosures, as a whole, would represent a significant extension of disclosures on financial instruments on own equity. However, they would provide a greater level of detail about financial instruments classified as equity, making the level of disclosure more similar to financial instruments that are classified as liabilities**

**In regard to disclosures on priority on liquidation, EFRAG notes that some considerations would have to be taken into account in terms of the reporting entity which is being considered. In regard to disclosures on potential dilution, EFRAG recommends the IASB to further discuss the scope of such disclosures. Finally, EFRAG provides a number of suggestions to improve current disclosures.**

- 342 EFRAG generally welcomes the IASB's proposed disclosures about priority of claims on liquidation, potential dilution and information about terms and conditions. EFRAG considers that improvements to existing disclosures is a key part of this project, not only for the consolidated financial statements of a group but also to the separate financial statements of the entities within a group.
- 343 Currently, IFRS Standards require some disclosures about the entity's capital structure, potential dilution and terms and conditions of financial instruments. However, there are a number of limitations. In particular, EFRAG agrees with the IASB's assessment that there is a significant difference between the information provided for items classified as equity compared with those classified as liabilities and that more information is needed about financial instruments classified as equity.
- 344 EFRAG consulted users of financial statements to understand their needs in terms of information about an entity's claims. Users considered that:
- (a) the classification needs to be supported by suitable disclosures about the contractual terms and conditions;
  - (b) entities should provide better disclosures about potential dilution. They wanted more information that would help them in assessing the effects of dilution resulting from instruments settled with own equity; and

- (c) entities should provide better disclosures on the 'waterfall'. They considered that information about priority of claims was useful to them, although some considerations would have to be taken into account in terms of the reporting entity which is being considered.

345 Therefore, EFRAG agrees that the DP's proposals on disclosures will help investors better understand the entity's capital structure and the impact of financial instruments with characteristics of equity.

346 EFRAG acknowledges that the proposed disclosures, as a whole, would represent a significant extension of disclosures on financial instruments on own equity. However, they would provide a greater level of detail about financial instruments classified as equity, making the level of disclosure more similar to those that are classified as liabilities. This may be particularly true for financial institutions that issue complex financial instruments in response to regulatory requirements and other entities with complex capital structures.

#### **Disclosure on priority of financial liabilities and equity instruments on liquidation**

347 Currently, entities (and especially financial institutions) have a variety of debt and equity instruments with different levels of seniority and subordination, with each instrument having its own rights, benefits, costs and risk.

348 IFRS Standards already require some disclosures about the entity's capital structure, however, there are a number of limitations:

- (a) IFRS 7 requires some specific disclosures about financial liabilities, however it does not have similar requirements for equity instruments; and
- (b) IAS 1 requires a company to disclose information in the financial statements to evaluate a company's objectives, policies and processes for managing capital. These disclosures are more oriented to issued capital and not debt instruments classified as equity. The outcome is often boilerplate disclosures about the goal of optimising the weighted average cost of capital without providing the details to support or to evaluate such statements.

349 EFRAG considers that detailed information about an entity's capital structure, including how it changes over time, is fundamental to users as they need information about:

- (a) management making capital structure decisions in terms of the mix between equity and debt and the relative costs of each;
- (b) the relative returns to each holder and the implications on the company's liquidity and solvency;
- (c) the priority of claims in the event of liquidation; and
- (d) if they are investors in the entity, the position of their investments in the capital structure.

350 Therefore, EFRAG supports the IASB's proposal to improve disclosures on priority of financial liabilities and equity instruments on liquidation.

351 Nonetheless, EFRAG notes that some considerations would have to be taken into account in terms of the reporting entity which is being considered. EFRAG notes that, in most jurisdictions, it is the legal entity that has the capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and is ultimately held responsible for its actions.

352 Therefore, providing information about priority of claims on liquidation for consolidated financial statements can be a challenging exercise and may be inconsistent with the individual entities of the group. Considering this, EFRAG

recommends the IASB to improve disclosures on priority of claims on liquidation both on separate and, if practicable, consolidated financial statements and any interactions between the two.

- 353 Finally, EFRAG considers that such disclosures should reflect the carrying amounts presented in the statement of financial position and not the fair value amounts required by IFRS 7. This is because it would require entities to calculate the fair value of their instruments on own equity, particularly if an approach other than full fair value is used for attribution, and would break the link to the statement of financial position. In addition, EFRAG notes that fair value amounts would even be more onerous for non-listed entities.

#### **Disclosures about potential dilution**

- 354 Currently, entities have a variety of liability and equity instruments that gives the right or the option to the holder to acquire or settle the claim with ordinary shares in the future, particularly financial institutions. IFRS Standards already require some disclosures on potential dilution. More specifically, IAS 33 already requires disclosure of:

- (a) the amounts used as the numerators in calculating diluted EPS and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period;
- (b) the weighted average number of ordinary shares used as the denominator in calculating diluted EPS and a reconciliation of these denominators to each other;
- (c) instruments that could potentially dilute basic EPS in the future, but were not included in the calculation of diluted EPS because they are antidilutive for the period(s) presented;
- (d) a description of those ordinary share transactions or potential ordinary share transactions that occur after the balance sheet date and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

- 355 In paragraphs 7.13 - 7.15 of the DP the IASB identifies a number of limitations regarding information provided by IAS 33. These limitations mean that users of financial statements have difficulties to determine the full impact that derivatives on own equity and other financial instruments may have on their position. In addition, EFRAG highlights that the diluted EPS is seen as an historical measure and not a predictor of dilution or a forward-looking number.

- 356 Therefore, EFRAG supports the IASB's proposal to improve disclosures on dilution, particularly disclosures around the total number of ordinary shares outstanding or potentially outstanding at the end of the period and their effects.

- 357 EFRAG considers that providing the users with the information about sources of potential dilution of the capital would increase the quality of the information provided in the financial statements and will help users to make the informed decisions. In EFRAG's view the additional information about potential dilution can be provided through the notes to the financial statements and should not impose excessive additional costs to the preparers.

- 358 EFRAG recalls that, in its comment letter to the IASB Discussion Paper *Conceptual Framework on Financial Reporting*, it had already identified potential ways to disclose dilutive effects:

- (a) scenario analysis, depicting the instruments in issue and their rights and/or payoffs in various material scenarios; and/or



- (b) the provision by the entity of financial models showing the rights holders of various instruments have on net cash inflows, and how the number and types of these instruments may change.

359 However, EFRAG notes that currently IAS 33 applies only to entities whose ordinary shares or potential shares are publicly traded. Considering this, EFRAG recommends the IASB to better discuss the scope of such disclosures. That is, whether such disclosures would only apply to listed entities and whether they should apply both to separate and consolidated financial statements.

#### **Information about terms and conditions**

360 EFRAG highlights the importance of having improvements to the disclosure requirements for financial instruments with characteristics of equity in many circumstances. Even though IFRS 7 already requires the key terms and conditions of financial instruments to be disclosed, it is not always clear how the instruments are classified and why an instrument had been classified as equity or as liability.

361 ESMA has recently published a report which identified a number of deficiencies on disclosures related to financial instruments classified as equity. In particular, EFRAG notes that for financial instruments that have many features, it is often difficult to understand what the key features are that lead to the classification of equity or liability.

362 Therefore, considering the lack of requirements in regard to disclosures on the terms and conditions of financial instruments, particularly for financial instruments with characteristics of equity, EFRAG considers that the IASB should give high priority to additional disclosures on the terms and conditions of financial instruments with characteristics of equity.

363 For example, if the Core Equity Tier 1 ratio of a bank falls below 5.125%, additional Tier 1 instruments are automatically converted into Core Equity Tier 1 instruments or written down. The specific mechanism may be specified in the contractual conditions. One point to consider is how to disclose the information about write downs that have taken in the year related to these instruments.

#### **Other potential improvements**

##### *Potential improvements to disclosures in IAS 1 on restrictions to transfer cash*

364 Many users have mentioned in the past that they often look for information about the nature and extent of any significant restrictions of the entity's ability to transfer funds to its shareholders in the form of cash dividends or any significant restrictions of the entity's ability to repay debt. To address user's needs, it could be argued that IAS 1 could be improved to require additional disclosures about the impact of externally imposed capital requirements (e.g. those resulting from borrowing arrangements, legal/regulatory requirements or contractual arrangements) or the existence of any other significant restriction (e.g. solvency test, cash flow test, undistributable reserves etc.) on the entity's ability to transfer, in practice, funds to its shareholders and creditors.

#### **Question to EFRAG TEG**

365 Does EFRAG TEG agree with the drafting and key messages of section 7 of the appendix 1 of the Draft Comment Letter?

## Section 8 - Contractual terms

### Notes to constituents – Summary of the IASB DP on economic compulsion and indirect obligations

- 366 *Some financial instruments grant the entity (the issuer) the right to choose between alternative settlement outcomes, instead of granting that right to the holder. In classifying such financial instruments as financial liabilities or equity instruments, challenges include:*
- (a) *determining whether the financial instrument, in substance, establishes an obligation that would meet the definition of a financial liability.*
  - (b) *determining whether economic incentives may prompt the entity to exercise the liability settlement outcome even though it has the right to select the equity settlement outcome (or vice-versa). In some cases, the incentives may be so strong that some would view the entity as being ‘economically compelled’ to exercise a particular outcome.*
- 367 *This type of issues arises, for example, with instruments that can be converted to a fixed number of ordinary shares at the issuer’s option (e.g. fixed-for-fixed reverse convertible bonds) and callable preferred shares with a ‘step-up’ dividend clause’ (IFRS IC 2006).*
- 368 *In paragraph 8.10 of the DP the IASB notes that its proposals would address the classification concerns of some of these instruments (e.g. callable preference shares with a step-up dividend clause) without the need to consider economic incentives and compulsion. This is because an obligation for an amount independent of the available economic resources of the entity would be classified as a financial liability. Accordingly, the classification of some instruments that gave an entity the option for a liability or equity settlement under IAS 32 would change because under the IASB’s preferred approach the alternatives would result in the instrument being always a liability instrument.*
- 369 *Nevertheless, there would still be other types of financial instruments with alternative liability and equity settlement outcomes within the control of the entity that would raise questions regarding economic incentives and economic compulsion (e.g. fixed-for-fixed reverse convertible bond).*
- 370 *In paragraphs 8.18 and 8.21 of the DP the IASB concludes that for classification purposes what is relevant is whether the entity has an unavoidable obligation to transfer economic resources at a specified time other than at liquidation, not whether it has the right to do so. It also noted that attempting to consider economic incentives in the classification of financial instruments would raise more questions than answers. Therefore, it proposes that economic incentives that might influence the issuer’s decision to exercise its rights should not be considered for classification purposes. The classification would only be based on the rights and obligations established by a contract.*
- 371 *However, in paragraph 8.22 of the IASB observed that sometimes one of the settlement options is always unfavourable or ‘structurally out-of-the-money’ and that IAS 32 already includes some requirements to help assess whether a financial instrument establishes an obligation that would meet the definition of a financial liability indirectly through its terms and conditions. As such guidance would reduce structuring opportunities and alleviate some of the concerns related to economic compulsion and incentives, in the IASB’s preliminary view, the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained.*

**Question 10**

Do you agree with the IASB's preliminary view that:

- a. economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?
- b. the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

*EFRAG's response*

**EFRAG welcomes the IASB's discussion on the role of economic incentives for classification purposes and agrees with the IASB's proposal to clarify that economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or equity instrument. This is because EFRAG considers that considering economic incentives for classification purposes may raise more questions than answers.**

**EFRAG also considers that retaining and improving the indirect obligations requirements in paragraph 20(b) of IAS 32 may alleviate some of the issues related to economic compulsion (to consider for example whether an entity is legally prohibited from exercising one of the settlement alternatives). Accordingly, EFRAG suggests improvements to current requirements.**

***Economic incentives that might influence the issuer's decision to exercise its rights***

- 372 In accordance with paragraph 15 of IAS 32, the classification of financial instruments is made in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. However, IAS 32 is silent on the role of economic compulsion and incentives.
- 373 As highlighted in paragraph 8.6 of the DP, the IFRS IC has discussed the role of contractual obligations and economic compulsion in the classification of financial instruments and asked the IASB whether anything could be done to achieve greater clarity. The issue is related to the fact that even though the terms and conditions of a financial instrument might grant the entity the right for an equity or liability settlement (leading to equity classification), there may be economic incentives for an entity to choose the liability option.
- 374 EFRAG considers that this is an important topic that needs standard-setting activities and welcomes the IASB's discussion on the role of economic compulsion and incentives for classification purposes. EFRAG also welcomes the IASB's proposal to clarify that economic incentives that might influence the issuer's decision to exercise its rights would not be considered when classifying a financial instrument as a financial liability or equity instrument.
- 375 EFRAG agrees with the views and arguments provided in paragraphs 8.18 to 8.21 that considering economic incentives on classification may raise more questions than it answers. In addition, as further described below, EFRAG considers that improvements to the indirect obligations requirements may alleviate some of the issues related to economic compulsion.
- 376 Finally, EFRAG welcomes the fact that the IASB's preferred approach would solve the issue of 'callable preferred shares with a 'step-up' dividend clause' without the need of considering economic incentives or compulsion.

377 EFRAG acknowledges the argument that bifurcating hybrid instruments with two settlement alternatives into liability and equity components, and focusing on the measurement aspects, may be more useful than reclassifying the whole hybrid instrument as a liability or equity. However, EFRAG notes that such an approach would increase significantly the cost of application of IAS 32 and that new guidance would have to be developed for more bifurcation within IAS 32 (more details please see section 5).

**Indirect obligations should be retained**

378 Notwithstanding the stated right of the entity to choose an equity settlement outcome in some claims with alternative settlement options, the terms and conditions may establish an indirect obligation for a liability settlement.

379 IAS 32 already includes some requirements to help establish whether a financial instrument establishes an obligation that would meet the definition of a liability indirectly through its terms and conditions. In particular, paragraph 20(b) of IAS 32 provides the example that an indirect contractual obligation would be established if a financial instrument provides that on settlement the entity will deliver either cash or its own equity instruments whose value is determined to exceed substantially the value of the cash.

380 In the IASB's preliminary view, the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained. EFRAG welcomes the IASB proposal and considers that retaining the current requirements on indirect obligations can alleviate some of the issues that arise when the manner of settlement of a financial instrument is at the option of the entity. EFRAG also highlights that this would in line with previous discussions by the IFRS IC which noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option.

381 However, EFRAG considers that the IASB should also take the opportunity to improve these requirements to incorporate the notion of 'no commercial substance' which is currently used in paragraph 41 of IFRS 2. This paragraph states that an 'entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (e.g. because the entity is legally prohibited from issuing shares)'.

382 EFRAG considers that it is important to make clear that when the terms and conditions of a financial instrument grant the entity the right for an equity or liability settlement, as a first step an entity should always consider whether one of the settlement alternatives:

- (a) has no economic substance (e.g. equity settlement outcome is structured in such a way that its value would always exceeds the liability settlement outcome); or
- (b) has no commercial substance (e.g. the entity is legally prohibited from exercising is legally prohibited from issuing shares).

**Question to EFRAG TEG**

383 Does EFRAG TEG agree with the drafting and key messages of section 8 "Economic compulsion and indirect obligations" of the appendix 1 of the Draft Comment Letter?

**Notes to constituents – Summary of the IASB DP on relationship between contracts and law**

- 384 *In accordance with paragraph 15 of IAS 32, the issuer of a financial instrument shall classify a financial instrument, or its component parts, in accordance with the substance of the contractual arrangement. However, determining whether rights and obligations arise from the contractual terms or from some other mechanism can be challenging, particularly when considering the relationship between contracts and law.*
- 385 *In the DP, the IASB acknowledges that, as a result of legislation, some governments or other authorities have the power in particular circumstances to impose losses on the holders of some financial instruments. It also notes that the IASB has already decided in IFRS 9 that when an entity assesses the classification of a contingent convertible financial asset it should limit the analysis to the terms and conditions in the contract when classifying the financial instrument. That is, entities should not consider effect of the regulation.*
- 386 *The IASB also acknowledged that IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments refers to relevant local laws and regulations in effect at the date of classification. However, the IASB noted that IFRIC 2 was developed for a very specific fact pattern with a limited effect in practice, therefore it does not think that it should reconsider that Interpretation or apply the analysis in that Interpretation more broadly.*
- 387 *Therefore, in the IASB's preliminary view, an entity would apply its preferred approach to the contractual terms of a financial instrument consistently with IAS 32 and IFRS 9. The IASB will consider whether it should take any action to address the accounting for mandatory tender offers, including potential disclosure requirements, following responses to this Discussion Paper.*

**Question 11**

The IASB's preliminary view is that an entity shall apply the IASB's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, why not?

*EFRAG's response*

**EFRAG agrees with the IASB that the classification of instruments should be based on the contractual terms of a financial instrument and that taking into account law on classification would raise more questions than answers.**

**However, EFRAG highlights some of the issues that arise in practice when the relationship between contracts and law in practice may have an impact. In particular, there are concerns about the potential different outcomes for identical contracts where one entity incorporates the law in the contracts terms while another does not (e.g. bail-in instruments). EFRAG recommends the IASB to further discuss this issue with regulators to better understand the challenges that arise in practice.**

**Finally, given the narrow fact pattern to which IFRIC 2 applies, EFRAG welcomes the fact that the IASB decided to retain IFRIC 2.**

**Contractual terms of a financial instrument consistently with the existing scope of IAS 32**

- 388 EFRAG considers that the interaction between ‘contractual rights and obligations’ and ‘regulatory and legal’ requirements is a fundamental issue.
- 389 In particular, EFRAG highlights the challenges that arise in practice from the interaction between the contractual rights and obligations and recent Bank Recovery and Resolution Directive (“BRRD”). For example, entities that issue bail-in instruments question whether the contractual terms of such instruments should simply state that the entity is under the scope of the BRRD, provide general reference to the BRRD or even replicate the legislation applicable to the entity’s jurisdiction to the extent possible. This is because it may be important to understand whether there are incremental rights or obligations that arise from legislation which are not mentioned in the contract.
- 390 EFRAG considers that currently IFRS Standards are not consistent when dealing with the ‘contractual rights and obligations’ and ‘regulatory and legal’ requirements. As mentioned in paragraphs 8.34 and 8.35 of the DP, IFRIC 2 considers the effects of legislative requirements for classification purposes while IAS 32 and IFRS 9 do not. In addition, we note that paragraph 4.31 of the *Conceptual Framework for Financial Reporting* states that many obligations are established by contracts, legislation or similar means. The latter could indicate that even if contracts would not establish an obligation, the obligation could arise as a result of the legislation.
- 391 In accordance with paragraph 5 of IFRIC 2, the contractual right of the holder of a financial instrument to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity’s governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter. By contrast, under IFRS 9 the effect of the regulation that introduces different contractual cash flows is not considered when assessing whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.
- 392 EFRAG considers that ideally there should be consistency between the different standards. Nonetheless, if effects of law were to be required for classification purposes this would represent a fundamental change to current requirements in IAS 32 which would have knock-on consequences to IFRS 9. In particular, EFRAG is concerned about the practical consequences of changing paragraph 15 of IAS 32 to require entities in to consider the effect of existing laws for classification purposes, particularly when considering the volume and complexity of existing laws and frequent changes that take place over time.
- 393 EFRAG notes for example, the requirements in IAS 32 are based on the assumption that transactions occur based on an agreement between parties to a contract, whereas law and regulation can be changed unilaterally by an authority without agreement from the counterparties. EFRAG acknowledges that if the effects of law on contracts is to be considered, then it raises the question of when they should be considered.
- 394 Therefore, EFRAG generally supports the IASB proposal that the classification should be mainly focused on the contractual terms of a financial instrument (consistently with IAS 32 and IFRS 9).
- 395 Considering the challenges that arise in practice, particularly with bail-in legislation, we recommend the IASB to further work on this issue to avoid a blanket rejection of the effects of the law and to discuss with regulators the challenges that arise with

the new BRRD, particularly when considering the role of the national resolution authorities and the possibility of capital instruments being written down or converted. In particular, EFRAG highlights that:

- (a) contingently convertible bonds may be, upon a trigger event, mandatorily convertible into a variable number of own shares or may be mandatorily written-down. Although mandatory conversion to deliver a variable amount of shares is consistent with a liability classification, financial instruments that have the mandatorily written-down feature can raise classification challenges;
- (b) the trigger event and form of resolution could be at the discretion of the regulator and it is not clear in advance which form of resolution the regulator will choose; and
- (c) these financial instruments raised questions about how to provide transparent information to users, particularly information about write-down features in the contract (resolution regulation) and write-downs recognised in a year.

396 EFRAG notes that the IASB has already taken a similar approach for IFRS 17 *Insurance Contracts* where specific legal issues are considered in the standard. Therefore, EFRAG considers that the IASB should have a more comprehensive discussion, beyond IAS 32 and IFRS 9, on how the relationship between contracts and law should be addressed in IFRS Standards, including taking into account the guidance in the *Conceptual Framework for Financial Reporting*.

#### **IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments**

397 In the DP the IASB explains that it does not intend to reconsider the requirements in IFRIC 2 given IFRIC 2 was developed for a very specific fact pattern with limited effect in practice that it is not aware of any challenges to its application.

398 EFRAG agrees that the IASB should not reconsider the guidance in IFRIC 2. In particular EFRAG notes that:

- (a) the recognition of members' shares in cooperatives as equity under IFRS Standards is governed by IAS 32 and the related Interpretation IFRIC 2 issued in 2004. The Interpretation builds upon the very specific features of members' shares and determines the condition for their treatment as equity. Since 2004 IFRIC 2 has become the blueprint for the design for members' shares for the majority of cooperatives which have to prepare financial statements under IFRS Standards.
- (b) the approach of IFRIC 2 for the distinction between equity and liabilities is also the basis for the recognition of members' shares as of cooperatives banks as Common Equity in the European Union's Banking Supervisory Law (Regulation (EU) 575/2013 and Commission Delegated Regulation (EU) 241/2014).

399 However, EFRAG considers that the IASB should take the opportunity to integrate IFRIC 2 in a revised IAS 32.

#### **Question to Constituents**

400 To what extent is the IFRIC 2 interpretation being used by the entities in your jurisdiction?

**Questions to EFRAG TEG**

- 401 Does EFRAG TEG agree with the drafting and key messages of section 8 “Relationship between contracts and law” of the appendix 1 of the Draft Comment Letter?
- 402 Does EFRAG TEG agree with the question to constituents to obtain data for future impact assessment?



## Other EFRAG comments on the IASB Discussion paper

### Notes to constituents – Interaction between FICE project and other IFRS Standards and Conceptual Framework

#### *The Conceptual Framework for Financial Reporting*

- 403 *In March 2018, the IASB published a revised Conceptual Framework for Financial Reporting. The discussion paper preceding the revised Conceptual Framework, included suggestions on how to distinguish between liabilities and equity. However, after the discussion paper, it was decided to consider this distinction in a separate project on Financial Instruments with Characteristics of Equity in order not to delay other improvements to the Conceptual Framework. The IASB noted that if necessary, the Conceptual Framework would be updated as one possible outcome of that project.*
- 404 *The Conceptual Framework for Financial Reporting defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events. The Conceptual Framework defines equity as the residual interest in the assets of the entity after deducting all its liabilities.*

#### *IFRS 2 Share-based payment*

- 405 *At present, the classification requirements in IFRS 2 and IAS 32 are not aligned and therefore result in transactions with the same characteristics to be classified differently. For example, IAS 32 requires an entity to classify a claim as a financial liability if the claim may be settled in a variable number of own equity instruments, but this characteristic does not prevent the classification of a claim as equity under IFRS 2.*
- 406 *The classification outcomes under the IASB's preferred approach are broadly aligned with those from IAS 32. Therefore, the classification outcome under the IASB's preferred approach would still not be aligned with IFRS 2.*
- 407 *If the outcome of the research project is a recommendation to add a project to amend IAS 32 and the Conceptual Framework, the IASB might consider the possibility of improving the consistency between IFRS 2 and IAS 32 in a future project.*

#### *EFRAG's comment*

**EFRAG considers that it would be undesirable to have conflicts between the newly revised *Conceptual Framework for Financial Reporting* and the distinction between liabilities and equity proposed in a new Standard.**

**EFRAG recommends the IASB to be cautious in considering any future changes to IFRS 2 requirements with the objective of aligning or introducing the DP's proposals as this would represent a fundamental change to IFRS 2.**

#### ***Interaction between the FICE project and Conceptual Framework***

- 408 *When commenting on the exposure draft resulting in the revised *Conceptual Framework for Financial Reporting*, EFRAG agreed with the IASB's decision to deal with the distinction between liabilities and equity in a project running in parallel with the broader Conceptual Framework revision. EFRAG, however, considered that it was important to solve the inconsistencies in current Standards on the distinction between equity and liabilities and to amend the Conceptual Framework to reflect the outcome of the separate project.*
- 409 *EFRAG notes that if the IASB does not update the Conceptual Framework (and IFRS 2) to reflect the outcome of the FICE project, inconsistencies between the*

IFRS Standard dealing with the distinction between equity and liabilities and the Conceptual Framework (and IFRS 2 – see below) would remain.

- 410 While EFRAG agrees that it is possible for the IASB to depart from the Conceptual Framework when setting Standards, EFRAG also assesses that it would be undesirable to have a main Standard on a given topic that would not comply with the Conceptual Framework. Such a situation would seem to be a clear indication of the need to change something in either the Standard or in the Conceptual Framework.
- 411 EFRAG acknowledges that any change to the Conceptual Framework may have to be made following an agenda consultation only. However, as part of the FICE project, EFRAG considers that the IASB would have to explain how it would amend the Conceptual Framework to reflect how it decides to distinguish between equity and liabilities. EFRAG is concerned that otherwise, the IASB could decide on a solution on a standard's level, which might not work at the conceptual level.
- 412 As acknowledged in the DP, the proposals in the DP would result in some instruments being classified as liabilities although they would not meet the definition of a liability included in the Conceptual Framework. The reason is that a promise to transfer own equity instruments can be considered a liability under the DP, but not under the Conceptual Framework. In addition to this, EFRAG considers that the IASB should also take into account that under the DP, only the contractual terms should be considered when distinguishing an equity instrument from a liability. In contrast, under the Conceptual Framework obligations can be established by legislation or similar means or from customary practices. Accordingly, although a financial instrument may not be a financial liability when only considering the contractual terms, it could be a liability under the definition included in the Conceptual Framework if for example legislation would require the issuer of the instrument to transfer an economic resource.
- 413 EFRAG assesses that some of the inconsistencies mentioned above might best be solved by providing additional guidance in the Conceptual Framework. Paragraph B6 of the DP states that the IASB does not expect that the potential changes arising from the DP will result in changes to the supporting guidance in paragraphs 4.28 – 4.35 of the Conceptual Framework. EFRAG notes that while it may not be necessary to delete any of that guidance, it may be necessary to supplement it.

#### **Interaction between the FICE project and IFRS 2**

- 414 If the IASB decided to extend its preferred approach to share-based plans, there would be significant changes to IFRS 2. Firstly, the IASB should decide if the new classification criteria would apply to share-based plans (which would represent a fundamental change to IFRS 2).
- 415 There are additional implications. For instance, the measurement of the cost in profit or loss for equity-settled plans is currently based on the grant date market value of the grant, and on the fair value of the grant at reporting date for cash-settled plans. Applying the separate presentation requirements (i.e. present in OCI changes to the liability) to share-based plans would result in the remeasurement of the liability attributable to changes in the fair value being presented in OCI and the measurement of the cost in profit or loss being aligned for all share-based plans.
- 416 The DP proposes attribution of comprehensive income to all equity instruments other than ordinary shares – extending this to equity-settled grants would represent a change, since IFRS Standards do not currently require it.
- 417 EFRAG recommends to be cautious in considering changes to IFRS 2 – these would increase the complexity of the Standard, especially the attribution of comprehensive income to equity-settled plans.

**Question to EFRAG TEG**

418 Does EFRAG TEG agree with the drafting of the appendix 1 of the draft comment letter on EFRAG other comments to the DP?

## Appendix 2 - Glossary

### Definitions provided in the discussion paper

- 419 **Entity's available economic resources:** are the total recognised and unrecognised assets of the entity that remain after deducting all other recognised and unrecognised claims against the entity
- 420 **Timing feature** - the timing of the required transfer of economic resources. It might be specified as a fixed date, or for example as:
- (a) payable on demand;
  - (b) dates of coupon or interest payments;
  - (c) dates of principal payment (e.g. at maturity or over the life of the instrument);
  - (d) option exercise dates; and
  - (e) at liquidation (i.e. perpetual term).
- 421 **The amount feature** - information about the amount of the obligation. The 'amount' does not refer to the fair value of the financial instrument, but rather to the amount specified in the contract.
- 422 **Amount that is independent of the entity's available economic resources:** only if the amount does not change as a result of changes in the entity's available economic resources; or the amount changes as a result of changes in the entity's available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity.
- 423 A **financial instrument** is a contract that gives rise to a financial asset of one entity (the holder) and a financial liability or an equity instrument of another entity (the issuer).
- 424 **Equity instrument:** is any contract that evidences a residual interest in the assets of the entity, after deducting all of its liabilities. Equity instruments issued by an entity are not economic resources of the entity (see paragraph 4.10 of the Conceptual Framework).
- 425 An **ordinary share** is the class of equity that:
- (a) is the most subordinate claim; and
  - (b) requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred at liquidation is equal to a pro rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.
- 426 **Net amount of a derivative:** refers to the net amount of the two legs of the exchange.
- 427 **Economic compulsion** - economic incentives to settle the claim in a particular way. In some circumstances, the incentives may be so strong that some would view the entity as being 'economically compelled' to exercise a particular outcome.
- 428 **Potential dilution** – is any actual or potential increase in the number of issued ordinary shares as the result of settling a financial instrument.

## Appendix 3 – How the IASB proposals address the issues that arise in practice

### EFrag assessment of how the DP’s proposals address the issues that arise in practice

429 This appendix presents EFRAG’s preliminary assessment of whether and how the DP’s proposals address the issues that arise in practice. This appendix will be updated during the consultation period, depending on the feedback received.

#### *How the IASB proposals address the issues that arise in practice*

##### **Application of the fixed-for-fixed condition to derivatives on own equity**

**Issue:** diversity in practice and requests for guidance on the application of the fixed-for-fixed condition (IFRS IC January 2010). In particular, the accounting for:

- **foreign currency instruments:** derivatives contracts that may be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency (e.g. convertible debt denominated in a foreign currency), including the foreign currency rights issue exception (IFRS IC June/September 2005);
- **foreign currency instruments exchangeable into equity instruments of other entities of the group:** for example, financial instruments issued by a subsidiary that provide holders with the rights to exchange a fixed number of equity instruments of the parent of the issuer at a fixed amount of currency (IFRS IC November 2006);
- features that cause variability on the amount of financial instruments, such as anti-dilution provisions, conversion features that may be adjusted on settlement date, conversion features that depend on a contingency and conversion features that are linked to net profit, EBITDA or other. This would include financial instruments that are *mandatorily convertible into a variable number of shares subject to a cap and a floor* (IFRS IC May 2014); *financial instruments which conversion ratio may be adjusted to consider payment of dividends; anti-dilution provisions; and financial instruments that are*

The IASB’s preferred approach clarifies that the underlying principle of the fixed-for-fixed condition is that to be classified as equity, the net amount of the derivative must not be affected by variables that are independent of the entity’s available economic resources.

The IASB’s preferred approach also provides additional guidance on some features that cause variability to the net amount of the derivative. For example, the IASB proposes detailed guidance on the variability introduced by the time value of money, anti-dilution provisions, contingencies, distributions to shareholders, non-controlling interest and conversion features that are linked to net profit, EBITDA or other elements of the financial statements.

In regard to the variability related to foreign currency, the IASB imposes a strict form of fixed-for-fixed condition. This means that financial instruments that currently meet the foreign currency rights issue exception in IAS 32 will be classified as liabilities under the IASB’s preferred approach while these instruments are classified as equity under IAS 32.

Therefore, **EFrag expects that the IASB’s preferred approach is expected to bring more guidance on the fixed-for-fixed, which would address many issues that give rise to diversity in practice.**

**However, EFRAG is concerned about the use a completely new terminology for derivatives on own equity, which will impact existing application guidance, and the IASB’s proposal to remove the foreign currency rights issue as it**

<p><b>How the IASB proposals address the issues that arise in practice</b></p>	
<p><i>mandatorily convertible into a variable number of shares, subject to a cap and floor, but gives the issuer the option to settle by delivering the maximum fixed number of shares (IFRS IC January 2014). As these features cause variability, questions arise on the fixed-for-fixed condition.</i></p>	<p><b>considers that the IASB is replacing a classification exception under IAS 32 by a presentation exception under the IASB’s preferred approach (exception that only liabilities for an amount that are dependent of the entity’s available economic resources should be separately presented in OCI). In alternative, EFRAG considers that the IASB should discuss whether a partly independent derivatives could be classified as equity is it meets the criteria in paragraph 6.34 of the DP.</b></p> <p><b>EFRAG would also welcome more illustrative examples which would help preparers understand how the new fixed-for-fixed guidance should be applied in practice, particularly on foreign currency and derivatives in which the underlying is an equity instrument of a reporting entity of the group.</b></p>
<p><b>Exception for puttable financial instruments and obligations arising on liquidation</b></p> <p><b>Issue:</b> inconsistent application of the existing definition of liability in IAS 32 and Conceptual Framework and the puttable amendments have been criticised for being rules-based and difficult to apply (IFRS IC November 2013 and March 2009). The IFRS IC has also considered a request for clarification on guidance relating to the classification of puttable financial instruments that include contractual obligations to provide pro rata distributions. The request observed such obligations were often included within the terms of income trust units that are redeemable on demand by the holder (IFRS IC 2010).</p>	<p>The IASB discussed whether the exception as set out in paragraphs 16A and 16B, or 16C and 16D, of IAS 32 is still needed given the classification and presentation requirements of the Gamma approach. Currently, the IASB is not aware of any issues with the application of the exception. The IASB also observed that applying the Gamma approach to instruments that meet the exception might address some, but not all, of the previous concerns which led to the exception. Hence, the exception to account for some financial liabilities as if they are equity instruments would be retained if they meet the conditions as set out in paragraphs 16A–16B or 16C–16D of IAS 32.</p> <p><b>Therefore, EFRAG agrees with the IASB’s conclusions and welcomes the IASB’s preferred approach to retain the existing puttable exception. However, EFRAG considers that the IASB should take the opportunity, during its outreach period, to ask stakeholders if there are any other improvements currently needed in IAS 32 which have not been discussed by the IASB. For example, identify the practical difficulties in identifying the most residual instrument.</b></p>
<p><b>Mandatory tender offers</b></p> <p><b>Issue:</b> whether a liability should be recognised for a Mandatory Tender Offer (MTO) required by law at the date the acquirer obtains control of the acquiree (<b>IFRS IC November 2012</b>).</p>	<p>For classification purposes, under the IASB’s preferred approach an entity will only consider the contractual terms of a financial instrument (i.e. it does not consider the effects of law). This is consistent with the current financial instruments literature in IFRS Standards, particularly with IAS 32 and IFRS 9 (except for IFRIC 2 which is considered to be very narrow in scope and where no challenges have been identified in its application guidance).</p>

<p><i>How the IASB proposals address the issues that arise in practice</i></p>	
	<p>As a result, in accordance with IAS 32 and the IASB’s preferred approach, MTOs will not be accounted for similarly to written put options, which would have been desirable given their similar economic consequences. The IASB will consider in the future whether it should take any action to address the accounting for MTOs.</p> <p><b>Although, EFRAG welcomes the DP’s proposals to focus on the contractual terms of a financial instrument, EFRAG considers that the IASB’s preferred approach does not solve the issue of mandatory tender options and that the IASB needs to address this issue in the future. We recommend the IASB to further work on the interaction between the terms and conditions of a contract and legal requirements to avoid a blank reject of the effects of the law from classification and to discuss with regulators the challenges that arise with imposed regulation.</b></p>
<p><b>Accounting for forward purchase contracts and written put options on an issuer’s equity instruments that require physical settlement in exchange for cash</b></p> <p><b>Issue:</b> challenges for forward purchase contracts and written put options on an issuer’s equity instruments that require physical settlement in exchange for cash typically relate to whether the redemption requirement meets the definition of a financial liability. This is particularly the case if the redemption price is equal to the value of the underlying share.</p>	<p>Under the IASB’s preferred approach, a derivative that extinguishes equity in exchange for a claim (e.g. written put option physically gross settled) will give rise to a financial liability for the present value of the redemption amount. Thus, under the IASB’s preferred approach entities will continue to apply a requirement similar to the existing redemption obligation requirement in paragraph 23 of IAS 32.</p> <p>The IASB’s preferred approach clarifies that this accounting treatment ensures that arrangements with the same liability and equity outcomes are classified consistently regardless of how they are structured. More specifically, it will ensure that the accounting for a convertible bond will be similar to the accounting for a written put option on own shares that is issued together with ordinary shares. In both cases, the holder will have the option to either receive cash or shares of the entity.</p> <p>As a consequence, the IASB’s preferred approach changes current guidance on the accounting for within equity, particularly for written puts:</p> <ul style="list-style-type: none"> <li>• the redemption amount is the present value of the strike price of the option (in accordance with IAS 32);</li> <li>• the derecognition from equity is based on the fair value of the ordinary shares at the date the written put is issued (a change to IAS 32);</li> <li>• the equity component is the sum of the premium received and the difference between the two amounts calculated above (a change to IAS 32). This would result</li> </ul>



**How the IASB proposals address the issues that arise in practice**

in an outcome similar to a written call option or conversion option in a convertible bond (a change to IAS 32). That is, the equity component would be accounted for as a conversion option in a convertible bond. Currently, the equity component reflects the premium received from the written put.

The redemption requirement should also apply to written put options where an entity repurchases equity instruments by transferring a variable amount of cash equal to the value of the underlying shares (e.g. fair value written puts). If the derivative requires the entity to transfer economic resources other than at liquidation, then it is a liability under the IASB's preferred approach. The equity component will be nil and all of the returns on the claim will be captured by the liability component (this would result in the shares being, in substance shares redeemable at fair value).

The separate presentation requirements will apply for liabilities which depend on the entity's available economic resources. Thus, the returns of such claim will be presented in OCI.

**EFRAG welcomes the IASB's proposal to retain the existing redemption obligation requirement in paragraph 23 of IAS 32. However, EFRAG does not consider that the accounting for a written put option on own shares that is issued together with ordinary shares should be similar to the accounting for a convertible bond and EFRAG is concerned with the final outcome. Instead, EFRAG believes that the redemption obligation requirements should be retained because when an entity issues these types of instruments, the entity does not have the unconditional right to avoid a liability settlement (i.e. does not have the unconditional right to avoid pay cash).**

**EFRAG is particularly concerned with the outcome of the accounting within equity when the written put option is physically gross settled as the IASB's preferred approach would affect the amount derecognised from equity and the calculation of the amount recognised as the new equity component would reflect a written call option or conversion option in a convertible bond rather than that of the written put option. EFRAG considers that such an outcome is complex for users and preparers to understand and not useful, regardless of whether the carrying amount is updated by an attribution requirement or not. EFRAG**



<p><i>How the IASB proposals address the issues that arise in practice</i></p>	
	<p><b>considers that this accounting becomes even less relevant and understandable for any attribution method other than full fair value.</b></p> <p><b>EFRAG considers that the IASB could use the principle that the entity does not have the unconditional right to avoid a liability settlement to justify the redemption obligation requirements with the benefit of changing existing requirements for accounting within equity.</b></p>
<p><b>Accounting for written put options and forward contracts on non-controlling interests</b></p> <p><b>Issue:</b> diversity in practice on the accounting for written put options and forwards on non-controlling interests (IFRS IC November 2006), in particular, on:</p> <ul style="list-style-type: none"> <li>• <b>initial recognition:</b> IAS 32 does not state clearly whether the contra to the liability recognised for the put option is a derecognition of NCI or a general reduction in equity (alongside NCI). There was also the question of whether the parent recognises a financial liability for the present value of the option exercise price (on a gross basis) or a derivative liability (on a net basis at fair value).</li> <li>• <b>subsequent measurement:</b> some believe that changes in the measurement of the financial liability should be recognised in profit or loss while others believe that these changes should be recognised directly in equity. There have also been requests for clarification around puts and forwards held by non-controlling interests that expire unexercised.</li> </ul> <p>There is also the issue of how an entity accounts for a written put option over non-controlling interests in its consolidated financial statements when the NCI put has a strike price that will, or may, be settled by the exchange of a variable number of the parent's own equity instruments. The question relates to whether the parent should account for the NCI put as a financial liability for the present value of the option's strike price on a gross basis, or as a derivative liability on a net basis (<b>IFRS IC November 2016</b>).</p>	<p>Under the IASB's preferred approach, an entity that issues a written put option (or forward contract to buy own shares) recognises a liability for the present value of the strike price. The IASB's preferred approach clarifies that this will ensure that the accounting for a convertible bond will be similar to the accounting for a written put option on own shares that is issued together with ordinary shares.</p> <p>The IASB's preferred approach provides additional guidance on the accounting within equity for NCI puts, particularly around derecognition/reclassification of the equity as a result of the recognition of the redemption amount. In particular, at initial recognition:</p> <ul style="list-style-type: none"> <li>• the redemption amount is the present value of the strike price of the option;</li> <li>• the derecognition from equity, against non-controlling interest, is based on the fair value of the ordinary shares at the date the written put is issued; and</li> <li>• the equity component is the sum of the premium received and the difference between the two amounts calculated above would reflect the fair value of a written call option or conversion option in a convertible bond rather than that of the written put option.</li> </ul> <p>On subsequent measurement of the liability component, if the redemption amount (i.e. present value of the strike price) is fixed, then the gains or losses that arise from the financial liability component are presented in profit or loss.</p> <p>However, if the NCI put is a fair value put, then the NCI equity component will be nil and all of the returns on the claim will be captured by the liability component. As the amount of the liability depends on the entity's available economic resources, then the separate presentation requirements will apply and the gains and losses that arise from the liability are presented in OCI.</p>

<p><b>How the IASB proposals address the issues that arise in practice</b></p>	
	<p>The equity component is potentially remeasured over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns, and it is a transfer within equity. At maturity the carrying amount of the equity component is transferred to ordinary shares. If the put option expires unexercised, then the carrying amount of the redemption amount would be reclassified to NCI shares.</p> <p>For variable share settled puts, if the amount of shares to be delivered is determined by a fixed amount independent of the entity's economic resources, then the obligation is a liability under the IASB's preferred approach.</p> <p><b>EFRAG welcomes the IASB's discussion on accounting within equity for NCI puts as this is an issue that raises diversity in practice. However, as described in section 5, EFRAG considers that the IASB should better explain its conclusions for the accounting for NCI puts for initial recognition and their subsequent measure. EFRAG also considers that the IASB needs to further discuss this topic to address all the issues that have been raised in the past.</b></p>
<p><b>Accounting for financial instruments in which the manner of settlement is conditional on rights within the control of the entity</b></p> <p><b>Issue:</b> notwithstanding the stated right of the entity to choose between alternative settlement outcomes in such claims, challenges include determining whether the claim, in substance, establishes an obligation that would meet the definition of a liability:</p> <ul style="list-style-type: none"> <li>• as a result of economic compulsion (e.g. callable preferred shares with dividend resets and reverse convertible bond) (IFRS IC March 2006 and November 2006);</li> <li>• indirectly through its terms and conditions; (IFRS IC September 2013); or</li> <li>• barriers to the entity exercising the equity settlement outcome, such as regulatory or legal requirements.</li> </ul>	<p>Under the IASB's preferred approach, economic incentives/compulsion that might influence the issuer's decision to exercise its rights should not be considered for classification purposes. Thus, under the IASB's preferred approach, classification would be based on the substantive rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract, which is similar to the requirements in IAS 32.</p> <p>Under the IASB's preferred approach, obligations for a specified amount will be classified as liability regardless of whether the manner of settlement is at the option of the entity. This would include callable preferred shares with dividend resets, which would be classified as liabilities under the IASB's preferred approach without the need to consider economic compulsion.</p> <p>Under the IASB's preferred approach, claims which grant the entity the unconditional right to avoid transferring cash or another financial asset until liquidation and to settle the claim at an amount that is dependent on the entity's available economic resources are classified as equity. This would include reverse convertible bonds, which would be classified as equity under the IASB's preferred approach.</p>

<p><b>How the IASB proposals address the issues that arise in practice</b></p>	
	<p>Finally, the IASB's preferred approach retains the current requirements on indirect obligations in paragraph 20. This would include, for example, equity settlement outcomes that are structured in such a way that their value always exceeds the liability settlement outcome.</p> <p><b>Therefore, EFRAG considers that the DP's proposals are consistent with current requirements in IAS 32 and have the benefit of clarifying the IASB's view on the notion of economic compulsion/incentives. Nonetheless, EFRAG considers that the IASB should take the opportunity to improve these requirements to incorporate the notion of no commercial substance which is currently used in IFRS 2, particularly to clarify the accounting for instruments with alternative settlement options when the entity is legally prohibited from issuing shares.</b></p>
<p><b>Accounting for financial instruments in which the manner of settlement is contingent on events beyond the control of the entity and the counterparty</b></p> <p><b>Issue:</b> there have been questions about how IAS 32 applies to features that are contingent on events beyond the control of the entity and the counterparty. Some have commented that it can be difficult to distinguish events that are within the control of the issuer, from those that are beyond their control. For example:</p> <ul style="list-style-type: none"> <li>• NCI puts where the share is puttable in the event of death of the holder;</li> <li>• instruments that require cash settlement or redemption in the event of a change in control;</li> <li>• instruments that require cash settlement or redemption in the event a future transaction with the entity occurs (such as an initial public offering);</li> <li>• ordinary share conversion 'ratchets' which require the delivery of a variable number of ordinary shares on conversion of a bond or preference share, if the share price is lower than a specified amount.</li> </ul>	<p>The requirements in IAS 32 on the unconditional right to avoid delivering cash (paragraph 19 of IAS 32) and contingent settlement provisions (paragraph 25 of IAS 32) are carried forward under the IASB's preferred approach. However, these requirements will have to be updated to reflect the features used to identify a liability under the IASB's preferred approach. The IASB's preferred approach also states that:</p> <ul style="list-style-type: none"> <li>• if an entity does not have the unconditional contractual right to avoid a settlement outcome that has one of both of the features of a financial liability, then the entity identifies that unavoidable obligation first and classifies that obligation as a non-derivative financial liability. If the non-derivative financial instrument also contains another possible settlement outcome that does not have the feature(s) of a financial liability then the entity considers whether the instrument is a compound instrument applying the requirements in paragraphs 3.25–3.28 and Section 5.</li> <li>• If an entity does not have the unconditional right to avoid a settlement outcome of a derivative on own equity that has the feature(s) of a financial asset or a financial liability, the derivative in its entirety would be classified as such regardless of whether its exercise is contingent on the holder or on an uncertain future event that is beyond the control of both the holder and the entity.</li> <li>• if a contingency affects the amount of a claim or the net amount of the derivative, then the entity would need to determine whether the variability introduced by a contingency depends on the entity's available economic resources. For example,</li> </ul>

<p><i>How the IASB proposals address the issues that arise in practice</i></p>	
	<p>if the contingency has the effect of varying the amount of cash or varying the number of equity instruments in a way that would not depend on the entity's available economic resources, then the instrument is a liability; and</p> <ul style="list-style-type: none"> <li>• For compound instruments (e.g. mandatorily convertible bond), effect of any conditionality in settlement outcomes would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability.</li> </ul> <p><b>EFRAG considers that in the DP the IASB has not specifically discussed the issue of whether the event specified is within the control of the entity, or beyond its control, and therefore whether the claim establishes a liability. This is particularly the case when the event relates to the entity's future activities, financial performance, or financial position (bonds that are convertible into ordinary shares of the entity if the entity's debt/equity ratio falls below a given percentage).</b></p>
<p><b>Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event</b></p> <p><b>Issue:</b> whether instruments that do not have a stated maturity date but 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 (comprised of a liability component and an equity component related to the issuer's discretion to pay interest). In addition, there have been questions on how the liability should be measured (IFRS IC January 2014).</p> <p>Similar challenges for classification of such contingently convertible instruments may arise from additional features such as caps or floors on the number of shares to be delivered or denomination in foreign currency.</p> <p>Additional Tier 1 capital instruments may also, upon a trigger event, be written down on a permanent or temporary basis. The permanent write-down could imply that they are actually subordinated even to the claims of shareholders since they absorb losses before the shareholder in a going concern.</p>	<p>For classification purposes, under the IASB's preferred approach an entity will only consider the contractual terms of a financial instrument (i.e. does not consider the effects of law). Consequently, any contingent equity conversion feature that results from a national authority's power derived from legislation will not be considered by the issuer for classification purposes and an entity will only consider contingencies reflected in the contract.</p> <p>In addition, according to the IASB's preferred approach, if an entity does not have the unconditional contractual right to avoid a settlement outcome that has one of both of the features of a financial liability, then the entity identifies that unavoidable obligation first and classifies that obligation as a non-derivative financial liability. In identifying the liability component, the entity would not consider the uncertainty that arises from conditionality.</p> <p>If the non-derivative financial instrument also contains another possible settlement outcome that does not have the feature(s) of a financial liability then the entity considers whether the instrument is a compound instrument applying the requirements in paragraphs 3.25–3.28 and Section 5.</p>

<p><b>How the IASB proposals address the issues that arise in practice</b></p>	
<p>Conversion or write-down a central element of the “bail-in” mechanism established by Directive 2014/59/EU (Bank Recovery and Resolution Directive). It applies to a wide range of liabilities at a point of non-viability decided by regulatory authorities.</p>	<p><b>EFRAG considers that the classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent ‘non-viability’ event is a relevant issue and that the IASB should better explain how its model applies to such instruments, in particular to derivatives that may be written down on a permanent or temporary basis. Considering the challenges that arise in practice, particular with bail-in legislation, we recommend the IASB to further work on this issue to avoid a blank reject of the effects of the law and to discuss with regulators the challenges that arise with the new BRRD, particularly when considering the role of the national resolution authorities and the possibility of capital instruments being written down or converted.</b></p>
<p><b>Classification of a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor</b></p> <p>Issue: in 2014 the IFRS IC discussed a financial instrument obliges the issuer to deliver a variable number of its own equity shares to equal a fixed cash amount, subject to a cap and a floor on the number of shares to be delivered.</p>	<p>Applying the IASB’s preferred approach, the entity would first classify the obligation to deliver a variable number of its own shares with a total value equal to a fixed amount as a non-derivative liability component.</p> <p>In identifying the liability component, the entity would not consider the uncertainty that arises from conditionality, i.e. the likelihood of the share price falling below the cap.</p> <p>Once the liability component is identified, the entity would classify the remaining rights and obligations applying the classification principle of the IASB’s preferred approach for derivative financial instruments.</p> <p><b>Therefore, EFRAG considers that the DP’s proposals are consistent with current requirements in IAS 32 and IFRS IC discussions and have the benefit of clarifying the IASB’s view on the uncertainty that arises from conditionality.</b></p>
<p><b>Payments at the ultimate discretion of the issuer’s shareholders</b></p> <p><b>Issue:</b> diversity in assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer’s shareholders, and consequently whether a financial instrument should be classified as a financial liability or equity. Rights to declare dividends and redeem capital may depend on the decision made in a general shareholders’ meeting, therefore the role of shareholders may be critical in deciding whether the entity has an unconditional right to avoid delivering cash. There are mixed views on this issue. Some take the view that if shareholders make decisions as part of the corporate governance</p>	<p>The IASB has not specifically addressed this issue in the FICE project, even though there were some brief discussions on classification based on rights.</p>

<p><b>How the IASB proposals address the issues that arise in practice</b></p>	
<p>decision-making process of the entity (generally exercised in a general meeting) this means that the entity has an unconditional right to avoid payment of cash and financial instruments such as preference shares should be classified as equity. However, there are others who believe that the actions of ordinary shareholders are not part of the entity's decision-making process and are outside the control of the issuing entity (IFRS IC March 2010).</p>	
<p><b>Inconsistency in the accounting of derivatives in IAS 32 and IFRS 2</b></p> <p><b>Issue:</b> the <i>classification of financial instrument differs between IFRS 2 and IAS 32:</i></p> <ul style="list-style-type: none"> <li>• In IFRS 2, obligations to deliver equity instruments prior to liquidation are classified as equity if certain conditions are met. Thus, if the entity has an obligation to deliver a variable number of equity instruments equal to a specified amount (i.e. if it uses its own shares as 'currency' to settle the instrument) it will be classified as equity under IFRS 2 while it is a liability under IAS 32.</li> <li>• obligations to transfer cash or other assets [prior to liquidation] are liabilities under IFRS 2. However, IAS 32 includes a limited-scope exception from the definition of a liability for some puttable instruments that represent a residual interest in the entity.</li> </ul>	<p>At present, the distinction between liabilities and equity under IFRS 2 is consistent with the revised Conceptual Framework (but not with IAS 32). If the IASB ultimately proposes changes to the Conceptual Framework as a result of the FICE project, the IASB would need to consider the implications for a future revision of IFRS 2 (e.g. whether the separate presentation and the attribution approach should also be applied to share-based payment transactions).</p> <p><b>Therefore, EFRAG does not consider that the IASB's preferred approach solves the inconsistency in the accounting of derivatives in IAS 32 and IFRS 2.</b></p>
<p><b>Requirements which lead to financial reporting that is counter-intuitive</b></p> <p><b>Issue:</b> Many have considered that the current requirements lead to financial reporting that is counter-intuitive for a number of instruments such as:</p> <ul style="list-style-type: none"> <li>• puttable shares;</li> <li>• derivatives over own equity including NCI Puts;</li> <li>• perpetual instruments that entitle holders to discretionary payments that are fixed or determinable; or</li> </ul>	<p>Under the IASB's preferred approach there will be subclasses of liabilities to which separate presentation requirements will apply. The income and expenses arising from financial instruments that meet the separate presentation requirements should be presented under OCI. More specifically:</p> <ul style="list-style-type: none"> <li>• income and expenses that arise from liabilities and derivatives that do not depend on the entity's available economic resources would be presented in profit or loss (e.g. interest and dividends on cumulative preference shares);</li> <li>• income and expenses that arise from liabilities and derivatives that depend on the entity's available economic resources would be presented in OCI (e.g. shares redeemable at fair value); and</li> </ul>



<p><b>How the IASB proposals address the issues that arise in practice</b></p>	
<ul style="list-style-type: none"> <li>instruments that require an entity to distribute an amount based on a proportion of profit or loss.</li> </ul> <p>(EFRAG Comment letter to the IASB Discussion Paper <i>Review of the Conceptual Framework for Financial Reporting</i>)</p>	<ul style="list-style-type: none"> <li>income and expenses that arise from partly independent derivatives will be separately presented in OCI if a specific criterion is met (e.g. foreign currency denominated written call option), which is limited to specific types of derivatives with foreign currency exposure and only under certain circumstances.</li> </ul> <p><b>EFRAG considers that the IASB addresses the issue that arises in practice. However, EFRAG notes that use of OCI may be controversial, will raise discussion of what performance is and why recycling should not be used in this case. EFRAG also notes that the IASB does not address how this new category of OCI should be dealt within equity. Finally, EFRAG recommend the IASB to use OCI on liabilities and derivatives that are solely dependent on entity's available economic resources (not for those partly dependent).</b></p>
<p><b>Inconsistency between IAS 32 and conceptual framework:</b> the classification outcome of obligations to deliver an entity's own equity instruments is one of the differences that arises from applying the definition of a financial liability in IAS 32 compared to applying the definition of a liability in the Conceptual Framework.</p>	<p>The Conceptual Framework defines a liability as 'a present obligation to transfer an economic resource as a result of past events.'</p> <p>Under the IASB's preferred approach obligations to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of currency would continue to be classified as financial liabilities. Therefore, <b>EFRAG expects that the IASB's preferred approach would not solve this inconsistency</b></p>
<p><b>Lack of information about financial instruments classified as equity:</b> <b>Issue:</b> IFRS Standards have more comprehensive disclosure requirements for financial liabilities than for equity instruments.</p>	<p>The IASB's preferred approach will require additional disclosures around equity, particularly on priority on liquidation and potential dilution.</p>
<p><b>Callable preferred shares with a step-up dividend clause</b> <b>Issue:</b> In March 2006 the IFRS IC received a request to clarify how an issuer would classify an irredeemable, callable financial instrument with dividends payable only if dividends are paid on the ordinary shares of the issuer (which themselves are payable at the unconditional discretion of the issuer). The instrument includes a 'step-up' dividend clause that would increase the dividend at a pre-determined date in the future unless the instrument had previously been called by the issuer, and it has a higher priority on liquidation than subordinated (i.e. junior) ordinary bonds.</p>	<p>The IASB's preferred approach would classify as a liability callable preferred shares with resets without the need to consider any other requirements and because they are obligations of a specified amount independent of the entity's available economic resources.</p> <p><b>EFRAG expects that the IASB's preferred approach would solve this issue.</b></p>

**How the IASB proposals address the issues that arise in practice**

**Other issues**

A number of other issues were raised by respondents to the Discussion Paper on the Conceptual Framework for the IASB to consider within the context of amending or developing standards, including:

- Significant differences between equity and liability classification in terms of presentation and measurement;
- disclosures for equity instruments;
- other depictions of the effects of dilution (e.g. earnings per share);
- accounting for compound instruments;
- accounting for remote events;
- hedge accounting for equity instruments (particularly if they are directly measured);
- instruments that are issued by limited-life entities; or
- classification of discretionary payments made on instruments which are wholly classified as liabilities;
- own shares that are held for trading purposes (IFRS IC August 2002)

The creation of subclasses of liabilities and equity and their separate presentation within the statement of financial position and statement of financial performance represents a significant change to existing presentation requirements in IAS 1 and IAS 32. The creation of subclasses of equity and liabilities aims to address the difficulties that arise from using a binary distinction between claims to depict a wide range of claims with various features and the polarised financial reporting effects of classifying those claims as either liabilities or equity.

The creation of subclasses will also impact the measurement of equity instruments and classes of equity “other than ordinary shares” are potentially remeasured over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns, and it is a transfer within equity.

In terms of disclosures, the IASB discussed improvements to disclosure requirements to provide information to users on the priority of claims on liquidation, the potential dilution of ordinary shares and additional disclosures to assist users in understanding the timing and amount of financial instruments classified as equity and liabilities under the Gamma approach (e.g. for each group of financial instruments classified as derivative equity claims, entities would have to disclose the fair value of the group of financial instruments).

On the other topics, the IASB’s preferred approach is not expected to be significantly different from current IAS 32.



## **Appendix 4 – Preliminary impact assessment on the DP’s proposals**

### **Notes to constituents on preliminary impact assessment on the DP’s proposals**

- 430 During the IASB’s consultation period EFRAG is going to outreach its constituents to better understand the impact of the DP’s proposals on the financial statements of the entities. EFRAG will use this information to develop an early stage impact analysis of the IASB proposals, which will be included in EFRAG final comment letter.
- 431 This early stage impact analysis will give emphasis to the real-world consequences of changing current IFRS requirements and is intended to help EFRAG and its constituents understand the potential impact of the new approach developed by the IASB on classification and presentation of financial instruments under the scope of IAS 32. In particular, it should help in understanding the impact of such a change on the statement of financial position and the solvency of European financial institutions.
- 432 EFRAG has already discussed internally (EFRAG TEG and its advisory groups) a high level preliminary impact assessment which prepared after the end of the IASB discussions on the FICE project (please click [here](#)).
- 433 This preliminary impact assessment was based on the IASB discussions and tentative decisions and was mainly focused on the classification and presentation changes that arise with the Gamma approach developed by the IASB during its discussions.