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

Financial Instruments with Characteristics of Equity
Draft Comment Letter

1 This agenda paper only includes the sections not discussed by EFRAG TEG on its July 2018 meeting.

Section 6 - Presentation

Notes to constituents – Summary of the IASB DP

215 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.

216 *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

217 *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.*

218 *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

219 *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).*

220 *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.*

221 *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

222 *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.*

223 *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

224 *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*[1]*.*

225 *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.*

226 *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*

[1] 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.

227 *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.*

228 *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.*

229 *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.*

230 *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

231 *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.*

232 *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

233 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.

234 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.

235 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.

236 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.

237 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.).

238 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 financial liabilities and derivatives (i.e. fair value through OCI) within the statement of financial position and statement of financial performance.

239 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 221 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.

240 Therefore, as explained below, EFRAG welcomes some of the DP's proposals on presentation of financial liabilities, but not all.

Statement of financial position

241 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).

242 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.

243 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).

244 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.

245 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.

246 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.

247 Considering this, EFRAG considers that requiring entities to arrange the claims by priority on liquidation on the face (paragraph 221 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 355 below (i.e. defining priority within consolidated financial statements can be challenging)

248 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 less disruptive than presentation on the face, while providing the same information.

Statement of financial performance

249 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.

250 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.

251 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 done either by using a separate line item within profit or loss, using OCI or through disclosures.

252 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.

253 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.

254 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.

255 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.

256 On the other hand, EFRAG acknowledges that many believe that an increase (decrease) in a financial liability should be reflected as performance, even if 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 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.

257 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

258 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.

259 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.

260 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.

261 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

262 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** dependent on the entity's available economic resources (e.g. shares redeemable at fair value);

263 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

264 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

265 *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.*

266 *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.*

267 *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.*

268 *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*[2] *(including NCI). The attribution of total comprehensive income to all equity instruments should be presented on the face of the statement of financial performance.*

269 *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.*

270 *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.*

271 *When discussing attribution methods, the IASB provided the following approaches without reaching a 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*

[2] 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.*

272 *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

273 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.

274 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).

275 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.*

276 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.

277 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

278 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*.

279 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.

280 EFRAG notes that *equity instruments other than ordinary shares* would encompass non-derivative instruments (e.g. non-cumulative preference shares, and participating equity instruments) and derivative instruments (e.g. warrants).

281 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[3] 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) how this definition would deal with financial instruments which can be written-down when the issuer or regulator trigger resolution. That is, these financial instruments would be seen as the most subordinated instruments, more than ordinary shares, in case of resolution (for more details on additional Tier 1 convertible bonds please see paragraph 398);

(e) the interaction between IAS 1 and IAS 33 in terms of definitions of 'ordinary equity shareholders' and 'potential equity shareholders';

(f) 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

282 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;

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[3] A perpetual bond is a non-redeemable bond with no maturity which pays a stream of interest indefinitely.

(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.

283 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.

284 However, EFRAG is concerned that the introduction of subclasses of equity and attribution mechanism will introduce significant complexity and increases the costs for preparers. 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.

285 Considering all the challenges identified, in paragraph 314 EFRAG suggests an alternative approach to the IASB.

Attribution requirements and their impact on primary financial statements

286 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).

287 Overall, EFRAG has the following concerns:

(a) EFRAG is concerned about the increased complexity and costs of the DP's proposals, particularly when considering that the IASB would require entities to update the carrying amount of 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

288 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*.

289 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).

290 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.

291 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.

292 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

293 Under current IFRS Standards, once a financial instrument is classified as an equity instrument, its carrying amount is not subsequently directly remeasured or updated.

294 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.

295 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.

296 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).

297 In paragraph 6.63 the DP argues 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.

298 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.

299 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.

300 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.

301 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. 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

302 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

303 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.

304 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.

305 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.

306 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

307 Although EFRAG is not in favour of an attribution mechanism, between the tree attribution approaches provided for derivatives, EFRAG 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.

308 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).

309 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

310 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.

311 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.

312 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.

313 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

314 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).

315 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

316 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.

317 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

318 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 335 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).

319 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.

320 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.

321 The DP proposes to align the attribution to 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.

322 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.

323 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 as to whether IAS 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

324 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

325 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

326 *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

327 *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.*

328 *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.*

329 *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.*

330 *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.*

331 *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.*

332 *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.*

333 *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).

334 *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

335 *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.*

336 *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.*

337 *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.*

338 *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.*

339 *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.*

340 *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.

341 *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*

342 *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.*

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

344 *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.*

Question 9

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 IASB's 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.

345 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.

346 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.

347 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.

348 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.

349 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

350 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 one own rights, benefits, costs and risk**.**

351 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.

352 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.

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

354 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.

355 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.

356 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

357 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.

358 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.

359 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.

360 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.

361 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.

362 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

363 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.

364 ESMA has recently published a report, *Enforcement and Regulatory Activities of Accounting Enforcers in 2017*, 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.

365 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.

366 For example, if the Common Equity Tier 1 ratio of a bank falls below 5.125%, additional Tier 1 instruments are automatically converted into Common 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

367 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

368 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

369 *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.*

370 *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).*

371 *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.*

372 *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).*

373 *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. In 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.*

374 *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

375 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.

376 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.

377 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.

378 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 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.

379 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.

380 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

381 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.

382 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.

383 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.

384 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)'. The IASB could also consider the existing guidance in paragraph 19(a) of IAS 32 and reflect the need for the entity to obtain the approval from a regulatory authority for a particular form of settlement.

385 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

386 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

387 *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.*

388 *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.*

389 *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.*

390 *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

391 EFRAG considers that the interaction between 'contractual rights and obligations' and 'regulatory and legal' requirements is a fundamental issue.

392 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.

393 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.

394 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.

395 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.

396 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.

397 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).

398 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) many financial institutions have issued convertible bonds that may be mandatorily convertible into a variable number of own shares or even written-down. Although mandatory conversion to deliver a variable amount of shares is consistent with a liability classification, issues arise with bonds that are written-down when the issuer or regulator trigger resolution;

(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.

399 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

400 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.

401 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).

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

Question to Constituents

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

Questions to EFRAG TEG

404 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?

405 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

406 *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.*

407 *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

408 *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.*

409 *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.*

410 *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

411 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.

412 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.

413 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.

414 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.

415 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.

416 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

417 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).

418 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 shared-based plans.

419 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.

420 EFRAG recommends the IASB 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

421 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

422 **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

423 **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).

424 **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.

425 **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.

426 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).

427 **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).

428 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.

429 **Net amount of a derivative**: refers to the net amount of the two legs of the exchange.

430 **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.

431 **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 DP's proposals address the issues that arise in practice

EFRAG assessment of how the DP's proposals address the issues that arise in practice

432 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**

How the IASB proposals address the issues that arise in practice	
*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.*	**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.** **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.**
Exception for puttable financial instruments and obligations arising on liquidation **Issue:** 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).	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. **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.**
Mandatory tender offers **Issue:** 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 (***IFRS IC November 2012***).	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).

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	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. **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 blanket rejection of the effects of the law from classification and to discuss with regulators the challenges that arise with imposed regulation.**
Accounting for forward purchase contracts and written put options on an issuer's equity instruments that require physical settlement in exchange for cash **Issue:** 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.	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. 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. As a consequence, the IASB's preferred approach changes current guidance on the accounting for within equity, particularly for written puts: • the redemption amount is the present value of the strike price of the option (in accordance with IAS 32); • 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);

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	• 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 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**

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	considers that this accounting becomes even less relevant and understandable for any attribution method other than full fair value.
Accounting for written put options and forward contracts on non-controlling interests **Issue:** diversity in practice on the accounting for written put options and forwards on non-controlling interests (IFRS IC November 2006), in particular, on: • **initial recognition:** 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). • **subsequent measurement:** 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. 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 **(IFRS IC November 2016).**	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. 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: • the redemption amount is the present value of the strike price of the option; • 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 • 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. 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. 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. 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

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	transferred to ordinary shares. If the put option expires unexercised, then the carrying amount of the redemption amount would be reclassified to NCI shares. 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. **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.**
Accounting for financial instruments in which the manner of settlement is conditional on rights within the control of the entity **Issue:** 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: • 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); • indirectly through its terms and conditions; (IFRS IC September 2013); or • barriers to the entity exercising the equity settlement outcome, such as regulatory or legal requirements.	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. 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. 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. Finally, the IASB's preferred approach retains the current requirements on indirect obligations in paragraph 20. This would include, for example, equity settlement

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	outcomes that are structured in such a way that their value always exceeds the liability settlement outcome. **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.**
Accounting for financial instruments in which the manner of settlement is contingent on events beyond the control of the entity and the counterparty **Issue:** 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: • NCI puts where the share is puttable in the event of death of the holder; • instruments that require cash settlement or redemption in the event of a change in control; • instruments that require cash settlement or redemption in the event a future transaction with the entity occurs (such as an initial public offering); • 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.	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: • 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. • 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. • 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, if the contingency has the effect of varying the amount of cash or varying the

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	number of equity instruments in a way that would not depend on the entity' available economic resources, then the instrument is a liability; and • 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. **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).**
Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event **Issue:** 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). 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. 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.	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. 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. 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. **EFRAG considers that the classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-**

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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.	**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 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**.
Classification of a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor 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.	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. 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. **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.**
Payments at the ultimate discretion of the issuer's shareholders **Issue:** 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 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	The IASB has not specifically addressed this issue in the FICE project, even though there were some brief discussions on classification based on rights.

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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).	
Inconsistency in the accounting of derivatives in IAS 32 and IFRS 2 **Issue: the** *classification of financial instrument differs between IFRS 2 and IAS 32:* • 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. • 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.	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). **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.**
Requirements which lead to financial reporting that is counter-intuitive **Issue**: Many have considered that the current requirements lead to financial reporting that is counter-intuitive for a number of instruments such as: • puttable shares; • derivatives over own equity including NCI Puts; • perpetual instruments that entitle holders to discretionary payments that are fixed or determinable; or • instruments that require an entity to distribute an amount based on a proportion of profit or loss.	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: • 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); • 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 • 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

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(EFRAG Comment letter to the IASB Discussion Paper *Review of the Conceptual Framework for Financial Reporting*)	denominated written call option), which is limited to specific types of derivatives with foreign currency exposure and only under certain circumstances. **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).**
Inconsistency between IAS 32 and conceptual framework: 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.	The Conceptual Framework defines a liability as 'a present obligation to transfer an economic resource as a result of past events. 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, **EFRAG expects that the IASB's preferred approach would not solve this inconsistency**
Lack of information about financial instruments classified as equity: **Issue:** IFRS Standards have more comprehensive disclosure requirements for financial liabilities than for equity instruments.	The IASB's preferred approach will require additional disclosures around equity, particularly on priority on liquidation and potential dilution.
Callable preferred shares with a step-up dividend clause **Issue:** 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.	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. **EFRAG expects that the IASB's preferred approach would solve this issue.**

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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

433 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.

434 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.

435 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).

436 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.