IASB DP/2018/1 Financial Instruments with Characteristics of Equity

Feedback to constituents – EFRAG Final Comment Letter

February 2019

Introduction

Objective of this feedback statement

EFRAG published its final comment letter on IASB DP/2018/1 *Financial Instruments with Characteristics of Equity* ('the DP') on 1 February 2019. This feedback statement summarises the main comments received by EFRAG on its draft comment letter and explains how those comments were considered by EFRAG during its technical discussions leading to the publication of EFRAG's final comment letter.

IASB Discussion Paper

On 28 June 2018, the IASB published the DP focused on potential improvements to the classification, presentation and disclosure requirements of financial instruments within the scope of IAS 32 *Financial Instruments: Presentation*. The DP was open for comments until 7 January 2019.

EFRAG's draft comment letter

EFRAG published its Draft Comment Letter ('DCL') on 28 August 2018, which was open for comments until 3 December 2019.

In its DCL, EFRAG welcomed the IASB's efforts to respond to the challenges that arise with IAS 32 and the fact that the IASB had considered a number of EFRAG's past requests. However, EFRAG also expressed reservations over some of the proposals in the DP, particularly on the use of completely new terminology.

In general, EFRAG provided a balanced view and highlighted that a careful weighing of the potential benefits of a better articulation of the principles in IAS 32 against the potential risks of unnecessary disruption and unintended consequences was essential.

Comments received from constituents

EFRAG received twenty-nine comment letters from constituents. These comment letters are available on the EFRAG website under 'Discussion Paper consultation'.

The comment letters were received from national standard setters, regulators, users' representatives, preparers and accounting and professional organisations.

The majority of the respondents acknowledged the challenges that arise with IAS 32 and appreciated the IASB's efforts to address these challenges and the existing diversity in practice by attempting to better articulate principles underlying the classification of claims between debt and equity.

These respondents acknowledged that there is room to improve IAS 32, particularly on disclosures about equity instruments and the accounting for complex instruments such as contingent convertible bonds.

However, there was less support for the IASB's preferred approach as described in the DP to address the challenges that currently arise in practice. Most concerns were related to the lack of clarity of the new terminology, the use of the 'amount feature' that considers payments on liquidation and the cost-benefit trade-off of implementing new principles intended to result in (mostly) the same outcome.

There was more support for specific improvements to current requirements in IAS 32, particularly additional guidance for the classification of complex instruments and improvements to disclosure requirements on equity instruments. Some respondents highlighted that the DP already identified some solutions to the issues that arise in practice which could be a good basis for further discussions.

Finally, some respondents called for a more conceptual and less rule-based approach to distinguishing debt from equity. However, these respondents provided mixed and sometimes contradictory views. For example, some supported the IASB approach, others supported an approach based on the timing feature only while others suggested an approach more aligned with the conceptual framework.

EFRAG's final comment letter

As respondents to EFRAG's draft comment letter and participants in the outreach events had either disagreed with or expressed only limited support for the IASB's preferred approach, EFRAG decided that the final comment letter should reject the IASB's preferred approach for classification and suggest potential targeted improvements to IAS 32.

EFRAG acknowledged that some constituents are calling for a more conceptual to distinguishing debt from equity. However, at this stage EFRAG has not identified any consensus among those constituents on how to achieve this in a reasonable timeframe. Therefore, developing a more conceptual and less rule-based approach will be very challenging and any alternative that results in widespread classification changes is likely to prove controversial (as with previous approaches discussed by the IASB and EFRAG).

Detailed analysis of issues, comments received, and changes made to EFRAG's final comment letter

EFRAG's tentative views expressed in the draft comment letter and constituents' comments	EFRAG's response to constituents' comments
Objective, scope and challenges	
In section 1 of the DP, the IASB describes the objective of the project, its scope and the application challenges that arise with IAS 32. Subsequently, the IASB seeks views on whether these challenges are pervasive enough to require standard-setting activity. In its DCL, EFRAG welcomed the IASB's efforts to respond to the challenges that arise with IAS 32 and considered that the application issues that arise with IAS 32 are pervasive enough to require standard-setting activity. EFRAG also highlighted that improvements to presentation and disclosures were currently needed and constituted a significant part, or even the most important part, of this project. Nonetheless, EFRAG listed a number of general concerns, including that FICE seemed an ambitious project. In general, respondents acknowledged the challenges arising with IAS 32 and appreciated the IASB's efforts to address the existing challenges and diversity in practice by attempting to better articulate the principles in IAS 32. Respondents also acknowledged that there is room to improve IAS 32, particularly on the accounting for complex instruments such as contingent convertible bonds (CoCos). However, as further described below, there was less support for the IASB's preferred approach to address the challenges that currently arise in practice. Most concerns were related to the lack of clarity of the new terminology, the use of the amount feature and the cost-benefit trade-off of implementing new principles intended to result in (mostly) the same outcome. Finally, some respondents noticed that the IASB had not identified all the issues that arise with IAS 32 and referred to issues discussed by the IFRS IC but not referred in the DP (e.g. if the payment of cash is at the ultimate discretion of the issuer's shareholders).	*EFRAG final position* Considering the feedback received, EFRAG decided to highlight that currently there is no consensus on the right approach for the distinction between debt and equity and that this a significant factor for the existing challenges with IAS 32 and a cause for diversity in practice when IAS 32 is unclear or lacks guidance. EFRAG also decided to change its position and not support the IASB's preferred approach as a way forward to address the identified challenges, particularly on the classification and presentation of financial instruments (more details in section 2 below). Nonetheless, EFRAG considered that there is room to improve IAS 32 to provide better information for users and that improvements to presentation and disclosures constitute a significant part, or even the most important part, of this project.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments

The IASB's preferred approach

In section 2 of the DP, the IASB discusses its preferred approach to the classification of financial instruments based on its analysis of various features of claims, including the proposed 'timing' and 'amount' features.

In its letter, EFRAG welcomed the IASB's efforts to improve IAS 32's requirements on classification but noted that the approach in the DP introduced completely new terminology. In addition, EFRAG considered that it was essential to weigh carefully the potential benefits of a better articulation of the principles in IAS 32 against the potential risks of unnecessary disruption and unintended consequences. Finally, EFRAG considered that presentation and disclosure constituted a significant part of this project.

The majority of the respondents were not convinced that the IASB's preferred approach was a significant improvement when compared to IAS 32. These respondents expressed concerns about the use of a complete new and unclear terminology and considered that implementation costs were likely to exceed any benefit, particularly as the classification outcomes would be in the majority of the cases similar to IAS 32.

When referring to next steps, many respondents did not support at this stage a comprehensive review of current requirements, which could involve the publication of a new standard, and would prefer targeted amendments to IAS 32 to address the challenges that arise in practice. It was noted that currently the application of IAS 32 does not raise significant classification challenges for the majority of financial instruments and that some of the existing issues (e.g. fixed-for-fixed condition for derivatives on own equity) could be solved with the new detailed guidance included in the IASB's preferred approach.

Finally, some respondents supported a more comprehensive and conceptual approach to distinguishing debt from equity. Nonetheless, these respondents provided mixed views on the best approach: some supported the IASB's preferred approach while others suggested alternative approaches.

EFRAG's response to constituents' comments

EFRAG final position

Considering the feedback received, EFRAG decided to change its position and not support the IASB's preferred approach. Instead, EFRAG suggested that the IASB focuses on targeted improvements to IAS 32 and other standards (e.g. IAS 33 *Earnings per Share*), particularly improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions.

Similar to the feedback received from respondents, EFRAG highlighted that the DP already identifies some practical solutions to the issues that arise in practice with IAS 32 which could be a good basis for further discussions

Finally, EFRAG acknowledged that some constituents are calling for a more conceptual and less rule-based approach to distinguishing debt from equity. However, EFRAG did not identify any consensus among those constituents on how to achieve this. Therefore, developing a more conceptual and less rule-based approach will be challenging and any alternative that results in widespread classification changes is likely to prove controversial. Accordingly, EFRAG suggested that the IASB reconsiders whether to continue with a comprehensive FICE project.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments	EFRAG's response to constituents' comments

Classification of non-derivative financial instruments

In this section the IASB explains how the IASB's preferred approach for classifying financial instruments applies to non-derivative instruments.

In its draft letter, EFRAG explained that it was not convinced that the identified changes in classification outcomes related to problematic areas of IAS 32. EFRAG also expressed concerns on the use of a completely new terminology for non-derivative instruments, particularly on the notion of 'an amount independent of the entity's available economic resources' and the fact that some financial instruments would be classified as liabilities even if they are only settled on liquidation. Finally, EFRAG welcomed the IASB decision to retain the puttable exception as the IASB's preferred approach did not solve all the issues that gave rise to the exception

Most respondents, including those that supported the IASB's preferred approach, expressed concerns about the use of new terminology, particularly the use of the amount feature. Some thought that "an amount independent of the entity's available economic resources" was difficult to apply, highly judgmental and not intuitive. Some highlighted that any reference to the fair value of the entity's own shares needed to be assessed with care.

In addition, a number of respondents highlighted that the IASB had not taken into account the business model of co-operative entities and that the "amount feature" could be problematic for those currently applying IFRIC 2.

Many respondents also highlighted that the IASB's preferred approach introduced significant classification changes and questioned their relevance. For example, respondents questioned the relevance of classifying claims with cumulative features as financial liabilities when an entity does not have to pay other than at liquidation and considered that such an outcome was inconsistent with the going concern principle in the Conceptual Framework.

Finally, many respondents welcomed the IASB decision to retain the puttable exception as the new approach did not solve all the issues that gave rise to it.

EFRAG final position

Considering the feedback received, EFRAG decided to give more prominence to the concerns raised by its constituents in its final comment letter.

More specifically, EFRAG decided to reiterate that it is not convinced that the identified changes in classification outcomes relate to areas of IAS 32 that are problematic and is concerned about the potential market impact of these changes in classification.

EFRAG also decided to reiterate that it has significant concerns on the use of a completely new terminology for the classification of non-derivatives, particularly on the notion of 'an amount independent of the entity's available economic resources' and the fact that some financial instruments would be classified as liabilities even if they are only settled on liquidation (e.g. cumulative preference shares) as such an outcome would be inconsistent with the Conceptual Framework and its going concern principle.

Finally, EFRAG supported the accounting treatment provided by paragraphs 16A to 16D of IAS 32 and considered that the puttable exception should be retained until the IASB is able to find another solution that addresses the issues that gave rise to the exception.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments

Classification of derivative financial instruments

In sections 4 and 5 the IASB explains how its preferred approach should be applied to derivatives on own equity, including those instruments that have a redemption obligation, and compound instruments.

In its DCL, EFRAG welcomed the IASB's efforts to clarify the existing guidance on derivatives on own equity but considered that the IASB should further analyse the option of accounting for all derivatives on own equity under the scope of IFRS 9 Financial Instruments. Although EFRAG welcomed the additional guidance on whether an instrument meets the fixed-for-fixed condition, the DCL raised a number of specific issues that need clarification. EFRAG also expressed concerns that the proposed guidance differed significantly from IAS 32, particularly in terms of terminology. Finally, EFRAG was not convinced that the accounting for a written put option on own shares and a convertible bond should be the same.

Many respondents expressed concerns about the use of new terminology and highlighted that the DP introduced significant classification changes to derivatives on own equity. Respondents also questioned the relevance of such classification changes and expressed concerns about their potential impact. Some respondents also considered that the accounting for financial instruments under the IASB's preferred approach was more complex and difficult to understand when compared to IAS 32. In addition, it was noted that currently there is uncertainty and diversity in practice on the classification of instruments with contingent settlement options (e.g. mandatorily convertible into a variable number of shares or written down upon a contingent 'non-viability' event) and considered that with the IASB's preferred approach, uncertainty would continue to exist.

Finally, there was no significant support for all derivatives on own equity being accounted for under IFRS 9 and there were mixed views on whether the accounting for a written put option on own shares and a convertible bond should be the same.

EFRAG's response to constituents' comments

EFRAG final position

Considering the feedback received, EFRAG decided to give more prominence to the concerns raised by its constituents. More specifically, EFRAG highlighted that it is concerned that the IASB's preferred approach differs significantly from current guidance, particularly in terms of terminology, which would introduce new uncertainties. In addition, EFRAG noted that the proposed classification changes are not related to areas of IAS 32 that are problematic and was concerned about the potential impact that these changes would bring to the market.

Nonetheless, EFRAG decided to highlight that the DP identifies some solutions to the issues that arise in practice with derivatives on own equity. EFRAG considered that this could be a good basis for further discussions on targeted improvements to IAS 32 (e.g. incorporating some of the detailed guidance on the difficulties related to the fixed-for-fixed requirement).

For financial instruments contingent on an uncertain event, EFRAG highlighted respondents' concerns that, due to the complexity of the IASB's preferred approach (particularly the amount feature), the uncertainty and diversity in practice that exists today on the classification of instruments such as financial instruments mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event would remain.

Finally, EFRAG decided to reiterate that it is not convinced that the accounting within equity for a written put option should be the same as for a convertible bond and to better explain its reasoning.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments

Presentation of financial liabilities

In section 6 of the DP, the IASB discusses potential improvements to presentation of financial instruments to address the existing limitations of a binary approach. In particular, it discusses the presentation in OCI of gains/losses for financial liabilities with equity-like returns.

In its DCL, EFRAG considered that the IASB needed to clearly identify all the cases which currently lead to counter-intuitive accounting and further discuss the scope of the separate presentation requirements for financial liabilities. It also considered that such requirements should apply only to liabilities, derivatives and embedded derivatives that are solely dependent on entity's available economic resources and not require entities to bifurcate hybrids.

As mentioned above, many respondents were more supportive of targeted improvements to IAS 32, including presentation requirements. Some of these respondents considered the DP already identified some solutions which could be a good basis for further development of IAS 32.

When referring explicitly to the IASB's proposals to separately present liabilities with equity-like returns, respondents provided mixed views.

A number of respondents were supportive of the IASB's suggestions to separately present financial liabilities with equity-like returns, particularly in the statement of financial performance. Nonetheless, some of these respondents highlighted some concerns. For example, the fact that gains or losses recognised in OCI would not be recycled to profit or loss and that the IASB needed to further discuss the scope of the separate presentation requirements.

In contrast, a number of respondents did not support of the IASB's proposal. These respondents were particularly concerned about extending the use of OCI, while there are conceptual and practical concerns around its use. Some of these respondents suggested that information about financial liabilities with equity-like returns could be provided in the notes.

EFRAG's response to constituents' comments

EFRAG final position

Considering the feedback received and the mixed views from its constituents, EFRAG decided to change its position to state that expanding the use of OCI may not be the most appropriate way to address the concerns related to counter-intuitive accounting.

Instead, EFRAG decided to recommend the IASB to consider providing such information within disclosures. More specifically, EFRAG recommended providing disclosures on liabilities, derivatives and embedded derivatives that are solely dependent on entity's available economic resources. Similarly, the disclosures should only apply 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.

Finally, EFRAG noted that if the IASB does pursue the OCI approach, EFRAG considers that its scope needs further development and the question of recycling should be considered further.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments	EFRAG's response to constituents' comments
Presentation of equity instruments	
This section of the DP discusses potential improvements to presentation of financial instruments to address the existing limitations of a binary approach. In particular, it discusses the creation of subclasses of equity and the attribution of comprehensive income to subclasses of equity In its DCL, EFRAG acknowledged that the attribution approach had some benefits, however it questioned whether the benefits of the information provided by the attribution approaches would exceed the related costs. EFRAG recommended the IASB to discuss improvements to existing presentation requirements without the attribution mechanism and provide information about dilution through improvements to IAS 33 and disclosures. Most respondents including those that supported the IASB's preferred approach, did not support the proposal to attribute comprehensive income to different types of equity and update their carrying amounts. These respondents argued that the attribution approach would introduce a new, complex, costly and judgmental reporting mechanism involving fair value of equity items with a questionable benefit for users. Some of these respondents suggested that the IASB should review IAS 33 and require disclosure of information about dilution, rather than introducing specific presentation requirements for equity instruments. In contrast, one respondent supported the attribution mechanism even though it is experimental thinking at this stage	*EFRAG final position* Considering the feedback received, EFRAG decided to reiterate that that although the attribution approach has some benefits, such as providing information about distribution of returns among the different types of classes of equity and reflecting similar information as the 'narrow equity' approach, it considers that the costs of the information provided by the attribution approaches are likely to exceed the related benefits. Instead, EFRAG reiterated its recommendation to the IASB to consider improvements to existing presentation requirements without the attribution mechanism (i.e. more disaggregation of equity components on the face of the financial statements to help users to, for example, distinguish existing shareholders from potential shareholders) and require information about dilution through improvements to IAS 33 and disclosures. If attribution is retained, EFRAG recommended the IASB to use the method similar to that currently used for non-controlling interests in IAS 33, based on the relative position of existing and potential shareholders at the year end.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments	EFRAG's response to constituents' comments
Disclosures	
In section 7 of the DP, the IASB explores possible improvements to disclosure requirements for priority of claims on liquidation, potential dilution of ordinary shares and terms and conditions of financial instruments. In its draft comment letter, EFRAG considered that disclosures were a key part of the project and welcomed the IASB's discussions. On disclosures on priority on liquidation, EFRAG noted the need for some consideration of the reporting entity being considered. On disclosures on potential dilution, EFRAG recommended the IASB to further discuss the scope of such disclosures. Finally, EFRAG provided a number of suggestions to improve current disclosures. As mentioned above, many respondents were more supportive of targeted improvements to current requirements in IAS 32, including disclosure requirements. Some of these respondents considered the DP already identified some solutions which could be a good basis for further development of IAS 32. Nonetheless, some of these respondents also considered that providing information about priority of claims on liquidation for consolidated financial statements can be challenging and there was a risk of disclosure overload, particularly when dealing with disclosures on the terms and conditions of financial instruments. In contrast, some respondents were not supportive of some or all the IASB's proposals for additional disclosures. These respondents were concerned about the incremental costs for preparers, particularly on the disclosures on the terms and conditions of financial instruments, and that an entity would have to provide disclosures on priority on liquidation while reporting on a going concern basis and at a group level.	*EFRAG final position* Considering the feedback received, EFRAG decided to maintain its initial position but give more prominence to the concerns raised by its constituents. In the letter, EFRAG noted that in regard to disclosures on priority on liquidation, the reporting entity would have to be considered. For disclosures on potential dilution, EFRAG recommended the IASB to further consider the scope of such disclosures. Finally, EFRAG provided a number of suggestions to improve current disclosures without creating disclosure overload.

EFRAG's tentative views expressed in the draft comment letter and constituents' comments	**EFRAG's response to constituents' comments**

Contractual terms

In section 8 of the DP, the IASB discusses whether economic incentives and effects of law should affect the classification of financial instruments.

In its draft comment letter, EFRAG agreed 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 and that retaining and improving the indirect obligation requirements in IAS 32 may alleviate some of the issues related to economic compulsion. EFRAG also generally supported retaining the broad approach in paragraph 15 of IAS 32, which focuses on the substance of the contractual arrangement in a financial instrument. However, EFRAG highlighted some of the challenges that arise in practice from the interaction between the contractual rights and obligations and EU regulation.

Many respondents accepted the IASB's preliminary view that economic incentives should be ignored for classification purposes as it would raise several questions and uncertainties. However, some of these respondents agreed that improving indirect obligations requirements in IAS 32 could help to address some of the issues around economic incentives.

Some respondents supported the IASB's preliminary view to retain the IAS 32 requirement and only consider the contractual terms of a financial instrument in the assessment of its classification. However, these respondents highlighted that there are significant practical challenges in distinguishing between rights and obligations that arise from contractual terms and those that arise from law, particularly with bail-in instruments.

Finally, many respondents were not in favour of completely ignoring the effects of the law and called for further research on the relationship between contracts and law.

EFRAG final position

Considering the feedback received, EFRAG decided to maintain its initial position but give more prominence to the concerns raised by its constituents, particularly the concerns raised by those that currently apply IFRIC 2.

Accordingly, EFRAG agreed that economic incentives that might influence the issuer's decision to exercise its rights should not be considered for classification purposes.

EFRAG also considered that improving the requirements for indirect obligations in paragraph 20(b) of IAS 32 may alleviate some of the issues related to economic compulsion. EFRAG also suggested improvements to current requirements based on the feedback received.

EFRAG supported focusing on the substance of the contractual arrangement in a financial instrument. However, EFRAG highlighted some of the challenges that arise in practice from the interaction between the contractual rights and obligations and EU regulation (e.g. bail-in instruments).

Finally, EFRAG reinforced the idea that it continues to believe that IFRIC 2 should continue to be applied by the entities for which it was originally designed. EFRAG also suggested that the IASB considers integrating IFRIC 2 into IAS 32.

Appendix 1: List of respondents

Table 1: List of respondents

Name of constituent	***Country***	***Type / Category***
Finance Denmark	Denmark	Business Association
Danske Revisorer	Denmark	National Standard Setter
The Institute of Chartered Accountants in England and Wales (ICAEW)	UK	Professional organisation
European Association of Co-Operative Banks	Europe	Business Association
Ørsted	Denmark	Energy Company
European Savings and Retail Banking Group	Europe	Business Association
Crédit Mutuel Group	France	Cooperative bank
Organismo Italiano di Contabilità (OIC)	Italy	National Standard Setter
Insurance Europe	Europe	Business Association
BNP Paribas	France	Financial Institution
UK Financial Reporting Council	UK	National Standard Setter
Erste Group	Germany	Financial Institution
European Fund Asset Management Association (EFAMA)	Europe	Business Association
European Federation of Financial Analysts Societies (EFFAS)	Europe	User Organisation
Accountancy Europe (AE)	Europe	Professional Organisation
Copa-Cogeca European Farmers European Agri-Coperatives	Europe	Cooperative
European Securities and Markets Authority (ESMA)	Europe	Regulator
KBC Group	Belgium	Financial Institution
Dutch Accounting Standard Board (DASB)	The Netherlands	National Standard Setter
Accounting Standards Committee of Germany (ASCG)	Germany	National Standard Setter
Polish Accounting Standards Committee (PASC)	Poland	National Standard Setter
Association for Financial Markets in Europe (AFME)	Europe	Business Association
The Swedish Financial Reporting Board (SFRB)	Sweden	National Standard Setter
Business Europe (BE)	Europe	Business Association
European Banking Authority (EBA)	European	Regulator
The Association of Chartered Certified Accountants (ACCA)	UK	Professional Organisation
Norwegian Accounting Standards Board (NASB)	Norway	National Standard Setter
The Autorité des Normes Comptables (ANC)	France	National Standard Setter
Swedish Enterprise Accounting Group	Sweden	Business Association