Financial Instruments with Characteristics of Equity Cover Note

Objective

1 The objective of the session is to:

(a) provide an overview on the IASB's tentative decisions on its project *Financial Instruments with Characteristics of Equity*;

(b) provide an overview of the EFRAG's discussion on this project:

(c) provide feedback on the IASB tentative decision to include in the forthcoming FICE ED consequential amendments to the forthcoming IFRS on Subsidiaries without Public Accountability; and

(d) provide steering on the continued work of EFRAG FR TEG and its working groups for the period before the IASB issue of an ED currently expected in Q4 2023.

Agenda Papers

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

(a) Agenda paper 10-02 – Presentation on an overview of the IASB discussions; and

(b) Agenda paper 10-03 – IASB Tentative decisions – Background only.

Background

3 The IASB's research project in 2018 on *Financial Instruments with Characteristics of Equity* was a new round of a long debate on how to distinguish liabilities from equity instruments. The IASB finalised its discussions and issued a Discussion Paper on 28 June 2018 (the DP).

4 In its comment letter, EFRAG acknowledged that some constituents were 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 in a reasonable timeframe. Therefore, EFRAG suggested focusing on targeted improvements to current requirements in IAS 32 and other standards (including IAS 33). In particular, EFRAG suggested the IASB pursuing improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions, including those that are mandatorily convertible or written down on a 'non-viability' event. For more details on this project please click here.

5 After considering feedback on the DP, the IASB tentatively decided to explore making clarifying amendments to IAS 32 *Financial Instruments: Presentation* to address common accounting challenges that arise in practice when applying IAS 32. The IASB also decided to develop additional presentation and disclosure requirements to provide information that is not provided through classification requirements; or to complement the classification requirements.

6 **The next milestone of this project is an Exposure Draft, which is expected in the last quarter of 2023.**

Overview of the IASB tentative decisions and feedback received from EFRAG Working Groups

7 In agenda papers 10-02 and 10-03 the EFRAG Secretariat provides an overview of the IASB tentative decisions until now.

8 In addition, in appendix 1 and 2, the EFRAG Secretariat provides an overview of the feedback received from all EFRAG groups, ie, EFRAG FRB, EFRAG FR TEG (including EFRAG CFSS) and EFRAG FIWG until now.

9 In general, the IASB focused on number of practice issues that arise when applying IAS 32. The majority of the issues had already been discussed by the IFRS Interpretations Committee in the past, often with the recommendation for the IASB to address the issues within a more comprehensive project on the distinction between debt and equity. Nonetheless, the IASB is not going to address all the existing issues that arise in practice (e.g., mandatory tender offers).

10 In terms of EFRAG's discussions, the feedback received has been positive and supportive of the direction of the project. In general, there are always concerns about potential changes to existing requirements that may lead to classification changes (e.g. those that lead to less equity or impact hedge accounting). Nonetheless, it has been acknowledged that the IASB is limiting changes to classification outcomes to those in which sufficient evidence exists that such a change would provide more useful information to users of financial statements and that the proposed clarifications largely reflect current practice.

11 The key issues raised by the EFRAG groups were:

(a) Potential factors to be considered on shareholders' discretion;

(b) The effects of laws on contractual terms;

(c) New guidance on reclassifications;

(d) Costs of compliance related to disclosures, where field testing will be key;

(e) Some disclosure requirements, for e.g., challenges relating to whether priority on liquidation stem from the contract or from related law/regulation and more guidance on debt-like and equity-like features.

12 A summary of the IASB proposals and feedback received can be found below.

Key IASB tentative decisions	Feedback received from all EFRAG groups
Classification of financial instruments	
Project direction: tentatively decided on an approach that addresses practice issues by clarifying some principles in IAS 32.	• In general, there was support for the IASB's tentative decision to address issues that arise in practice by clarifying some underlying principles in IAS 32 and adding application guidance to facilitate consistent application of the principles. There was also support for the list of issues that the IASB considered in this project; • noted that this project is particularly relevant for financial institutions that typically issue complex financial instruments. If the clarifications will result in

Key IASB tentative decisions	Feedback received from all EFRAG groups
	changes in classification, this may lead to implementation costs; and • considered that it was important to have a clear view on the classification changes resulting from this project to assess the impact of the IASB's proposals.
Financial instruments settled in own equity instruments (including 'fixed-for-fixed' condition in IAS 32): The IASB developed two principles to meet the 'fixed-for-fixed' condition: a foundation principle and adjustment principle that would apply to the classification of derivatives on own equity	• There was support for the IASB's proposed approach as the fixed-for-fixed principles proposed by the IASB are fairly aligned with current practice. However, the final wording for the passage-of-time adjustment will be central (e.g. the possibility using a variable interest rate, such as a benchmark interest rate, to measure the passage of time); and • there were questions on whether the IASB will retain the foreign currency rights issue exception as it was considered useful.
Obligations that arise only on liquidation (e.g., perpetual instruments): the IASB will not change how such instruments should be classified. Instead, the IASB focused on developing presentation and disclosure requirements to meet the information needs of investors in ordinary shares	• Welcomed that the IASB will not change the classification of such instruments.
Financial instruments with contingent settlement provisions: The IASB tentatively decided to clarify initial recognition and measurement of financial instruments with contingent settlement provisions and clarify the terms "liquidation" and "not genuine"	• Welcomed the IASB's tentative decision to clarify initial recognition and measurement of such financial instruments and noted that the clarifications seemed to be fairly aligned with current practice and current requirements in IAS 32. • There was support for the liability component of a compound financial instrument with contingent settlement provisions to be measured at the full amount of the obligation (even if IFRS 9 currently requires a financial liability to be recognised at fair value on initial recognition) as it would provide relevant information to users (i.e. would reflect that immediate settlement may be required); • on the zero-value equity component, it was considered that disclosure requirements may be needed for users to understand why payments are recognised as dividends; • acknowledged that if the payments at the discretion of the issuer are recognised in equity, then an entity cannot hedge the interest payments made in a foreign currency. This could be a problem for entities that issue these instruments in a currency that is different from its functional currency. This may have to be addressed in the Post-Implementation Review of IFRS 9 *Financial Instruments;*

Key IASB tentative decisions	Feedback received from all EFRAG groups
	• on the meaning of 'liquidation', considering that different jurisdictions have different requirements for the liquidation process (different stages and may take significant time until complete close of business), the IASB should clearly explain the meaning of 'process of permanently ceasing operations; and • on the meaning of 'non-genuine', it might be useful to link this clarification to the concepts of 'not being legally enforceable' and 'not substantive' and to see how non-genuine is used in other IFRS Standards.
The effects of applicable laws on the contractual terms of financial instruments: The IASB decided to provide a principle to determine whether the rights and obligations arising from a legal requirement are taken into account in classifying the financial instrument as a financial liability or equity and in determining the 'substance of the contractual arrangement'.	• Welcomed the IASB's discussions on the interaction between the terms and conditions of a contract and applicable law to avoid a blanket rejection of the effects of the law from classification; • noted that it may be difficult to assess whether the terms explicitly stated in the contract are actually in addition to what is established by law (i.e., an entity would have to consider all elements of the law to assess whether the rights and obligations are in addition to those). Therefore, disclosures may be needed to explain the interaction between the contractual terms and applicable law; • considered that Mandatory Tender Offers (MTO) were an important issue that needed to be addressed in the future; and • the IASB should test its approach against some well-known financial instruments, such as bail-in instruments and instruments that involve mandatory distribution of dividends by law or by contractual terms.
Shareholders' discretion: The IASB tentatively decided to explore a factors-based approach to help an entity apply its judgement when classifying a financial instrument where payments are at the discretion of the issuer's shareholders	• Highlighted the difficulty and subjectivity of developing guidance on how to determine whether the shareholders are acting in their individual capacity or as part of the entity's operating and corporate governance processes; • the IASB's factors-based approach may have a high impact on current requirements and change significantly current practice. If the new factors lead to the conclusion that the decision of shareholders is not within the control of the entity, this would lead to the reclassification of some instruments (from equity to financial liabilities), having a significant impact on current practice.
Reclassification between financial liabilities and equity instruments: the IASB tentatively decided to add general requirements on reclassification to IAS 32 to prohibit reclassification other than for changes in the substance of the contractual terms arising from changes in	• Expressed concerns on the IASB's tentative decisions related to reclassifications and questioned whether these were only on the context of the fixed-for-fixed or wider; • there were also concerns that reclassification of 'passage-of-time changes' would be prohibited and at the same time additional disclosures would have to be

Key IASB tentative decisions	Feedback received from all EFRAG groups
circumstances outside the contract (e.g., *a change in functional currency or losing control over a subsidiary)*	provided to assist users of financial statements in understanding the key terms and conditions of financial instruments with these features.
Obligations to redeem own equity instruments (eg put options on non-controlling interests): The IASB tentatively decided to clarify recognition and measurement of obligations to redeem own equity instruments, including the accounting on initial recognition and on expiry their presentation (gross basis), and their initial and subsequent measurement.	• Generally welcomed the IASB's tentative decisions as this is a topic where companies use many different accounting policies when accounting for such obligations; • a few considered that it was counter-intuitive to a have a redemption amount recognised as a liability (reflecting a claim from NCI) and at the same time have the related NCI recognised within equity (the contra to the liability would be a general reduction in equity and not reduction in NCI); • considered that the IASB should at least refer and/or include a question in a forthcoming ED on the issue related to subsequent measurement changes to the redemption amounts. This is because there were members who disagreed with having such measurement changes being recognised in profit or loss (e.g., it will be difficult for management to explain the entity's performance if such instruments impact profit or loss).
Financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in its net assets: The IASB tentatively decided to require an entity with financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in its net assets and measured at fair value through profit or loss to disclose in each reporting period the total gains or losses that arise from remeasuring such financial liabilities	• Raised questions on the scope of the disclosures, particularly on the criteria that disclosures would only be provided when the instruments are measured at fair value. It was considered that such criteria would exclude instruments that were measured at amortised cost but were "fair value like" (i.e. measured at amortised cost with continuous catch-up adjustments linked to the net assets of the entity without separately presenting the interest component); and • some considered that it was important to test the disclosures against different instruments to understand whether the IASB was restricting too much the scope and excluding instruments that could be similar to fair value measurement.
Presentation	
***Equity instruments*:** IASB tentatively decided to amend the requirements in IAS 1 to ensure amounts attributable to ordinary shareholders are clearly visible on an entity's primary financial statements and improve disclosures on equity instrument within IFRS 7	• In general, there was support for the IASB's tentative decision to separately present the amounts attributable to ordinary shareholders from other owners in the primary financial statements. However, there were many questions on how the IASB's tentative decisions should be applied in practice; • for example, members were not sure that this would be an easy split as currently there are several subcategories within issued capital (with multiple classes of shares) and reserves and there is diversity practice on the presentation of items within equity (e.g., share premiums, retained earnings, dividend pushers and

Key IASB tentative decisions	Feedback received from all EFRAG groups
	translation differences). In addition, regulators may have specific presentation requirements on the presentation of equity and it should be assessed how the IASB's tentative decisions would interact with such presentation requirements; and • the IASB's proposals would put pressure on the definition of ordinary shareholders, as there are cases in which it is difficult to assess whether a specific class of shareholders is considered as ordinary shareholders
Disclosures of financial instruments	
Disclosures - terms and conditions: *An entity is required to disclose:* o 'debt-like features' of the financial instruments that are classified as equity instruments; o 'equity-like features' of the financial instruments that are classified as financial liabilities; o debt-like and equity-like features that determine the classification of such financial instruments as financial liabilities, equity instruments or compound financial instruments.	• More generally, members welcomed improvements to disclosures on the priority of claims on liquidation, potential dilution and information about terms and conditions. Members considered that it was important to test with European Stakeholders whether the IASB's proposals on presentation and disclosures are clear and can be implemented by entities that have many complex financial instruments. For that purpose, the IASB should organise a field-test focused on disclosures to better assess their feasibility and related costs. There were also concerns about disclosure overload (if the scope of the disclosures is too wide) and suggested allowing cross references to existing regulatory information. • considered that it was key to define debt-like features or equity-like features or to provide additional guidance or examples as in practice it may be difficult to assess whether instruments will be in scope of the disclosures;
Disclosures Potential dilution: the IASB tentatively decided to require an entity to disclose information about the maximum dilution of ordinary shares in the notes (e.g., maximum number of additional ordinary shares that an entity could be required to deliver for each type of potential ordinary share outstanding at the reporting date)	• Welcomed the IASB's refinements to the disclosures proposed in the DP. In particular, members welcomed having more disclosures on potential maximum dilution of ordinary shares and suggested having a scenario approach for these disclosures. • highlighted the importance of having additional information about dilution for both listed and non-listed entities and having a better definition of dilution;
Disclosures - The nature and priority of claims against an entity: the IASB tentatively decided to require an entity to disclose and categorise in the notes its claims that are financial instruments in a way that reflects differences in their nature and priority (including minimum distinctions to be made). These disclosures have to be made for all financial liabilities and equity instruments that are within the scope of IAS 32.	• Welcomed the IASB's tentative decisions

Key IASB tentative decisions	Feedback received from all EFRAG groups
Disclosures - Terms and conditions about priority on liquidation for particular financial instruments: The IASB tentatively decided that an entity should be required to disclose in the notes terms and conditions about priority on liquidation, including those that may lead to changes in priority and other more specific disclosures.	• Entities can face challenges determining whether priority stem from the contract or from related law/regulation. Some examples provided where there would be these challenges related to contractually subordinated financial instruments; • companies prepare financial statements on a going concern basis and real-life situations can be more complex than simply liquidation. In particular, for regulated financial entities, the issue can be more related to a 'resolution' than to 'liquidation. • Priority on liquidation would be particularly useful if it showed the capital and funding structure of the group.
Scope of IFRS 7: The IASB tentatively decided to expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its current and potential ownership structures are.	• Members were supportive of the IASB's tentative decisions.
Reclassifications: The IASB tentatively decided to relocate the disclosure requirement in paragraph 80A of IAS 1 to IFRS 7 and expand it to cover reclassifications when changes in the substance of the contractual terms arise from changes in circumstances outside the contract.	• Not clear what 'outside of the contract' means. It could be interpreted to mean as per law and regulation. • If disclosure on reclassifications is useful for the users, then why is it not relevant that the instrument be reclassified if the change from passage of time is such that the reason why it was classified, for example as a financial liability, is no longer applicable.
Obligations to redeem own equity instruments: The IASB tentatively decided to require entities to disclose certain information for instruments containing obligations to redeem its own equity instruments.	• Members supported the IASB's tentative decisions.
Financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets: The IASB tentatively decided to require separate disclosure of the total gains or losses in each reporting period that arise from remeasuring financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets.	• Members supported the IASB's tentative decisions.
Disclosures for subsidiaries without public accountability	
Disclosures for SWPA: The IASB tentatively decided to propose	• It was noted that EFRAG was going to comment on consequential amendments to a future IFRS Standard

Key IASB tentative decisions	Feedback received from all EFRAG groups
consequential amendments to be made to the IFRS Accounting Standard Subsidiaries *without Public Accountability* after it has been issued (expected to be issued in Q1 2024). The amendments within the FICE project would add to the future Standard part of the disclosure requirements that are to be proposed in the FICE ED.	that had not yet been endorsed and that would be the case in more than one project. • Therefore, EFRAG should be careful on the process. This could also raise the issue of partial endorsement of future consequential amendments in case the IFRS SWPA would not be endorsed in Europe.

Next steps

13 The EFRAG Secretariat is planning to discuss key messages for EFRAG Draft Comment Letter (based on the IASB's tentative decisions) with its technical groups in September 2023 and provide an additional update to EFRAG FRB in November 2023.

Questions for EFRAG FRB members

14 Does EFRAG FRB have any comments or concerns on the IASB tentative decisions to date?

15 Does EFRAG FRB have any additional comments or concerns to those mentioned in the table above?

16 Does EFRAG FRB agree with the IASB's tentative decision to include in the forthcoming FICE ED consequential amendments to the forthcoming IFRS on Subsidiaries without Public Accountability? If not, does EFRAG FRB have any suggestions on how the IASB should proceed?

17 Does EFRAG FRB has any specific requests for EFRAG FR TEG (including its working groups) to work on?

Appendix 1 – IASB discussions on this project

Key topics discussed by the IASB

18 The key topics discussed by the IASB can be found below:

Analysis of the feedback received on the DP *IASB March – July 2019*	• The IASB discussed the feedback received from stakeholders on the Discussion Paper *Financial Instruments with Characteristics of Equity*.
Project Direction *IASB September 2019 and December 2020*	• The IASB discussed the direction of the project and tentatively decided on an approach that addresses practice issues by clarifying some principles in IAS 32. • The IASB discussed whether it should move the project from the research programme to the standard-setting programme and decided to add this project to its standard-setting programme.
Project Plan *IASB October 2019*	• The IASB discussed the project plan, including a list of practice issues that could be addressed as part of the project.
Classification: financial instruments settled in an entity's own equity instruments: fixed for fixed *IASB December 2019 – April 2020*	• The IASB explored potential clarifications to the underlying principle for classifying derivatives on own equity and tentatively decided that for a derivative on own equity to meet the fixed-for-fixed condition in IAS 32, the number of functional currency units to be exchanged with each underlying equity instrument must be fixed or only vary with allowable preservation adjustments or allowable passage of time adjustments. • In addition, the IASB tentatively decided to classify as equity a contract that can be settled by exchanging a fixed number of non-derivative own equity instruments with a fixed number of another type of non-derivative own equity instruments. • It also tentatively decided to provide guidance on the meaning of adjustments arising from preservation and passage of time.
Classification: financial instruments with obligations that arise only on liquidation of the entity *IASB February 2021*	• The IASB discussed the classification of financial instruments with obligations that arise only on liquidation of the entity (e.g., perpetual bonds) and decided not to change how such instruments should be classified; but instead to develop presentation and disclosure requirements to meet the information needs of investors in ordinary shares.
Disclosures *IASB March 2019 - May 2021*	• The IASB discussed potential refinements to the disclosures proposed in the DP FICE. For that purpose, the IASB considered the feedback from stakeholders on its proposals included in the ED, the feedback received in additional outreaches activities focused on disclosures and the IASB Staff research on regulatory disclosures provided by banks and insurers. • These potential refinements were focused on disclosures on priority on liquidation; potential dilution and terms and conditions.

Classification: Financial instruments with contingent settlement provisions *IASB November 2021 – February 2022*	• The IASB discussed the accounting for financial instruments that contain contingent settlement provisions, including: o the classification and measurement of financial instruments with contingent settlement provisions, including compound financial instruments (December 2021); o recognition of discretionary dividends (December 2021); o the meaning of 'liquidation' and 'non-genuine' (December 2021); o shareholder discretion, including factors-based approach to help and entity apply its judgement (February 2022).
Classification: the effects of laws on contractual terms *IASB September 2021 – December 2021*	• The IASB discussed to what extent, an entity should be required to treat a legal requirement or a term that is required by law as part of the contractual terms and tentatively decided to require an entity to consider, in classifying a financial instrument, only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by applicable law
Reclassification *IASB March-June 2022*	• The IASB explored what clarifications could potentially be made to IAS 32 on reclassifications between financial liability and equity instruments by requiring an entity to consider, in classifying a financial instrument, only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by applicable law. • The IASB also tentatively decided to clarify what happens when the substance of the contractual terms changes because of changes in circumstances outside the contract and the importance of disclosures in helping users of financial statements better understand the changes in classification and its effects on measurement, if any.
Classification: Obligations to redeem own equity instruments *IASB July-September 2022*	• The IASB met in July and September 2022 to discuss the accounting for financial instruments containing obligations for an entity to redeem its own equity instruments, including written put options on non-controlling interests. The IASB discussed problems that arise when entities apply paragraph 23 of IAS 32. The IASB also discussed possible clarifications it could develop to help resolve these problems.
Presentation: Presentation of equity instruments and of financial liabilities *IASB December 2022 – February 2023*	• The IASB met in December 2022 and February 2023 to discuss: o *Presentation of equity instruments*: in particular, the presentation of equity instruments other than ordinary shares or perpetual instruments. o *Presentation of liability instruments*: discussed a subset of financial liabilities subsequently measured at fair value through profit or loss, applying IFRS 9 Financial Instruments
Classification: Sweep issues on the classification	• The IASB met in December 2022 and February 2023 to discuss sweep issues on the classification and presentation in the FICE project plan, including:

and presentation in the FICE project plan *IASB March 2023*	○ Fixed-for-fixed condition; ○ Reclassification; ○ The effects of laws on the contractual terms; ○ Obligations to redeem own equity instruments; ○ Instruments containing contingent settlement provisions; ○ Presentation of financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets.
Scope of IFRS 7 and Additional disclosures *IASB April 2023*	• The IASB discussed: ○ proposed amendments to the scope and objective of IFRS 7 to cover the proposed disclosure requirements in relation to an entity's issued equity instruments; and ○ additional disclosure proposals identified as a result of the IASB's deliberations on the classification and presentation topics in the FICE project plan.
Transition *IASB April 2023*	• The IASB discussed IASB Staff recommendations related to transition when an entity applies the proposed amendments to IAS 32, IFRS 7 and IAS 1 as part of the FICE project.
Disclosures for subsidiaries without public accountability *IASB May 2023*	• The IASB Staff asked the IASB for tentative decisions on proposed consequential amendments to the forthcoming IFRS Accounting Standard *Subsidiaries without Public Accountability* on disclosure requirements for eligible subsidiaries.

Appendix 2 – detailed feedback received from all EFRAG groups

EFRAG Financial Instruments Working Group

19 The EFRAG FIWG members have been receiving updates on the project and have provided the following feedback (January 2020, November 2021, May 2022 and October 2022, May 2023):

Project direction

(a) in general, members agreed with the project direction and identification of issues that arise in practice. Members observed that these issues are sometimes interrelated, e.g. NCI puts, the fixed-for-fixed criterion and the existence of discretion.

(b) In addition, they expected that the discussion will probably require revisiting existing interpretations such as IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* and would appreciate if the project could also include implications to other standards driven by equity classification such as IAS 33 *Earnings per Share* and measurement of financial liabilities arising from puttable instruments.

Fixed-for-fixed requirement

(a) members supported the IASB's proposed approach and agreed that the principles were fairly aligned with current practice. However, it was noted that the final wording for the passage-of-time adjustment may be central for the acceptance or not of the proposals;

(b) some members observed that the IASB's example where strike price is CU 100, CU 150 and CU 500 at the end of each of three years respectively seemed to indicate a change in practice as in their view such instrument would currently meet the fixed-for-fixed requirement. They did not have a view as to whether the proposed accounting would be an improvement or not;

(c) while allowing a benchmark rate adjustment would introduce some variability, some considered that a variable rate could be considered to meet the fixed-for-fixed requirement under the passage-of-time adjustment proposals as these are phrased in terms of present value; and

(d) one member also referred to an equity rate swap where dividend streams are swapped for interest rates where the funding for the equity may be variable in nature, and this should still qualify as fixed for fixed.

Disclosures

(a) *Liquidation*: companies prepare financial statements on a going concern basis and real-life situations can be more complex than simply liquidation. In particular, for regulated financial entities, the issue can be more related to a 'resolution' than to 'liquidation. The EU regulation is focused on avoiding the liquidation, which is really the last step. Therefore, focusing simply on liquidation without considering resolution, the financial statements will not reflect the complexity of a financial institution;

(b) *Liquidation*: for non-financial institutions such disclosures were relevant, although not directly related to resolution/liquidation. For example, there

were many events that took place before liquidation, such as change of control or initial public offering, where this information was also useful;

(c) *Contractually subordinated*: entities can face challenges determining whether priority stem from the contract or from related law/regulation. For example, in Sweden payments to government have higher priority, therefore, all other liabilities are subordinated, regardless of what is in the contract. In addition, financial institutions have difficulties in making the assessment on priority due to the interaction between the contractual rights and obligations and regulation. Hence, disclosures should consider both legal and contractual priority;

(d) *Contractually subordinated*: there are other areas of complexity that should be considered such as the legal structure of international groups. Whether or not an instrument is secured or subordinated, it will depend on regulatory requirements and local legislation. The legal framework may change depending on the jurisdiction on where the instruments have been issued. Therefore, it may be useful to provide information based on subgroups if they are located in different jurisdictions (with different local legal requirements) and information on how the structure of the group affects priority;

(e) *Disclosures to be made on debt-like and equity-like features*: considered that it was key to define debt-like features or equity-like features or to provide additional guidance as in practice it may be difficult to assess whether instruments will be in scope of the disclosures; and

(f) Finally, members suggested that the IASB should organise a field-test focused on disclosures once it has finalised the discussions on disclosures.

Contingent settlement provisions: compound instruments

(a) welcomed the IASB's tentative decision to clarify the accounting for compound financial instruments with contingent settlement provisions and noted that the clarifications seemed to be fairly aligned with current practice and current requirements in IAS 32 (e.g. paragraph BC12 of the Basis for Conclusions of IAS 32 which refers to the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation);

(b) on the liability component of a compound financial instrument with contingent settlement provisions, members agreed that it should be measured at the full amount of the obligation, even if IFRS 9 currently requires a financial liability to be recognised at fair value on initial recognition. Measuring the financial liability component at the full amount would provide relevant information to users (i.e. would reflect that immediate settlement may be required) and would only be applicable to the liability component of a compound financial instrument with contingent settlement provision. In addition, member considered that measuring a liability at a probability-weighted amount taking into account the likelihood and timing of the contingent event would:

  (i) be a significant change to current requirements (and not simply a clarification);

  (ii) add complexity to the measurement calculation and additional costs to preparers;

(iii) involve significant judgement and continuous reassessment. This would also lead to instability and volatility in the statement of financial position (e.g. on ratios like equity/debt) and statement of profit or loss;

(iv) for bail in instruments, it would impact negatively the statement of profit or loss and the statement of financial performance in the worst possible moment (i.e., the liability would have to be recognised when the non-viability event becomes probable).

(c) on the zero-value equity component, members considered that disclosure requirements may be needed for users to understand why payments are recognised as dividends; and

(d) acknowledged that if the payments at the discretion of the issuer are recognised in equity, then an entity cannot hedge the interest payments made in a foreign currency. This could be a problem for entities that issue these instruments in a currency that is different from its functional currency. This may have to be addressed in the Post-Implementation Review of IFRS 9 *Financial Instruments*.

Contingent settlement provisions: meaning of liquidation and non-genuine

(a) on the meaning of liquidation, considering that different jurisdictions have different requirements for the liquidation process, the IASB should clearly explain the meaning of 'process of permanently ceasing operations;

(b) one member noted that the process of permanently ceasing operations may take years and it may be better to be closer to a dissolution event (i.e., the legal entity stops to exist) ;and

(c) on the meaning of non-genuine, it might be useful to link this clarification to the concepts of 'not being legally enforceable' and 'not substantive'. The latter was considered by the IFRS Interpretation Committee when discussing the classification of a financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares. More specifically, link to the discussion on whether the issuer's early settlement option is substantive. "*To determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or business reasons that the issuer would exercise the option. For example, among other factors, the issuer could consider whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms*".

The effects of laws on contractual terms

(a) welcomed the IASB's discussions on the interaction between the terms and conditions of a contract and applicable law 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. Nonetheless, it was considered that the IASB should make clear that applicable law also encompasses financial regulation;

(b) considered that Mandatory Tender Offers (MTO) were an important issue that needed to be addressed in the future;

(c) one member was not convinced that the IASB's tentative decision would be sufficient to address the issues that arise with the interaction between some

contingent financial instruments and the bank recovery and resolution directive (BRRD). This is because the BRRD overrides all other legislation and contractual terms. Therefore, the IASB will need to clarify that the proposed clarifications will only apply on a going concern basis;

(d) noted that it may be difficult to assess whether the terms explicitly stated in the contract are actually in addition to what is established by law (i.e., an entity would have to consider all elements of the law to assess whether the rights and obligations are in addition to those). Therefore, disclosures may be needed to explain the interaction between the contractual terms and applicable law (e.g., when applicable laws prevent the enforceability of a contractual right or a contractual obligation or when specific obligations arise from applicable laws such as BRRD or an MTO).

Shareholders discretion

(a) noted the difficulty and subjectivity of developing guidance on how to determine whether the shareholders are acting in their individual capacity or as part of the entity's operating and corporate governance processes;

(b) the IASB's factors-based approach may have a high impact on current requirements and change significantly current practice. If the new factors lead to the conclusion that the decision of shareholders is not within the control of the entity, this would lead to the reclassification of some instruments (from equity to financial liabilities), having a significant impact on current practice;

(c) it is important to test the approach to avoid any unintended consequences, including situations where there are institutional investors (e.g., funds).

Obligations to redeem own equity instruments

(d) EFRAG FIWG members agreed that the IASB should at least refer and include a question in a forthcoming ED on the issue related to subsequent measurement changes to the redemption amounts as per IAS 32.23, in particular in relation to written put options and forwards contracts on non-controlling interests (NCI puts). This is because there are different views in practice on whether such measurement changes should be recognised in profit or loss or in equity.

(e) EFRAG FIWG members considered that it was counter-intuitive to a have a redemption amount recognised as a liability (reflecting a claim from NCI) and at the same time have the related NCI recognised within equity (the contra to the liability would be a general reduction in equity and not reduction in NCI). However, members recognised that it was important to have clear requirements in this area to improve comparability and eliminate diversity in practice that continues to exist.

(f) EFRAG FIWG members considered that it was important to provide relevant additional information to users on own equity transactions, which could be provided through more disaggregation of the face of the financial statements or in the notes.

Presentation of equity instruments (May 2023)

(g) In general, members agreed with the IASB tentative decision to separately present the amounts attributable to ordinary shareholders from other owners in the primary financial statements. However, members raised a

number of questions on how the IASB's tentative decisions should be applied in practice.

(h) In particular, how the allocation to issued capital and reserves attributable to ordinary shareholders of the parent and those attributable to other owners of the parent should be done. Similar concerns were raised on the attribution to be made within the statement of financial performance and called for additional application guidance and illustrative examples.

(i) Members were not sure that this would be an easy split as currently there are several subcategories within issued capital (with multiple classes of shares) and reserves and there is diversity practice on the presentation of items within equity (e.g., share premiums, retained earnings, dividend pushers and translation differences).

(j) In addition, regulators may have specific presentation requirements on the presentation of equity and it should be assessed how the IASB's tentative decisions would interact with such presentation requirements

(k) Finally, members noted that the IASB's proposals would put pressure on the definition of ordinary shareholders, as there are cases in which it is difficult to assess whether a specific class of shareholders is considered as ordinary shareholders.

Presentation of financial liabilities (May 2023)

(l) Some members raised questions on the scope of the disclosures, particularly on the criteria that disclosures would only be provided when the instruments are measured at fair value. They considered that such criteria would exclude instruments that were measured at amortised cost but were "fair value like" (i.e., measured at amortised cost with continuous catch-up adjustments linked to the net assets of the entity without separately presenting the interest component). Members considered that it was important to test the disclosures against different instruments to understand whether the IASB was restricting too much the scope and excluding instruments that could be similar to fair value measurement.

Sweep issues (May 2023)

(m) When discussing a number of sweep issues on classification, the EFRAG FIWG members provided the following comments:

   (i) *Effects of laws on contractual terms*: Some members questioned why the IASB had changed its tentative decision on the effects of laws on contractual terms (use of "enforceable contractual terms" in the definition rather than having a separate criterion stating "applicable laws that prevent the enforceability of a contractual right or a contractual obligation"). For these members, the initial drafting was clearer and if the IASB would proceed with the new definition, they called for the IASB to explain the reasoning in the Basis for Conclusions.

   (ii) *Contingent settlement provisions*: one member expressed concerns on contingent settlement provisions. He was concerned that the IASB clarifications on measurement would be interpreted as affecting other than compound financial instruments with contingent settlement provisions.

(iii) *Reclassifications*: members expressed concerns on the IASB's tentative decisions and questioned whether these were only on the context of the fixed-for-fixed or wider. Example on when there is change of control.

(iv) *Shareholders discretion*: Members expressed concerns on the IASB's discussions on shareholders discretion, particularly on the factors presented. When considering the factors provided, it was not always clear what the outcome would be (whether the shareholder's decision was treated as a decision of the entity or of the shareholder).

(v) *Clarifications on the accounting for the obligations to redeem own equity instruments*: one member welcomed the IASB tentative decision to remove reference to IFRS 9 Financial Instruments for subsequent measurement from paragraph 23 of IAS 32 (to avoid any confusion and reduce diversity in practice about how to calculate the carrying amount of the financial liability subsequently). He questioned whether such type of instruments should be explicitly scoped out from IFRS 9.

Scope of IFRS 7 and additional disclosures (May 2023)

(n) In general, members did not disagree with the IASB's tentative decisions.

(o) Regarding a compound instrument, if an entity chooses the fair value option on the liability side and there is a derivative against it, but the entity is not exposed to the derivative component in the instrument itself, this member questioned whether it made sense to have quantitative disclosures on the derivative component.

(p) Some members iterated that clarity/examples were needed on what was meant by 'debt-like' and 'equity-like' features, e.g., economic compulsion being captured by 'debt-like' features.

(q) Some members challenged the tentative decisions on reclassification, referring to the disclosures on information about terms and conditions that become, or stop being, effective with the passage of time before the end of the contractual term of the instrument. They indicated that if this disclosure is useful for the users to know, then why is it not relevant that the instrument be reclassified if the change from passage of time is such that the reason why it was classified, for example as a financial liability, is no longer applicable,

(r) One member considered that there should be information on the restriction to transfer funds as highlighted in EFRAG's comment letter.

Transition (May 2023)

(a) In general, members did not disagree with the IASB's tentative decisions.

(b) On the fully retrospective approach, one member suggested transition relief to not apply the full retrospective approach to instruments that do not exist at the time of initial application of the amendments. This member stated that sufficient time is needed for implementation.

Overall comments on the project (May 2023)

(a) The EFRAG FIWG members in general welcomed this project and considered that the areas that would raise more discussion were:

(i) the effects of law on the contractual terms;

(ii) shareholders discretion; and

(iii) reclassifications.

EFRAG FR Technical Expert Group

20 EFRAG FR TEG has been receiving updates on the project and provided the following feedback (November 2021, May 2022, November 2022, March 2023 and June 2023):

Project direction

(a) welcomed the IASB's tentative decision to address issues that arise in practice by clarifying some underlying principles in IAS *32* and adding application guidance to facilitate consistent application of the principles;

(b) welcomed the list of issues that the IASB would consider in this project and the project timeline;

Fixed-for-fixed requirement

(c) on the fixed-for-fixed condition for financial instruments settled in own equity instruments, EFRAG FR TEG members considered that further research was needed for preservation and passage of time adjustments;

(d) questioned whether the IASB was going to retain the 'foreign currency rights issue' exception as it was considered useful;

(e) highlighted the importance of having enhanced disclosures on financial instruments with characteristics of equity;

Contingent settlement provisions

(f) welcomed the IASB's tentative decision to clarify the accounting for compound financial instruments with contingent settlement provisions and noted that the clarifications seemed to be fairly aligned with current practice and current requirements in IAS 32 (e.g. paragraph BC12 of the Basis for Conclusions of IAS 32 which refers to the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation). However, members noted that in practice there are entities that are recognising discretionary distributions in profit or loss. Thus, they are allowed to apply hedging accounting to such instruments. If discretionary distributions have to be presented in equity, this will represent a change to some entities;

(g) on the meaning of liquidation, considering that different jurisdictions have different requirements for the liquidation process, the IASB should clearly explain the meaning of 'process of permanently ceasing operations. This is because, the meaning of liquidation for accounting may end up being different from the meaning of legal liquidation;

(h) some members considered that the threshold for being considered non-genuine should be high; and

(i) on the meaning of non-genuine and liquidation, it would be useful to consider how these concepts are used in other IFRS Standards, as a change to their definition in this project may have knock-on effects on other IFRS Standards.

The effects of laws on contractual terms

(j) considered that the IASB should further discuss the effects of laws on contractual terms and better explain its principles on when the law should be considered for classification purposes. In addition, the IASB should test its approach against some well-know financial instruments, such as bail-in instruments and instruments that involve mandatory distribution of dividends by law or by contractual terms;

(k) highlighted the importance of addressing the issues that arise in practice with the accounting for mandatory tender offers; and

(l) on shareholders discretion, members highlighted how difficult and subjective it is to develop guidance on determining whether the shareholders are acting in their individual capacity or as part of the entity’s operating and corporate governance processes. Thus, field testing on the final wording would be needed. Members also suggested having a rebuttable presumption on shareholders discretion.

Obligations to redeem own equity instruments

(m) welcomed the IASB's discussions on 'obligations to redeem own equity instruments' as this is a topic where companies use many different accounting policies when accounting for such obligations;

(n) on initial recognition of 'obligations to redeem own equity instruments', a few members considered that it was counter-intuitive to a have a redemption amount recognised as a liability (reflecting a claim from NCI) and at the same time have the related NCI recognised within equity (the contra to the liability would be a general reduction in equity and not reduction in NCI);

(o) on subsequent measurement of 'obligations to redeem own equity instruments', members considered that the IASB should at least refer and/or include a question in a forthcoming exposure draft on the issue related to subsequent measurement changes to the redemption amounts. This is because there were members and stakeholders who disagreed with having such measurement changes being recognised in profit or loss (e.g., it will be difficult for management to explain the entity's performance if such instruments impact profit or loss);

(p) on the recognition of a liability for the present value of the option exercise price, a few members considered that it was debatable whether a 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);

(q) on options with caps, a few members did not agree that the financial liability should be measured at the capped amount, particularly if the fair value of the liability is smaller than the capped amount. Thus, this issue should also be discussed in the forthcoming ED;

(r) a few members considered that the IASB should clarify the accounting for NCI puts in separate financial statements, including initial measurement; and

(s) members in general considered that the impact of the forthcoming ED would depend significantly on the wording used by the IASB and highlighted the importance of improved disclosures.

Presentation

(t) presentation of Equity - EFRAG FR TEG members considered that it would be useful to have illustrative financial statements reflecting the IASB's tentative decision on the presentation of equity;

(u) presentation of financial liabilities - members considered that it would be useful to have specific examples of financial instruments that would be under the scope of the IASB tentative decisions on the presentation of financial liabilities that contain a contractual obligation to pay the holder an amount based on the entity's performance or changes in the entity's net assets and questioned how prevalent these disclosures would be.

Sweep issues:

21 EFRAG FR TEG members expressed some concerns on:

(a) the IASB's discussions on shareholders' discretion (e.g., how the proposed factors should be considered and the extent of the disclosures);

(b) the revised tentative decisions on the effects of laws on the contractual terms (e.g., how it would apply to bail-in, IFRIC 2-type instruments and limited life companies)

(c) on the removal from paragraph 23 of IAS 32 the reference to IFRS 9 Financial Instruments as it could create confusion on how to measure the liability subsequently

22 On 6 June 2023, EFRAG FR TEG discussed the April and May 2023 IASB tentative decisions:

(a) *IFRS 7 and additional disclosures*: Members were in general supportive of the disclosure requirements. Some specific comments are as follows.

(b) *Disclosures relating to terms and conditions*:

(i) A question was raised regarding whether the disclosure to allocate initially to the financial liability and equity components of compound financial instruments would be done only at inception or on an ongoing basis.

(ii) The disclosure on significant judgements made in classifying financial instruments should be captured under IAS 1.

(iii) There should be reclassification if there are changes to the effective terms and conditions of the financial instruments.

(iv) Need to check the guidance relating to 'equity-like' features and 'debt-like' features as there was not an agreement with some of the explanations in past IASB Staff papers, e.g., 'equity-like' features reflecting an obligation to distribute a percentage of profits.

(c) *Additional disclosures*:

(i) Reclassification: Not clear what 'outside of the contract' means. It could be interpreted to mean as per law and regulation.

(ii) Regarding no additional proposals being made on the effects of laws on contractual terms: for example, if a financial instrument is classified as equity but the effects of law changes that financial instrument to be more liability-like, disclosures describing these changes by law and the reasons why it would provide useful information. It would also be linked to the 'debt-like' or 'equity-like' features

(d) *Transition*: Members were, in general, supportive of the disclosure requirements.

(e) *Subsidiaries without public accountability (SWPA):*

(i) In general, EFRAG FR TEG acknowledged the concerns from the EFRAG Secretariat but considered that it was a practical and acceptable approach from the IASB.

(ii) It was noted that EFRAG was going to comment on consequential amendments to a future IFRS Standard that had not yet been endorsed and that would be the case in more than one project. Therefore, EFRAG should be careful on the process. This could also raise the issue of partial endorsement of future consequential amendments in case the IFRS SWPA would not be endorsed in Europe.

(iii) IASB member highlighted that European companies that have subsidiaries located in different parts of the world could benefit from the IFRS SWPA even if not endorsed in the EU.

(iv) Members agreed that there was a need to make a cost and benefit analysis on the disclosures for SWPA during the consultation period.

(f) *Topics to be included in EFRAG's draft comment letter*:

(i) One member noted that the IASB was moving in the right direction and that there were important clarifications, even if sometimes a more conceptual discussion was missing in the project.

(ii) It was noted that this project is significant and that EFRAG's stakeholders might not be fully aware of the clarifications that the IASB will propose.

(iii) The effects of law on contractual terms is an interesting topic and during the consultation EFRAG will have to see if this leads to classification changes of financial instruments.

(iv) Many of the IASB's clarifications were linked to topics that had been discussed by the IFRS Interpretations Committee ('IFRS IC') in the past. Many of these clarifications seemed to rectify the views expressed by the IASB Staff in the IFRS IC agenda papers.

(v) On the issue of NCI puts, it was welcomed that the IASB had reached a conclusion and that this topic would be discussed within the IASB's on FICE ED. It was fundamental to obtain feedback from European Stakeholders.

(vi) It will also be important to test with European Stakeholders whether the IASB's proposals on presentation and disclosures are clear and can be implemented by entities that have many complex financial instruments.

(vii) It was also noted that this project would have impact on the application of other IFRS Standards such as hedging and classification of financial assets under IFRS 9.

23 In April 2022, the **EFRAG FR TEG and EFRAG User Panel** members received an update on the IASB's redeliberations and provided the following feedback

(a) welcomed the IASB's refinements to the disclosures proposed in the DP. In particular, members welcomed having more disclosures on potential maximum dilution of ordinary shares and suggested having a scenario approach for these disclosures.

(b) although EFRAG User Panel members were not usually focused on liquidation in their analysis, information about the priority on liquidation would be particularly useful if it showed the capital and funding structure of the group.

(c) on compound financial instrument with contingent settlement features, in practice there are entities that are recognising discretionary distributions in profit or loss. Consequently, they are allowed to apply hedging accounting on such instruments. If these discretionary distributions have to be presented in equity, these would represent a change to some entities.

24 The **EFRAG FR TEG and EFRAG CFSS** members discussed some of the IASB's tentative decisions to date, in particular disclosures, financial instruments with contingent settlement provisions and effects of laws on the contractual terms (December 2020 and June 2022).

Disclosures

(a) In general, EFRAG FR TEG-CFSS welcomed improvements to disclosures on the priority of claims on liquidation, potential dilution and information about terms and conditions.

(b) *On disclosures about priority on liquidation*, EFRAG FR TEG-CFSS members highlighted that the interaction between the contractual terms and the law (e.g., bail-in instruments) raised many challenges. Thus, members welcomed the IASB efforts to address these challenges with improvements to disclosures. In addition, if short-term liabilities were in the scope of such disclosures, then the IASB should also consider interim financial statements.

(c) *On disclosures about potential dilution*, EFRAG FR TEG-CFSS members highlighted the importance of having additional information for both listed and non-listed entities and having a better definition of dilution.

(d) EFRAG FR TEG-CFSS members highlighted the risk of disclosure overload and suggested that the IASB focus on the most relevant and material financial instruments (e.g. those with characteristics of equity and debt) and allow cross references to existing regulatory information.

Contingent settlement provisions

(e) Members in general supported the direction of the IASB discussions on compound instruments with contingent settlement provisions. However, some members noted that in practice there are entities recognising discretionary distributions in profit or loss. Thus, such entities are allowed to apply hedging accounting to such instruments. If discretionary distributions have to be presented in equity, this will represent a significant change to some entities; and

(f) On the meaning of liquidation, members highlighted the risk that the meaning of liquidation for accounting purposes may end up being different from the meaning of legal liquidation.

The effect of laws on contractual terms

(g) On the effect of laws on contractual terms, members considered that the IASB should further discuss and better explain its principles on when the law should be considered for classification purposes.

EFRAG FR Board

25 In July 2022 the EFRAG FRB members received an update on the IASB's redeliberations and provided the following feedback:

(a) Members agreed with the general direction of the project. This project is particularly relevant for financial institutions that typically issue complex financial instruments. If the clarifications will result in changes in classification, this may lead to implementation costs.

(b) Members considered that the wording would be key for the forthcoming Exposure Draft. Members suggested that the EFRAG Secretariat proceeds with an analysis for different financial instruments, comparing the outcome of the IASB clarifications with what we have today in IAS 32 to better assess the impact of the IASB clarifications.