Key messages for EFRAG Draft Comment letter on FICE

Issues Paper

Objective

1 The objective of this agenda paper is to discuss EFRAG's key messages for the draft comment letter (based on the IASB's tentative decisions) on the forthcoming Exposure Draft on Financial Instruments with Characteristics of Equity.

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2 A summary of the IASB tentative decisions and possible key messages for EFRAG Draft Comment letter can be found below. These key messages are based on the IASB's tentative decisions as published on the IASB website and may need to be adjusted in accordance with the final wording included in the IASB's ED.

Key IASB tentative decisions	Key messages to be considered for EFRAG DCL
Classification of financial instruments	
Project direction: tentatively decided on an approach that addresses practice issues by clarifying some principles in IAS 32	• Support the IASB's project and approach 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. Also support for the list of issues that the IASB considered in this project, except for some of the issues mentioned below in the letter which the IASB should also address in this project (question to EFRAG FR TEG – anything missing?); • note that this project is particularly relevant for financial institutions that typically issue complex financial instruments and note that there are concerns on potential classification changes, particularly on hybrid instruments. Thus, highlight the importance of having a clear view on the

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	classification changes resulting from this project to better assess the impact of the IASB proposals and assess whether the benefits will outweigh the costs. For that purpose, it will be fundamental to test the IASB proposals with stakeholders.
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	• Support for the IASB's proposed approach as the fixed-for-fixed principles proposed by the IASB would improve consistency and are fairly aligned with current practice; • however, the final wording for the passage-of-time adjustment will be central, including the possibility of using a variable interest rate, such as a benchmark interest rate, to measure the passage of time; and • welcome that the IASB will retain the foreign currency rights issue exception, as it is 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	• Welcome that the IASB will not change the classification of such instruments and the IASB's approach to develop presentation and disclosure requirements to meet the information needs of investors in ordinary shares.
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	• Welcome the IASB's proposal to clarify initial recognition and measurement of such financial instruments and highlight that the clarifications seem to be fairly aligned with current practice and current requirements in IAS 32.

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terms "liquidation" and "not genuine"	• 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, disclosure requirements may be needed for users to understand why payments are recognised as dividends; • highlight 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; • potential question to constituents on the proposed classification which will also impact on how payments to holders are recognised in the financial statements (in the statement of profit or loss or equity); • agree with the IASB assessment that measuring a liability at a probability-weighted amount taking into account the likelihood and timing of the contingent event would be a significant change to current requirements (and not simply a clarification), add complexity to the measurement calculation, involve significant judgement and continuous reassessment, additional costs to preparers and for bail-in instruments, it would

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	impact negatively the statement of financial position in the worst possible moment; • 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'.	• Welcome 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; • note 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), particularly for international groups with subsidiaries in many different jurisdictions with different law requirements. Therefore, disclosures may be needed to explain the interaction between the contractual terms and applicable law; • consider that Mandatory Tender Offers (MTO) is an important issue that needs to be addressed in the future;

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	• note that it is important to test the IASB's 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, to understand whether there are any unintended consequences. • Potential question to constituents on whether they expect changes in classification from the IASB proposals, particularly on Bail-in, IFRIC 2-type instruments and limited life companies. • Ensure that there are no unintended consequences of the application of law and regulation with paragraph 20 of IFRS 17;
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	• Highlight 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. • Any proposed factors should help preparers in reaching a conclusion on whether the shareholder's decision should be treated as a decision of the entity or of the shareholder – the outcome should be clear. • Caution that the IASB's factors-based approach may have a high impact on current requirements and change significantly current practice. If the new factors lead more often 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

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	to financial liabilities), having a significant impact on current practice. • Potential question to constituents on whether they expect changes in classification from the IASB proposals, particularly changes to the classification of financial instruments from equity to liability.
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 circumstances outside the contract (e.g., a change in functional currency or losing control over a subsidiary)	• Welcome the IASB's efforts to address the issue of lack of guidance on reclassification in IAS 32. • Express concerns on the IASB's tentative decisions related to reclassifications and raise questions on the scope (whether these are only on the context of the fixed-for-fixed or wider). • Express concerns that reclassification of 'passage-of-time changes' would be prohibited (even when it provides useful information to users) and at the same time additional disclosures would have to be 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, welcome the IASB's tentative decisions as this is a topic where companies use many different accounting policies when accounting for such obligations; • welcome the IASB tentative decision to remove the 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); • note that it was counter-intuitive to a have a redemption amount recognised as a liability

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	(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); and • if the IASB does not include a specific question, include a question to constituents on the issue related to subsequent measurement changes to the redemption amounts. This is because there are stakeholders that disagree 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). • On options with caps, there are different views on whether a 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 within this project.
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	• Refer to the scope of the disclosures, particularly on the criteria that disclosures would only be provided when the instruments are measured at fair value. Such criteria would exclude instruments that are measured at amortised cost but are "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 • highlight the importance of testing the disclosures against different instruments to understand whether the IASB is restricting too much the scope

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	and excluding instruments that could be similar to fair value measurement.
Presentation of equity instruments	
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	• Support for the IASB's tentative decision to separately present the amounts attributable to ordinary shareholders from other owners in the primary financial statements. Such presentation will help users in better understanding the ordinary shareholders value. • However, raise questions on how the IASB's tentative decisions should be applied in practice. • For example, 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. Similarly, how the attribution should be made within the statement of financial performance. • Note that it will not always 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); and • call for additional application guidance and illustrative examples to ease implementation. • In addition, note that 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

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	• 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	
General comments	• Welcome improvements to disclosures on the priority of claims on liquidation, potential dilution and information about terms and conditions. • It is 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, i.e., a cost/benefit assessment. • Concerns about disclosure overload (if the scope of the disclosures is too wide) and suggest allowing cross references to existing regulatory information.
Disclosures - terms and conditions: An entity is required to disclose: 'debt-like features' of the financial instruments that are classified as equity instruments; 'equity-like features' of the financial instruments that are classified as financial liabilities; debt-like and equity-like features that determine the classification of such	• Consider it 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.

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financial instruments as financial liabilities, equity instruments or compound financial instruments.	
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)	• Welcome the IASB's refinements to the disclosures proposed in the DP, in particular, having more disclosures on potential maximum dilution of ordinary shares and suggested having a scenario approach for these disclosures. • Highlight 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	• Welcome the IASB's tentative decisions.
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	• There are challenges in determining whether priority stems from the contract or from related law/regulation. Some examples of challenges relate to contractually subordinated financial instruments; and • companies preparing financial statements on a going concern basis and real-life situations can be

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that may lead to changes in priority and other more specific disclosures	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	• 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.	• Support for the IASB's tentative decisions.
Financial liabilities containing contractual obligations to pay amounts based on an entity's	• Support for the IASB's tentative decisions.

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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	
Disclosures for subsidiaries without public accountability	
Disclosures for SWPA: The IASB tentatively decided to propose 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.	• Include a disclaimer that IASB is requesting comments on consequential amendments to a future IFRS Standard that had not yet been issued or endorsed. • 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. • Generally agree with the IASB's proposal, which seems to be a fair balance between costs and benefits related to providing disclosures. Nonetheless, EFRAG will make a cost and benefit analysis on the disclosures for SWPA during the consultation period, particularly on disclosures on the nature and priority of claims against an entity. • However, highlight that financial institutions, including insurance companies, are out of the scope of the forthcoming IFRS Standard for subsidiaries without public accountability. This means that their subsidiaries applying IFRS would

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	have to provide a comprehensive package of new disclosures on financial liabilities and equity, without any reduction. • Potential a question to constituents on costs and benefits.
Transition	
Fully retrospective approach: The IASB tentatively decided to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information. Also, there are some transition requirements for entities already applying IFRS Accounting Standards and no additional transition relief for first-time adopters.	• Highlight that there are more changes in practice than anticipated and as a result, this will also impact transition. • Therefore, sufficient time is needed for implementation. • Explore an optional transition relief to not apply the full retrospective approach to instruments that do not exist at the time of initial application of the amendments, similar to the approach taken in other recent standards. • Concerns on retrospective application, for example, there could be an impact on coefficients linked to debt/equity could be triggered due to the restatements and may cause breaches.

Questions for EFRAG FR TEG members

3 Do EFRAG FR TEG members agree with key messages on the project? Do you have any suggestions? Are there any issues missing that should be addressed in this project?

4 Do EFRAG FR TEG members agree with key messages on classification? Do you have any suggestions?

5 Do EFRAG FR TEG members agree with key messages on presentation? Do you have any suggestions?

6 Do EFRAG FR TEG members agree with key messages on disclosures? Do you have any suggestions?

7 Do EFRAG FR TEG members agree with key messages on transition? Do you have any suggestions?