

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

Financial Instruments with Characteristics of Equity

Cover Note

Introduction and Objective

- 1 The objective of the session is:
 - (a) for EFRAG FR TEG to recommend a draft comment letter ('DCL') on the IASB Exposure Draft ('ED') on *Financial Instruments with Characteristics of Equity* to EFRAG FRB for approval; and
 - (b) for EFRAG FRB to approve the DCL for publication.
- 2 The ED and respective IASB documents can be found here:
 - (a) [Snapshot of the ED](#);
 - (b) [Exposure Draft *Financial Instruments with Characteristics of Equity*](#);
 - (c) [Basis for Conclusions on the ED](#); and
 - (d) [Illustrative Examples and Implementation Guidance](#).
- 3 Besides the questions in paragraphs 41 and 42 below, additional questions for members are in agenda papers 04-02/04-03.

Background of the project

- 4 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 financial liabilities from equity instruments. The IASB finalised its discussions and issued a Discussion Paper on 28 June 2018 (the DP).
- 5 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 pursue 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 and the EFRAG comment letter please click [here](#).

- 6 After considering the 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.
- 7 In general, the IASB focused on several practice issues that arise when applying IAS 32. Many 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. The expected effects of the proposed amendments are:
- (a) improved financial reporting for some issues that currently arise in practice by clarifying the underlying classification principles without fundamentally changing the requirements in IAS 32 and adding application guidance; and
 - (b) provision of more useful information to users of financial statements via additional disclosures that will enable users of financial statement to better understand the nature of the financial instruments and the effect of their contractual terms on the amount, timing and uncertainty of the entity's future cash flows or its ownership structure.
- 8 Nonetheless, the IASB is not going to address all the existing issues that arise in practice (e.g., mandatory tender offers).

Background of the EFRAG discussions

- 9 As soon as the IASB started its redeliberations, the EFRAG Secretariat started to closely monitor the IASB meetings and discussed the IASB's tentative decisions with different working groups.
- 10 In general, 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 are:
- (a) Q1: The effects of laws on contractual terms;
 - (b) Q3: Obligations to redeem own equity instruments (e.g. put options on non-controlling interests);
 - (c) Q5: Potential factors to be considered on shareholders' discretion;
 - (d) Q6: New guidance on reclassification between financial liabilities and equity instruments; and
 - (e) Q7: Costs of compliance related to disclosures, where field testing will be key.

Summary of key changes based on the 19 December 2023 EFRAG FR TEG and EFRAG FRB meeting

- 12 EFRAG FR TEG and EFRAG FRB discussed the initial draft of EFRAG DCL and provided several comments and drafting suggestions. It was decided that the revised DCL will be approved at a joint EFRAG FR TEG-FRB meeting on 8 January 2024.
- 13 Below is a summary of key changes made to the updated draft comment letter in agenda papers 04-02/04-03 as agreed with EFRAG FR TEG and FRB.

Question 1 - Classification: The effects of relevant laws or regulations

- 14 Indicated support for the direction of travel of the IASB's proposals.
- 15 Explained the consequences of considering the law (i.e. an all-inclusive approach).
- 16 Deleted the sentence about an entity needing to continually monitor changes to the law.
- 17 Added unintended consequences, regarding:
 - (a) on AT1 instruments that are convertible into a fixed number of shares, whether an entity should consider the enforceability of such contract if the resolution authorities have the power to mandate conversion into a variable number of shares;
 - (b) the classification of financial instruments under IFRS 9 Financial Instruments from the holder perspective.
- 18 Explained further why Mandatory Tender Offers (MTO) are still an important issue.
- 19 Added a question to constituents on whether the IASB should address MTOs and also to ask if there are any classification changes expected for limited partnerships.

Question 2 - Classification: Settlement in an entity's own equity instruments

- 20 Deleted EFRAG's response regarding down-round features.
- 21 Expanded the explanation of the issue regarding options that can be exercised at different predetermined dates and added a question to constituents on whether the IASB's proposals on passage of time adjustments will lead to classification changes for options that can be exercised at different predetermined dates.
- 22 Requested for explicit clarity on whether the fixed-for-fixed condition is met for a convertible loan of variable interest rate (where both principal and interest are compounded to the convertible amount), similarly to the fixed interest rate loan.

Question 3 - Classification: Obligation to purchase an entity's own equity instruments

- 23 Indicated that EFRAG disagrees with the IASB's proposal to continue recognising non-controlling interest on initial recognition and supports the initial accounting within equity (derecognition of NCI) and presentation of subsequent changes to the carrying amount of the financial liability (against equity, particularly if NCI retains ownership rights).
- 24 Indicated that the IASB should further discuss the alternative views of Mr Uhl described in the Basis for Conclusions on gross versus net presentation on derivatives on own equity (including in the separate financial statements).
- 25 In addition, included questions to constituents.
- 26 Highlighted that due to lack of guidance in IAS 32, in practice there are different views on how to determine the present value of the redemption amount (e.g. how the financial

liability is measured if the amount payable on redemption is variable and subject to a cap. Suggest that the IASB specifically address more comprehensively the questions that arise in practice related to the measurement of the liabilities under IAS 32 (including discussions from September 2022 meeting, e.g. if there is a cap on the redemption amount).

Question 4 - Classification: Contingent Settlement Provisions

- 27 Added a paragraph to ask for clarity on the accounting treatment for the difference between the full obligation amount and the consideration received when the entity issued the instrument on initial measurement.
- 28 Asked for clarity on how liquidation interacts with insolvency.

Question 5 - Classification: Shareholder discretion

- 29 Removed any support of the IASB proposals on the factors, at this stage, in order to keep the text neutral.
- 30 Suggested to also consider making an assessment based on whether shareholders are making decisions as ‘part of the entity’ (as members of the entity’s corporate governance structure), or whether they are distinct from the entity itself when making these decisions (as holders of a particular instrument).
- 31 Added a question to constituents on whether to mandate a particular treatment or whether it should be left to judgement based on the factors and if the latter, which additional factors need to be considered.

Question 6 - Classification: Reclassification of financial liabilities and equity instruments

- 32 Added a paragraph to ask for clarification on what requirements to apply when there is a substantial modification to equity instruments and compound instruments.

Question 7 – Disclosures

- 33 Kept the EFRAG response neutral in not indicating support for the IASB proposals.
- 34 Deleted EFRAG’s response relating to disclosures on financial liabilities containing contractual obligations to pay amounts based on the entity’s performance or changes in its net assets and EFRAG response on the IASB not proposing further disclosures on restrictions to transfer cash.

Question 8 - Presentation of amounts attributable to ordinary shareholders

- 35 Deleted a paragraph on interaction of the IASB presentation proposals with regulatory requirements.

Question 9 - Transition

- 36 Highlighted that the relief not to require the restatement of information for more than one comparative period could also be helpful in other projects, such as *Primary Financial Statements*.

Question 10 - Disclosure requirements for eligible subsidiaries

- 37 No changes made.

EFRAG’s deadline for comment letters

- 38 The EFRAG Secretariat is proposing a deadline for comments from constituents to be 13 March 2024. This is suggested taking into consideration the following:

29 March 2024	IASB deadline for comments (EFRAG FRB has requested an extension to the IASB deadline – Agenda paper 04-04. If granted, the EFRAG Secretariat will update the timeline.)
27 March 2024	EFRAG FRB meeting to approve the FCL (additional meeting)
20 March 2024	EFRAG FR TEG meeting to recommend the FCL to EFRAG FRB (additional meeting)

Next steps

39 In addition, the EFRAG Secretariat is in the process of planning the activities the following activities, the feedback of which will be used in EFRAG’s final comment letter:

- (a) **Field-tests:** One of the key comments that the EFRAG Secretariat has been receiving is that field-testing the IASB’s proposals is important.
 - (i) Therefore, the EFRAG Secretariat will conduct:
 - An extensive field-test whereby entities would apply the IASB proposals and compare the results with current practice; and
 - A lighter version, i.e., a survey which will be qualitative in nature.
 - (ii) The EFRAG Secretariat will bring the questions for the field test and survey to the January 2024 EFRAG FR TEG meeting.
- (b) **Outreach events:** There will be limited time between the publication of the FICE ED and IASB deadline for comment letters (including a holiday season). Therefore, in order to provide useful input from different jurisdictions and to leverage from various sources, the EFRAG Secretariat is requesting for help from National Standard Setters to organise outreach events on the FICE ED.
- (c) **Questions to constituents:** To better assess the effects of the IASB proposals, the EFRAG Secretariat will suggest a number of questions to constituents in the DCL focused on potential impact on classification, presentation and disclosures (including related costs and benefits and unintended consequences).

Tasks	Jul-Sept 23	Oct 23	Nov 23	Dec 23	Jan 24	Feb 24	Mar 24
Key messages	FRB /FIWG/ IAWG / FR TEG						
Work on DCL		Drafting	Drafting	FR TEG recommendation to EFRAG FRB	EFRAG FRB approval and DCL issued		
Outreach events			Coordination	Coordination	Coordination /Events	Events	

Field Testing and Survey					Testing (as from end January)	Testing	
Work on FCL						Updates	FCL

Agenda Papers

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

- (a) Agenda paper 04-02 – EFRAG’s Draft Comment Letter – marked up version compared to DCL of 19 December 2023 EFRAG FR TEG and FRB meeting;
- (b) Agenda paper 04-03 – EFRAG’s Draft Comment Letter – clean version;
- (c) Agenda paper 04-04 – EFRAG letter to the IASB requesting to extend comment period – for background; and
- (d) Agenda paper 04-05 – Key messages used as a basis to draft EFRAG’s DCL – for background.

Questions for EFRAG FR TEG and FRB members

- 41 Referring to paragraph 38 above, does EFRAG FR TEG/EFRAG FRB agree with the suggested deadline for comments from constituents, i.e., 13 March 2024?
- 42 Does EFRAG FR TEG agree to recommend the Draft Comment Letter to EFRAG FRB for approval?
- 43 Does EFRAG FRB approve the Draft Comment Letter for publication?