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Financial Instruments with Characteristics of Equity

Cover Note

Introduction and Objective

- 1 The objective of the session is for EFRAG FR TEG to recommend a draft comment letter to EFRAG FRB for approval on the Exposure Draft ('ED') on *Financial Instruments with Characteristics of Equity*.
- 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 paragraph 16 and 17 below, additional questions for members are in agenda paper 07-02.

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 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 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 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. 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 the Appendix to this cover note, the EFRAG Secretariat provides an overview of the feedback received from all EFRAG groups and other stakeholders (seven EFRAG FR TEG meetings; seven meetings with EFRAG FIWG; two EFRAG FRB meetings; four meetings with EFRAG's Stakeholders from cooperative banks, users and auditors; three EFRAG IAWG meetings; two EFRAG FR TEG-CFSS meetings and two EFRAG UP meetings).
- 11 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.
- 12 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.

EFRAG’s deadline for comment letters

13 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
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

14 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

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

- (a) Agenda paper 07-02 – EFRAG’s Draft Comment Letter; and
- (b) Agenda paper 07-03 – Key messages used as a basis to draft EFRAG’s DCL – for background.

Questions for EFRAG FR TEG and FRB members

- 16 Referring to paragraph 13 above, does EFRAG FR TEG/EFRAG FRB agree with the suggested deadline for comments from constituents, i.e., 13 March 2024?
- 17 Does EFRAG FR TEG agree to recommend the Draft Comment Letter to EFRAG RFB for approval?

Appendix - Feedback received from EFRAG Groups and other stakeholders

EFRAG Financial Instruments Working Group

18 The EFRAG FIWG members have been receiving updates on the project and have provided the following feedback (January 2020, November 2021, May 2022, October 2022, May 2023, September 2023 and December 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. 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

- (b) 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;
- (c) 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;
- (d) 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
- (e) 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

- (f) 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;
- (g) 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;

- (h) Contractually subordinated: entities can face challenges determining whether priority stem from the contract or from related law/regulation. For example, in Sweden, and many other jurisdictions, 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;
- (i) 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;
- (j) 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
- (k) 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

- (l) 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);
- (m) 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).
- (n) 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
- (o) 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

- (p) 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’;
- (q) 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
- (r) 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

- (s) 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;
- (t) Considered that Mandatory Tender Offers (MTO) were an important issue that needed to be addressed in the future;

- (u) 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;
- (v) 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

- (w) 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;
- (x) 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;
- (y) 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

- (z) 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.
- (aa) EFRAG FIWG members considered that it was counter-intuitive to 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.
- (bb) 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)

- (cc) 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.

- (dd) 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.
- (ee) 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).
- (ff) 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.
- (gg) 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)

- (hh) 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)

- (ii) When discussing a number of sweep issues on classification, the EFRAG FIWG members provided the following comments:
- (jj) 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.
- (kk) 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.

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- (ll) 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.
- (mm) 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).
- (nn) 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)

- (oo) In general, members did not disagree with the IASB's tentative decisions.
- (pp) 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.
- (qq) Some members reiterated 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.
- (rr) 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.
- (ss) One member considered that there should be information on the restriction to transfer funds as highlighted in EFRAG's comment letter.

Transition (May 2023)

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

- (vv) 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.

19 In September 2023, EFRAG FIWG members received a presentation on the IASB's tentative decisions and EFRAG discussions. Subsequently, EFRAG FIWG members discussed key messages for EFRAG comment letter and provided the following comments:

- (a) Direction of the project: Welcomed the IASB's focus on targeted improvements to current requirements in IAS 32 by clarifying some of the underlying principles in IAS 32. However, some highlighted the importance of pointing out that the IASB's proposals are likely to impact/change the classification for a number of financial instruments (e.g., financial instruments with contingent settlement provisions) and that EFRAG should request the IASB to limit the changes to the classification outcomes (particularly for hybrid instruments such as AT1) to only when it clearly improves the information provided to users of financial statements.
- (b) Field-testing: Highlighted the importance of field-testing the IASB's proposals (both principles and specific wording), with real life financial instruments. Although the IASB is focusing on specific instruments, there is also a need to ensure that the overall consistency on the classification of the financial instruments (taking into account the classification changes). This should be in the scope of the field tests.
- (c) Non-genuine: Highlighted the importance of addressing the issues related to the use of different terms such as "non-genuine" and "non-substantive".
- (d) Effects of law on classification: Highlighted the importance of confirming (e.g., field-tests) whether the IASB's proposals on the effects of law on classification will not lead to unintended consequences, particularly for financial instruments within the scope of IFRS 9.
- (e) Financial instruments with contingent settlement provisions: there were concerns about using the "worst case scenario" on the measurement of liabilities other from a contract that contains an obligation for an entity to purchase its own equity instruments (debt component of compound instruments).
- (f) Reclassification: there were concerns that the IASB proposals did not cover changes in the substance of contractual terms as a result of passage of time. For example, there are financial instruments that are classified as a liability at initial recognition because of an initial variability in the exercise price. However, the substance of the contractual terms may change when existing contractual terms become effective with the passage of time and such variability would disappear. The IASB proposals would prohibit passage of time reclassifications, even if it would provide relevant information to users.
- (g) Disclosures: Highlight the importance of a cost/benefit assessment.
- (h) Transition: There would be more changes in practice than anticipated as a result of the project and this will also impact the transition requirements. In addition, it was mentioned that there was no retrospective application for IFRS 9 and IAS 32. One member suggested not to have retrospective application when hedge accounting is applied. An example provided are hybrid instruments which are classified as financial liabilities and the foreign exchange risk and interest rate risk have been hedged and

the interest will be recognised in equity. If there is retrospective application, there will be open derivatives with fair value changes that would impact the earnings resulting in an accounting mismatch and does not reflect the performance of the entity. Another member did not support retrospective application in general, indicating that coefficients linked to debt/equity could be triggered due to the restatements and may cause breaches.

20 In December 2023, EFRAG FIWG and IAWG members were provided with an overview of the IASB's ED by the IASB staff, as well as with EFRAG's key messages for the DCL.

(a) Classification

- (i) On **compound instruments**, such as bail-in instruments, the IASB seems to refer only to compound instruments which are convertible into a variable number of shares (no reference to compound instruments which are convertible into a fixed number of shares). This raised the question of whether those that are convertible into a variable number of shares have priority.
- (ii) Derivatives that are not denominated in the functional currency of the reporting entity are not equity (except for rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency. Those are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments). However, the IASB seemed to be silent on **perpetual instruments** that are in a foreign currency and have discretionary dividends (i.e. whether it is equity or a liability and whether interest payments should be presented in profit or loss or as equity). Particularly when considering that in IAS 32 the definitions refer to the residual is an "equity instrument" (and not simply equity) and at the same time an equity instrument in a foreign currency is a liability. It was noted that when there is a merger of the parent with its subsidiary that have different functional currencies, the **non-controlling shareholders receive shares denominated in a different currency**. This raised questions on the currency that should be used as a reference.
- (iii) It was noted that the relevance of this **project is also very important for many corporates**, in particular private equity backed corporates where they have multiple classes of shares.
- (iv) Highlighted that one of the reasons for avoiding classification changes for financial instruments that currently, to EFRAG's acknowledge, do not raise concerns in practice, is the **potential impact on hedging accounting** when there is a change in the classification of financial instruments from liability to equity classification. This can change behaviour on the use of specific instruments and their hedging. It was noted that this is a cross-cutting issue that should be considered by the IASB, particularly when considering the DRM project, as for the moment, equity is not eligible as a hedged item in the DRM model.
- (v) For bail-in instruments, one member questioned the EFRAG Secretariat conclusion that measuring a **liability at a probability-weighted amount** close

to a resolution would “impact negatively the statement of financial position in the worst possible moment”. This is because, if the measurement of the liability considers the possibility of the instruments being written down, the reduction of the amount of liabilities would lead to the recognition of income for the entity and increase the capital (before resolution). However, it was acknowledged that if the entity subsequently enters into a recovery stage, the liability could increase again, impacting negatively profit and loss and equity (making recovery more difficult). Therefore, it was suggested deleting this conclusion.

(vi) There were mixed views on the **measurement related to contingent settlement provisions**. More specifically, it was noted that:

☐ it was preferable to measure the liability that arise from hybrids at a probability-weighted amount as the market prices of the instruments consider probabilities and it is also the basis for the amortised cost accounting;

☐ measuring the liability at a probability-weighted amount would be a significant change to current requirements, add complexity to measurement calculations and involve significant judgement, particularly for AT1 instruments;

☐ it was preferable to measure the liability at a probability-weighted amount (as it was reflected in the price of the instrument), but it would add complexity. There was a need to reach a compromise.

(vii) In regard to **shareholder’s discretion**, members noted that it was going to be difficult to apply as these were factors that would involve a lot of judgement and would raise a lot of debate with auditors and enforcers. Still, as currently there is no guidance, the IASB’s proposals were a step forward that would help support the thinking and decisions on whether the shareholders’ discretion is treated as a decision of the entity.

(b) Disclosures

(i) One member was not clear in which order to provide the disclosures on terms and conditions about priority on liquidation – based on resolution or based on liquidation. If not based on resolution, then the information would not capture the true risk for investors to be aware of.

(ii) In addition, this member, referring to the illustrative example on terms and conditions that indicate priority on liquidation, indicated that it did not make sense to provide these disclosures for the group but more for the individual entities as the write down bail-in’s take place at each legal entity level.

(iii) The IASB Staff indicated that the disclosures are based on the contractual terms and if resolution happens before liquidation and there is a change in priority order because of this, then it can give a narrative description of that. Also, if a group has many subsidiaries, they did not want to overburden preparers to provide information per subsidiary.

- (c) Presentation, Transition and Disclosures for Subsidiaries without Public Accountability
 - (i) These topics were not discussed due to a lack of time. Members were requested to provide written input (including other topics already discussed).

EFRAG FR Technical Expert Group

21 EFRAG FR TEG has been receiving updates on the project and provided the following feedback (January 2020, November 2021, May 2022, November 2022, March 2023 and June 2023, September 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:

- 22 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
- 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.

Contingent settlement provisions

- (d) 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

- (e) 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

- (f) 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.

IFRS 7 and additional disclosures (June 2023)

- (a) Members were in general supportive of the disclosure requirements. Some specific comments are as follows:

Disclosures relating to terms and conditions (June 2023)

- (b) 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.
- (c) The disclosure on significant judgements made in classifying financial instruments should be captured under IAS 1.
- (d) There should be reclassification if there are changes to the effective terms and conditions of the financial instruments.
- (e) 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.

Additional disclosures (June 2023)

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

Transition (June 2023)

- (h) Members were, in general, supportive of the disclosure requirements.

Subsidiaries without public accountability (SWPA) (June 2023)

- (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.
- (j) 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.

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

Topics to be included in EFRAG's draft comment letter (June 2023)

- (m) 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.
 - (n) 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.
 - (o) The effects of law on contractual terms are an interesting topic and during the consultation EFRAG will have to see if this leads to classification changes of financial instruments.
 - (p) 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.
 - (q) 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.
 - (r) 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.
 - (s) 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.
- 2 In September 2023, EFRAG FR TEG discussed key messages for the EFRAG's draft comment letter based on the IASB's tentative decisions:
- (a) Project direction
 - (i) Members noted that at this stage, it would be difficult to disagree with the project direction.
 - (ii) Members highlighted potential unintended consequences on the classification of financial assets. It would be useful to include a question to constituents on unintended consequences related to this issue.
 - (b) Classification
 - (i) Members questioned whether there was a need to have separate disclosures on the zero-value equity component. Instead, it was suggested having this information reflected in the terms and conditions of a financial instrument.

- (ii) The effects of applicable laws on the contractual terms of financial instruments is an important issue as it could change current practice (e.g. bail-in instruments where the regulator has the power to decide, on a non-viability event, that conversion rate would be changed into a variable number of shares rather than into a fixed number of shares, as established in the contract), even if the IASB intention was not to change current practice.
 - (iii) The topic reclassification raised a lot of concerns. For example, that the reclassifications from 'passage-of-time changes' would be prohibited, that there is no guidance on reclassification when there is a change in the terms of the contract and that there is no guidance on reclassification for compound instruments.
 - (iv) The topic "shareholders' discretion" was a very important, however there was a need to see the final wording in the ED as the IASB discussions had not been entirely clear.
 - (v) Members highlighted the importance of having consistency on classification and measurement of financial instruments in the scope of IAS 32, which seemed to be the IASB's objective (rather than making fundamental changes on classification and measurement).
 - (vi) Members highlighted that the issue of obligations to redeem own equity instruments was also very important (e.g., put options on non-controlling interests) and raised many conceptual debates on initial and subsequent accounting of such instruments. The IASB was clarifying the requirements in IAS 32, which was useful. However, there are diverse views on this topic, particularly on initial recognition and subsequent measurement changes to the obligation to redeem own equity instruments (whether they should be in profit or loss or equity).
- (c) Presentation on equity
- (i) Members questioned how the IASB's proposal would affect the statement of changes in equity, particularly whether a preparer would have to present many columns and whether it would be better to present such information in the disclosures.
- (d) Disclosures
- (i) One member asked to consider the interaction of the EPS disclosures in the FICE ED with IAS 33.
 - (ii) It was noted that this project typically raised comments from financial institutions, which were not in the scope of the forthcoming project on SWPA. Thus, it would be difficult to obtain input from stakeholders within this project.

EFRAG FR Board

24 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.

25 In July 2023 the EFRAG FRB members provided the following feedback:

- (a) In general, there was support for the project direction and the IASB's tentative decisions, which seemed to address issues submitted to the IFRS Interpretations Committee. There were some questions and concerns related to this project that needed to be addressed but these had already been identified by EFRAG's Technical Working Groups and described in the agenda paper.
- (b) The disclosures seem to be quite comprehensive and demanding (e.g., information on liquidation preferences). Therefore, the IASB should clearly explain why there is a need to introduce a new set of additional disclosures as often this information is not readily available. There was also a need to have additional guidance on specific disclosures such as the meaning of liquidation (e.g., events that qualify as a liquidation event).
- (c) On subsequent measurement of redemption liabilities for obligations to redeem own equity, where there is diversity in practice in regard to the statement of profit or loss, it was recommended to have question to constituents.
- (d) There are topics that still need to be further discussed and carefully analysed such as the effect of law on the classification of financial instruments, the wording on the fixed-for-fixed principles and financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in its net assets.
- (e) It would be useful to perform field-testing on classification and disclosures to ensure that there would be no unintended consequences such as unexpected changes in classification and disclosure overload.
- (f) There were concerns on the classification of NCI puts, a topic that generates a more conceptual discussion (e.g., counter-intuitive effects on the statement of profit or loss).

EFRAG FR TEG-CFSS

26 In June 2022, The EFRAG TEG and EFRAG CFSS members discussed financial instruments with contingent settlement provisions and effects of laws on the contractual terms and provided the following feedback:

- (a) compound instruments with contingent settlement provisions: 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. However, members noted that in practice there are entities that recognise 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 significant change to some entities.

- (b) 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. Members also highlighted that there was the risk that the meaning of liquidation for accounting purposes may end up being different from the meaning of liquidation for legal purposes.
 - (c) non-genuine: some members considered that the threshold for being considered non-genuine should be high.
 - (d) 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.
 - (e) Effects of laws on contractual terms: Considered that the IASB should 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.
 - (f) Effects of laws on contractual terms: highlighted the importance of addressing the issues that arise in practice with the accounting for mandatory tender offers;
- 27 In December 2020, members discussed potential refinements to the disclosure requirements discussed in the DP published in June 2018.
- (a) In general, EFRAG TEG-CFSS welcomed improvements to disclosures on the priority of claims on liquidation, potential dilution and information about terms and conditions.
 - (b) Disclosures about priority on liquidation,
 - (i) for regulated financial entities, the issue is more related to a ‘resolution’ rather than ‘liquidation’;
 - (ii) highlighted that the interaction between the contractual terms and the law raised many challenges (e.g. bail-in instruments) and welcomed the IASB’s efforts to address these challenges with improvements to the disclosures;
 - (iii) regulated entities already provide comprehensive information to regulators on priority on resolution and providing a summary of that information can be challenging;
 - (iv) if short-term liabilities are in the scope, then the IASB should also consider interim financial statements;
 - (v) the IASB should focus on entities that issue material and significant financial instruments with characteristics of equity to avoid disclosure overload
 - (vi) Having information on economic compulsion is key to better understand the economic substance of a contract.
 - (c) Disclosures about potential dilution,

- (i) highlighted the importance of having additional information for both listed and unlisted entities;
- (ii) highlighted the importance of having a better definition of dilution as in practice it is not always clear what dilution is;
- (d) Disclosures about terms and conditions:
 - (i) 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
 - (ii) It would be useful to have, at a certain point in time, field-testing of the IASB's proposals on disclosures.

EFRAG IAWG

28 In May 2022, members received an update on the IASB discussions.

- (a) Clarifying the fixed-for-fixed condition
 - (i) One member was not sure whether there would not be major changes in practice. The EFRAG Secretariat responded that there would be a change in practice but major changes to current practice were not expected.
- (b) Disclosures
 - (i) One member indicated that the insurance industry is regulated and has a ranking of instruments prescribed by regulation. To his knowledge insurance companies do provide information on order of priority and liquidation. Nonetheless, any new disclosures should be subject to materiality.
- (c) Effects of law on contractual terms
 - (i) One member noted that if there were legal requirements that were connected to the contractual terms, then they should be considered on classification. However, the challenge was that the applicable law is different across jurisdictions. Therefore, disclosures may be needed to help users to understand classification.
- (d) Shareholders' discretion
 - (i) One member considered that the issue related to shareholders' discretion was too complex. It was important that information to be included in the financial statements is reasonable certain and shareholders' discretion is a difficult topic to assess and report.

29 There was a joint EFRAG FIWG and IAWG meeting in December 2023. Please refer to paragraph 20 in the Appendix above.

EFRAG User Panel

30 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 2018 Discussion Paper. 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.

31 In December 2023, EFRAG User Panel members were provided an overview of the FICE ED by the IASB staff and were also provided with an overview of key messages to be included in EFRAG's draft comment letter.

- (a) Presentation:
 - (i) Members welcomed the IASB proposals to present amounts attributable to ordinary shareholders separately from other owners of the parent. It was noted that it is fundamental for the users to have information about multiple equity providers and multiple financial instruments not aggregated in a single line. This will help them to understand how the proceeds would be distributed on the sale of a business.
 - (ii) It was further noted that for the large, regulated businesses such as banks or insurance companies it is important for the equity owners to determine what they should pay for the shares and at what price they should contribute incremental equity into the business. For that being able to calculate a book value per share in a relatively clear and unambiguous way is very important.
 - (iii) One member asked whether other owners of the parent should be better called other equity providers, as they are not necessarily owners. The IASB representative replied that this wording may be revised in according to Conceptual Framework and proposals in IFRS 18.
 - (iv) This member further asked whether the split between ordinary shares with voting and non-voting rights will be required. He expressed his preference to present them altogether within an ordinary shares category. The IASB representative responded that it was not the intention, but the entities could choose to present them separately if they consider it useful. This member also suggested that other forms of equity-like instruments, e.g., preference shares, perpetuals, etc should be presented separately from ordinary shares.
 - (v) Another member noted that in his jurisdiction (Italy) it is important to provide a distinction between voting and non-voting shares.
 - (vi) Members also noted the overall support of the IASB presentation proposals during the CRUF meeting.

- (b) Disclosures

- (i) One member agreed with the disclosures being proposed by the IASB. On disclosures relating to the maximum dilution of ordinary shareholders, one member indicated that it would also be useful to know the value of what would be contributed to ordinary equity by the maximum conversion to shares in order to calculate the enterprise value.

User organisation meeting (December 2023)

32 The following input was provided:

- (a) Presentation: Agreement with the IASB proposals. There were comments on whether there would be information on shares with voting/no voting.
- (b) Disclosures: Agreement with the disclosures being proposed as these would help users in how to treat an instrument and in implementing their methodology.

Meeting with auditors (December 2023)

33 The following feedback was provided:

- (a) Instruments with contingent settlement provisions – Mixed views as some were not in agreement with IASB proposals on not taking into account probability while others did not mind if probability was considered or not.
- (b) NCI puts – There were comments that the French preparers would not agree with the IASB proposals on obligations to purchase an entity's own equity instruments. Another auditor indicated that there is diversity in practice in Germany and the proposals would be helpful as it would reduce diversity.
- (c) Shareholder's discretion – The factors were seen to be difficult to apply in practice especially if companies are cross-border.
- (d) Transition – Suggestion that IASB consider providing a transition relief if a reclassification occurred because of a change in circumstances external to the contractual arrangement. Classification based on current terms and conditions of a financial instrument could be used for prior comparative period.
- (e) Disclosures on priority on liquidation – Not sure how in practice it would work to provide information that is relevant, useful and understandable to users.
- (f) There were some comments on knock on effects to hedging if an instrument is previously liability and now is equity.
- (g) Presentation – Not clear how to do the allocation between attributable to ordinary shareholders and to other owners.