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Financial Instruments with Characteristics of Equity

Summary and analysis of the comment letters received and outreach feedback

Objective

- 1 The objective of this agenda paper is to:
 - (a) provide a summary of the feedback received during outreach activities;
 - (b) provide a summary of the comments received in response to EFRAG's request for comments.
- 2 Based on the comments received, the EFRAG Secretariat has developed a revised draft EFRAG final comment letter that is presented as agenda paper 02-02 (for the clean version) and 02-03 (for the marked-up version).

Structure of the paper

- 3 This comment letter analysis contains:
 - (a) Summary of the feedback received from EFRAG Outreach Activities;
 - (b) Definition of terms;
 - (c) Summary of comment letters received from respondents;
 - (d) Executive summary of respondents' views; and
 - (e) Appendix - List of respondents.

Summary of the feedback received from EFRAG Outreach Activities

- 4 EFRAG has conducted several outreach activities on the Financial Instruments with Characteristics of Equity ('FICE') ED and issued the EFRAG's draft comment letter ('DCL').
- 5 The following joint outreaches were held:

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Location	Co-host(s)	Date
Virtual	ASCG (The Accounting Standards Committee of Germany) together with AFRAC (Austrian Financial Reporting Advisory Committee) – Link to the report is here .	4 March 2024
Virtual	EAA (European Accounting Association)	11 March 2024
Italy with virtual streaming	OIC (Italian Standard Setter)	12 March 2024

- 6 EFRAG staff also presented at/attended a further 10 meetings which included mostly meetings of accounting committee groups, EFRAG working groups (EFRAG IAWG, FIWG, User Panel) and other external meetings.
- 7 EFRAG also presented a summary of the survey results at the March 2024 ASAF meeting. A summary of the discussions can be found in paragraphs 29 to 30 below.
- 8 The feedback received as part of these activities is summarised below. Most of the concerns and comments related to the effects of law and regulation (ED Q1) and NCI puts (ED Q3).

Effects of laws and regulations

- 9 There were concerns with this proposal including potential unintended consequences:
- (a) there were concerns that stocks and co-operative shares would not be classified as equity. There were comments about why the law/regulation and the contract arrangement should be considered differently.
 - (b) some banking products in France, notably savings deposits, where all key parameters are highly regulated by law and the same conditions would be proposed by any bank. Therefore, applying the IASB proposals about the effects of laws and regulation may lead to unintended consequences.
 - (c) further examples of issues concerning the impact of laws and regulation (e.g., in Bulgaria, any specific terms that deviate from what the regulator perceives as ordinary market conditions is not considered to be covered and protected by the deposit protection program; in Germany, there are some puttable features which are enshrined in the law and not in the contract).

- (d) the classification of puttable instruments in partnerships was still unclear based on the IASB proposals.
- 10 Also, there were comments that in Germany, the law can refuse redemptions in certain cases and may also restrict when an entity can pay out. Also, some questioned the interaction between the proposals on the effects of laws and regulations and IFRIC 2.
- 11 Suggested solutions were as follows:
- (a) At the OIC event, stakeholders had no particular need for clarification on this topic. A practice common practice has been developed. The new proposals could lead to operational challenges and changes to the current practice.
 - (b) An all-inclusive approach without significant unintended consequences.

Fixed-for-fixed condition for derivatives

- 12 In general, there was agreement with, or not objecting to, these IASB proposals.

Obligations to purchase an entity's own equity instruments

- 13 In general, there was support for gross presentation rather than net presentation.

Initial recognition

- 14 In general, the majority disagreed with the IASB's proposals on initial recognition and considered that the debit should go to NCI. Some reasons provided were double counting ((i.e., simultaneously recording the financial liability as possible cash outflows under the written put option and the equity attributable to NCI shareholders reflecting their rights to receive future cash flows from the subsidiary, e.g. dividends); negative effect on bank's equity for regulatory purpose; and practice disruptions.
- 15 At the German/Austrian event, around half of the participants agreed with the IASB proposals both on initial recognition while a large minority agreed with debiting NCI equity.
- 16 In general, there were questions raised, for example, what happens if the initial debit exceeds the NCI balance. Some had concerns against reflecting a negative value of NCI part of equity (both at initial recognition and during subsequent remeasurement) and were supportive of limiting it to zero.

Subsequent measurement

- 17 In general, there was more support for changes in the financial liability going to equity rather than to profit or loss. Some reasons for this were that there is a transaction between shareholders, therefore recognition in profit or loss is counterintuitive; practice

Financial Instruments with Characteristics of Equity - Summary and analysis of the comment letters received

disruptions; conflict with the nature of the transaction; and the performance of the entity may not be appropriately understandable.

- 18 At the German/Austrian event, there were mixed views with nearly half agreeing to the IASB's proposals while the other half preferring changes in the liability going to equity. For those who chose equity - there were mixed views on whether it should be parent equity or NCI equity.
- 19 There was no support for changes in the financial liability going to other comprehensive income ('OCI').
- 20 There were questions raised, for example, would there be continued attribution of the NCI share of profit in the year. One stakeholder indicated that EFRAG's preliminary position (i.e. subsequent changes going to equity) worked well if the exercise price is at fair value. However, if the exercise price is fixed, NCI shareholders, in substance, no longer have an interest in performance of the underlying business. In effect, NCI shareholders become lenders to the group and reporting a liability with a related accretion interest expense in profit and loss (and to not attribute any profit to NCI) made a lot of sense.
- 21 It was also questioned what the effect of the new proposal on the accounting treatment of NCI puts would be in the separate financial statements.

Contingent settlement provisions

- 22 In general, there were mixed views on whether the probability and estimated timing of the contingent event occurring should be considered. Some considered that not including probability could lead to misleading results because for example the liability could be higher than its fair value. Also, more clarity is needed about the meaning of "process for permanently ceasing operations" to avoid different interpretation among jurisdictions and thus different classification outcomes.

Shareholder discretion

- 23 There seemed to be support for the factors and in line with the widely used principle of "control". Also, the clarifications seemed to be in line with current practice in one jurisdiction.

Reclassification of financial liabilities and equity instruments

- 24 There were mixed views for those who spoke on this topic. In the ASCG/AFRAC outreach, there was agreement with the proposals or no objection to them.
- 25 In another meeting, there were concerns about non-reclassification/non-derecognition of non-derivative financial liabilities on expiration of contingent settlement provisions.

Disclosures

- 26 At the OIC outreach event, users and preparers expressed different views. Users supported the proposals, in particular disclosures on terms and conditions of financial instruments. The preparers instead highlighted a number of risks (overload and obscuring), operational challenges and implementation costs.

Presentation

- 27 In general, further guidance would be needed to allocate issued share capital and reserves between ordinary shareholders and other owners of the parent. This distinction may be particularly difficult for earning reserves and valuation reserves.
- 28 A user at the OIC outreach event did not consider particularly useful this type of information.

March 2024 ASAF meeting

- 29 On classification requirements:
- (a) The Canadian member stated that it was good to know there is some commonality for some of the issues. In Canada, they have the issues on contingent settlement provisions and the effects of laws and regulations. He was, however, surprised by the comments on the requirements regarding passage of time for the fixed for fixed condition whereby there was agreement with the IASB's proposals. He indicated that there is a well-established practice with the Bermudian style options that can be exercised at predetermined amounts at predetermined dates. Currently entities do not consider whether it is a reflection of present value and just look at it as distinct at each period of time.
 - (b) The IASB Chair indicated that the purpose is not to seek new accounting but rather to bring about clarity. However, this did not mean that some of the proposals would not come with change, especially in areas where there is diversity. They would look at the robustness of the technical arguments and will consider other proposals.
 - (c) One of the IASB Staff considered helpful to include in the comment letter whether reference is made to NCI puts exercisable at fair value or at fixed price.
- 30 On the disclosure requirements:
- (a) The Canadian member heard similar comments as EFRAG from preparers and not from users who agreed with the disclosures. Users felt that the disclosures were more important than correcting diversity on the classification. If they know, for example, the terms and conditions and dilutive effect, they can make their decisions

rather than the IASB focussing on getting the classification right as the instruments are too complex. Therefore, they preferred to keep the disclosure requirements and not proceed with classification requirements.

- (b) The UK member heard similar messages from the users as the Canadian member. Even though it would be a challenge for preparers. It was important to maintain the disclosures requirements.

Definition of terms

- 31 The % in this document refers to the total number of respondents to the relevant question, unless indicated differently.

Term	No. of respondents as a %
Almost all	90% - 100%
Most	75% - 89%
Majority, Significant majority	51% - 74%
Half	50%
Many	25% - 49%
Some, others	0% - 24%

Summary of comment letters received from respondents

- 32 At the time of writing, 18 comment letters have been received. The letters are summarised below.

Executive summary of respondents' views

The effects of relevant laws and regulations

- 33 Many respondents generally welcomed the IASB's discussions and efforts to address the questions that arise in practice on how laws or regulations applicable to a financial instrument affect the classification of the instrument.
- 34 However, when specifically responding to the IASB's questions set out in the ED, most respondents, particularly preparers and regulators, **expressed significant concerns on the IASB's proposals on the effects of relevant law and regulations.**
- 35 In general, these respondents indicated that the IASB's proposals were not sufficiently clear, raised application challenges and uncertainty on the outcome of the IASB's proposals, could lead to a significant change to current practice, introduced a risk of

unintended consequences, and could lead to a new diversity in practice. Some of these respondents explicitly disagreed with the IASB's proposals.

- 36 In particular, many respondents expressed significant concerns on how the IASB's proposals would apply to instruments for which some or all all key parameters are regulated by law or regulation, including regulated saving accounts, some cooperative banks' products and bail-in instruments, which currently do not raise significant classification issues.
- 37 On mandatory tender offers, some respondents, including regulators and users, considered that the IASB should address this issue due to unclarities regarding the treatment of MTOs mentioned in the EFRAG's draft comment letter.
- 38 On how to move forward, many respondents encouraged the IASB to **reconsider the project direction** on the effects of relevant laws and regulations. These respondents considered that the best way forward would be to adopt an **"all-inclusive"**. As an all-inclusive approach may disrupt some current practices, two respondents considered that the IASB may provide limited exceptions, especially for bail-in instruments.
- 39 Still, many respondents called for the IASB to further consider its proposals (revise), make more field-testing and provide more clarifications and examples to illustrate the application of the IASB's proposals. This with the objective of helping the assessment of whether a contractual right or obligation is required by laws or regulations, ensure comparability across companies, ensure effectiveness and coherence of the requirements, and avoid unintended consequences on the classification of financial instruments.

Fixed-for-fixed condition for derivatives

- 40 Many respondents **generally agreed with the IASB's proposals** for instruments settled with an entity's own equity instruments, considered that these clarifications will reduce the existing diversity in practice.
- 41 On the **passage of time and preservation adjustments**, some respondents, while supportive, expressed some concerns and called for additional guidance, particularly on the use of a variable rate. There were also concerns on the IASB's proposals related to which functional currency should be the reference point.

Obligations to purchase an entity's own equity instruments

Initial recognition of the obligation to redeem an entity's own equity instruments

- 42 Most of the respondents did not support the IASB's proposal on the gross presentation whereby an entity initially recognises a financial liability for the redemption amount with

the debit side going against the parent's equity, if the entity does not yet have access to the rights and returns associated with ownership of those equity instruments. Instead, these respondents prefer that the debit side at initial recognition goes against the NCI share of equity.

- 43 The key arguments provided by the respondents were the concerns about double recognition (i.e. NCI in equity and purchase obligation as financial liability); the view that the IASB's proposals do not properly reflect the economic substance of the transaction in question and result in counterintuitive effects; punitive impact on banks prudential own funds and an existing guidance in paragraphs BC11, BC68 and AG29 of IAS 32.

Net presentation

- 44 Even though many respondents expressed various degree of sympathy for the 'net presentation', however, a majority of these respondents mentioned their understanding that such a change would be too fundamental, given the scope of the IASB's project.

Subsequent measurement of the financial liability

- 45 Respondents expressed mixed views as to whether the subsequent remeasurement of the financial liability should be reflected via profit or loss or via equity. Whilst most of those respondents who expressed a preference supported reflecting the effects of remeasurement in equity, some supported the IASB's proposal that it is treated via profit or loss.
- 46 It is worth noting that many respondents were either not categorical in their choice (eg., acknowledged the merits of the alternative approach) or preferred not to express a preference at all, citing mixed views of their members.
- 47 The respondents opposing the IASB's proposals referred to the following key arguments: (a) these instruments should be viewed as transactions with owners in their capacity as owners; (b) it is counterintuitive to have measurement changes being presented in profit or loss, as performance decreases when the value of the shares subject to the put option increases, and vice versa; (c) double effect on profit or loss; (d) accounting complications if the put option expires without exercise.

Other issues

- 48 Presentation in profit or loss – some respondents appreciated that entities can develop the appropriate accounting policy on how to present the value changes and decide whether an interest component would be recognised separately.

- 49 Some respondents specifically pointed out that the IASB's proposals could result in a significant change of the established accounting practice in their jurisdiction.

Contingent settlement provisions

- 50 In general, respondents that replied to this question agreed with the IASB's proposals on contingent settlement provisions, although many disagreed with the IASB's proposal on initial and subsequent measurement of the liability (i.e., the IASB's proposal to disregard probability).

- 51 On subsequent measurement, there are different views on whether the liability should remain measured at the full amount of the conditional obligation subsequently or whether the probability and estimate of the timing of the contingent event occurring should be considered. Many see the benefits of the IASB's approach on subsequent measurement where an entity is required to measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right. Such an approach has the benefit of being consistent with initial measurement requirements by not introducing significant changes to current requirements and not adding complexity to the measurement calculation, as it would involve significant judgement, continuous reassessment and additional costs to preparers. However, there are also many who consider that it is preferable to measure the liability that arises from hybrids at a probability-weighted amount as the market prices of the financial instruments consider probabilities, and it is the basis for the amortised cost accounting.

- 52 The respondents that referred to payments at the issuer's discretion agreed with the IASB proposal that payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero. However, some respondents provided a number of suggestions (e.g. transition relief).

- 53 On the meaning of liquidation and non-genuine, respondents called for the IASB to outline further (e.g. in the Basis for Conclusions) the situations that present practical application difficulties and how its proposals would apply.

Shareholder discretion

- 54 A significant majority of respondents agreed or (cautiously) welcomed the proposed requirements on how to treat shareholders' decisions. They considered that the proposals would provide useful and helpful guidance and would allow entity-specific judgments.

- 55 The majority of these respondents requested for illustrating examples or further guidance/specific principles on the application of the factors to help minimise the risk of diversity in application and improve comparability.

Reclassification of financial liabilities and equity instruments

- 56 Respondents, in general, were supportive or not objective of reclassification when a change of the substance of the contractual arrangement is due to a change in external circumstances.

- 57 However, the majority of respondents did not support the prohibition of reclassification for contractual terms that become, or stop being, effective with the passage-of-time ('passage-of-time changes'). They considered that the resulting information would be potentially misleading for the readers of the financial statements, i.e., may no longer faithfully represent the substance of the financial instrument. In addition, reclassification for passage-of-time changes would be consistent with transition requirements in paragraph 97W of the ED and with reclassification of puttable instruments.

- (a) Half of these respondents considered that reassessing, at each reporting date, whether an instrument should be reclassified would not be onerous.

- 58 Many respondents, on the other hand, supported the IASBs proposals considering it a reasonable approach.

Disclosures

- 59 The majority of respondents acknowledged that the users of financial statements would like to understand the complex instruments and (some) of the disclosure requirements would be useful for users.

- 60 A significant majority of respondents had concerns on the disclosure requirements with many of them indicating that the package of disclosures does not strike the right balance between the benefit of disclosures to the users and the cost of preparers. However, many respondents supported the disclosure requirements or indicated that they could be prepared at a reasonable cost and effort.

- 61 The main concerns on the proposed disclosure requirements stem from:

- (a) Disclosures on liquidation:

- (i) Many respondents indicated that IFRS Standards are based on a going concern principle and not liquidation or resolution. Therefore, disclosures on liquidation are contrary to the information based on a going concern view;

- (ii) Many respondents questioned the operationality without undue cost and effort of disclosures relating to the nature and priority of claims against the entity on liquidation. They also questioned whether these disclosures could be presented in a way that is useful to users. For example, difficulty to perform a complex legal analysis in each relevant jurisdiction to determine the nature and priority of the claims especially if the liquidation rules significantly differ, for example, a group with international subsidiaries.
 - (b) Disclosures on the terms and conditions of financial instruments with both financial liability and equity characteristics, whereby many respondents considered these disclosures to be specifically burdensome to comply with and were unsure how the users of the financial statements are going to absorb and use all the mostly narrative information of different levels of granularity between entities.
- 62 On the other hand, many respondents supported the disclosure requirements or could be prepared at a reasonable cost and effort.
- 63 Some respondents provided some suggestions to reduce the burden of disclosure overload. For example, there was a suggestion to allow cross-referencing to other public disclosure documents required by existing regulatory bodies, similar to paragraph B6 of IFRS 7. Also, there was a suggestion to narrow the scope of the disclosures to only complex instruments. Another proposed solution was not to proceed with the proposed disclosures requirements in the Exposure Draft.

Presentation of amounts attributable to ordinary shareholders

- 64 Respondents had mixed views about the IASB's proposals in general. Whilst many respondents supported, sometimes strongly, the proposals, at least their objective, many others denied, sometimes categorically, the necessity of such presentation requirements.
- 65 Both supporters and opponents of the proposed disclosure requirements emphasised, from their perspective, the importance of the cost/benefit analysis of the IASB's proposals.
- 66 A majority of the respondents had concerns about the clarity of the IASB proposals and emphasised that additional application guidance and illustrative examples would be needed to be able to perform the split. In particular, they had concerns about the effect of various equity instruments other than ordinary shares, the illustrative examples in paragraph IG6A of draft Amendments to Guidance on Implementing IAS 1, calculation of the attribution for AT1 instruments.

67 Many respondents emphasised that lack of guidance and examples may result in inconsistencies in practice and would limit the usefulness of the proposed presentation requirements.

68 Some respondents had concerns about the use of the terms “ordinary shareholders” and “Other owners of the parent” in the ED.

Transition

69 Most of the respondents supported for the IASB’s proposals in general. However, only four respondents expressed their support without having any significant issues, while the others mentioned one or more concerns.

70 The key concerns and suggestions of the respondents included complications that could arise for entities applying hedge accounting, the need to carefully assess the fully retrospective approach in terms of timing and cost-benefit analysis, a proposal to provide a transition relief for instruments that have been derecognised before initial application of the amendments and the issue of retrospective application and hindsight.

Disclosure requirements for eligible subsidiaries

71 Two respondents indicated that the reduced disclosures were not applicable to them, which they regret, as they are financial institutions while another two generally welcomed the reduced disclosure requirements.

Questions for EFRAG FRB

72 Does EFRAG FRB has any comments or observations with regards to the analysis performed?

Appendix - List of respondents

	Name of organisation	Jurisdiction	Type of respondent
CL01	Diogo Pesoa	Portugal	Academic researcher
CL02	WSBI-ESBG	Belgium	Preparer organisation
CL03	Accountancy Europe	Europe	Professional organisation
CL04	Credit Agricole	France	Financial Institution
CL05	European association of co-operative banks (EACB)	Europe	Preparer organisation
CL06	Finance Finland	Finland	Preparer organisation
CL07	ERSTE group	Germany	Preparer
CL08	GDV	Germany	Preparer
CL09	Allianz	Germany	Preparer
CL10	European Securities and Markets Authority (ESMA)	Europe	Regulator
CL11	Dutch Accounting Standards Board (DASB)	Netherlands	National Standard Setter
CL12	European Insurance CFO Forum	Europe	Preparer organisation
CL13	OIC	Italy	National Standard Setter
CL14	The European Federation of Financial Analysts Societies (EFFAS)	Europe	User organisation
CL15	BusinessEurope	Europe	Preparer organisation
CL16	Accounting Standards Committee of Germany (ASCG)	Germany	National Standard Setter
CL17	ANC	France	National Standard Setter
CL18	Mazars	France	Auditor