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Submitted via websites

Brussels, 17 December 2018

Subject: IASB Discussion Paper on Financial Instruments with Characteristics of Equity (FICE) & EFRAG's Draft Comment Letter thereon

Dear Mr. Hoogervorst, Mr. Gauzès,

We are pleased to respond to the IASB's Discussion Paper (DP) concerning Financial Instruments with Characteristics of Equity (FICE) and EFRAG's Draft Comment Letter thereon.

Accountancy Europe appreciates the IASB's efforts to issue a DP around the distinction between liabilities and equity for the issuers of financial instruments. The FICE project is indeed already on the IASB's work programme for a considerable period of time.

The IASB's preferred approach

Accountancy Europe welcomes the holistic approach taken by the IASB, which addresses presentation and disclosure in addition to classification. We agree that classification alone in a binary model does not meet all the information needs of users, and that additional disclosures and presentation solutions are required.

We fully concur with the list of features of claims, described in the DP 2.3-2.12, that are relevant to the users of the financial statements. We agree that the objective of the criteria should be to assess liquidity and solvency of the entity as explained in the revised *Conceptual Framework*. We therefore welcome additional disclosure by requiring more information on potential dilutive effects and on some features that affect the classification.

We believe that the 'timing' criterion, covered by both the IASB's preferred approach and IAS 32, is indeed providing some information that is relevant in assessing the liquidity of the entity. We however think that this criterion needs to be reinforced.

On the other hand, we challenge, but only for equity classification on the balance sheet, the benefits and the relevance of the 'amount' test¹, used cumulatively with the 'timing' feature². The 'amount' test used cumulatively with the 'timing' test, has no or little relevance with regard to the solvency objective in our opinion when the claim is settled using a variable number of the entity's own shares which the entity has the ability to issue. Such claim should meet the definition of equity. This test is moreover complex to implement, which is likely to result in numerous application issues.

We therefore encourage the IASB to consider an alternative classification principle based on the 'timing' (liquidity) criterion only (i.e. the alpha approach). This approach would solve the inconsistency between IAS 32 on the one hand, and the revised *Conceptual Framework* and IFRS 2 on the other hand concerning instruments settled in shares. Many of the practical issues would also be solved as a result of the application of the alpha approach to the classification of financial instruments with characteristics of equity.

The accounting treatment of derivatives on own equity and redemption obligation

The majority of our members propose approaching the accounting for derivatives on own shares by using the following building block approach, whose overarching principle is linked to our 2 main objectives of providing information, i.e. to assess liquidity and solvency. For gross physically settled derivatives, we would differentiate contracts to deliver the entity's own shares, that should be classified as equity as long as the entity has the ability to issue the number of shares to settle the contractual obligation, from those that may lead to the entity buying back its own shares. Regarding the latter population, we would apply our approach on the substance of the contractual terms to determine whether these derivatives should result in the recognition of a gross financial liability. We refer to our detailed response to question 5 (Annex 1) for further details.

We acknowledge that the aforementioned approach may result in contracts, whether derivatives or not, that could have a dilutive effect on existing shareholders, being nevertheless classified as equity. The potential dilutive effect would be captured by the enhanced disclosure requirements.

¹ i.e. an unavoidable obligation for an amount dependent of the entity's available economic resources (<> IASB definition)

² i.e. an avoidable obligation to transfer economic resources at a specified time other than at liquidation (<> IASB definition)

A minority of our members³ believe that the majority of application issues in IAS 32 arise from the 'fixed-for-fixed' criterion. They share the view that the timing feature should be the only relevant criterion for distinguishing equity and liabilities for funded financial instruments. However, those members think that any instrument that is for future receipt or delivery of equity instruments should not be presented as equity and be accounted for as derivative financial assets or financial liabilities measured at fair value through profit or loss. In their view, this would better reflect the performance attribution for current providers of capital that hold a residual interest in the entity. This would also simplify the classification process for such unfunded instruments, reduce the practical application issues and avoid structuring opportunities – something the proposals in the DP would not achieve. They also believe that equity instruments, that contain a redemption obligation from the entity against cash, should be split into an equity host and a derivative on own shares. If the exercise price of the redemption obligation equals fair value of the underlying shares, such split accounting would result in the shares still being classified within equity. Some information on the potential obligation to deliver cash would then need to be provided in the IFRS 7 liquidity disclosures.

We encourage the IASB to analyse the potential impact that any changes to IAS 32 may have on hedging activities.

Presentation

We appreciate the IASB's innovative thinking in providing certain information about the distinction between liabilities and equity through presentation in the primary financial statements and disclosure, rather than classification. We encourage the IASB to further develop these preliminary views.

Although we acknowledge the challenges and complexities associated with the 'amount' criterion, Accountancy Europe supports the OCI presentation of the income and expenses arising from financial liabilities that fail the 'timing' criterion and that contain an obligation for an amount that is dependent on the entity's available economic resources since we believe that this criterion is relevant to assess whether the instrument participates in the risks and rewards of the entity.

Substance of the contractual terms, indirect obligation and alternative settlement outcomes

We acknowledge the challenges in considering the substance of the contractual terms when classifying financial instruments.

We however ask the IASB to put more emphasis on the substance of the contractual terms by considering bringing more alignment between IAS 32.20, i.e. the indirect obligation requirements, and the contingent settlement provisions (IAS 32.25). This alignment could take the form that if an entity had a choice between an equity and a financial liability outcome in many scenarios that are beyond both its control and the holder's control, for the contract to be classified as equity, the liability outcome should not be higher than the equity outcome in all genuine scenarios (i.e. not only in a few scenarios as currently stipulated in IAS 32.20 and interpreted accordingly). We suggest taking more time to thoroughly research the overall issue and its consistent application in the light of the 'true and fair view' concept and some of the new concepts in the revised *Conceptual Framework*, for example 'having no practical ability to avoid'.

Relationship between contracts and law

We disagree with the proposed status quo, i.e. applying the approach to the contractual terms of the financial instrument consistently with IAS 32 and IFRS 9 *Financial Instruments*. Focusing solely on the contractual terms (i.e. the current IAS 32 approach) risks to be arbitrary given that contractual rights and obligations are often inseparable from the legal requirements.

³ Including our German member body

We suggest starting with the terms and conditions stipulated in the contract but we would also consider laws and regulations that clarify, limit or explain the rights and obligations arising from the contract.

Transitional provisions

We recommend the IASB to evaluate different options to provide transitional relief for preparers in case of any reclassifications from equity to debt or vice versa in order to prevent any undesirable consequences (cliff effects) resulting from the immediate application of the new classification principles, such as a transition period to allow entities to revise their capital structure. The transition from the current IAS 32 to the new proposed standard could indeed have a significant and non-manageable impact on equity ratios of preparers with a potentially important negative impact on both preparers and financial markets.

Please do not hesitate to contact Ben Renier (Ben@accountancyeurope.eu) in case of any additional questions or remarks.

Sincerely,



Olivier Boutellis-Taft
Chief Executive

ABOUT ACCOUNTANCY EUROPE

Accountancy Europe unites 51 professional organisations from 37 countries that represent 1 million professional accountants, auditors and advisors. They make numbers work for people. Accountancy Europe translates their daily experience to inform the public policy debate in Europe and beyond.

Accountancy Europe is in the EU Transparency Register (No 4713568401-18).

ANNEX 1 – DETAILED RESPONSE TO THE IASB'S DISCUSSION PAPER

- (1) Important remark: Please note that the annex is completed based on the majority view of our members (Please refer to the cover letter).
- (2) We are pleased to present below our detailed responses to the questions raised in the IASB's Discussion Paper (DP) on Financial Instruments with Characteristics of Equity (FICE).

Question 1: Missing IAS 32 challenges

Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.

(a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

- (3) We have identified the following **application challenges** which have not been covered in the discussion paper:
- Re-classifications between liability and equity when features lapse or conditions change (e.g. functional currency change, redemption/issuance of an instrument whose cash flows are mandatory and are linked to the cash flows of another instrument);
 - Definition of a contractual obligation and the determination of whether a party is acting as the entity (i.e. part of the governance structure of the entity) or as an instrument's holder/investor;
 - Determining whether an instrument is in the scope of IAS 32 or IFRS 2 *Share-based Payment* when the instrument is issued at a price, which is not equal to fair value. Inconsistency in principles (e.g. when a variable number of shares are issued) results in different classification depending on which standard is considered applicable.
- (4) We think that the following IAS 32 **conceptual challenges** should be addressed as well:
- Assessing whether the classification criteria from the issuer's perspective should be the same as from the holder's perspective and whether, when an exception is provided to the principles, such exception should be brought into the definition of financial liabilities and equity. Please refer to our response to question 4.
 - Reconciling the inconsistency between IAS 32 on the one hand and the revised *Conceptual Framework* and IFRS 2 on the other hand for instruments settled in shares (as well as any clarifications around the scope of IFRS 2 and IAS 32).
 - Reconcile that an obligation to distribute future cash flows, that depend upon the entity's performance (such as revenues, EBITDA, future profits), results in the recognition of a gross financial liability before the entity has actually performed in accordance with other standards such as IFRS 15 *Revenue from Contracts with Customers*.
- (5) We believe the IASB should prioritise those different issues by considering the amounts at stake, which should result in focusing on the below issues:

1. Economic compulsion/indirect obligations/form over substance: By focussing on the form rather than on the substance of the contractual provisions, the IASB has allowed many structuring opportunities which result in equity classification. Such structures are however generally perceived as financial liabilities by credit analysts and banking regulators. We believe that there is an urgent need to tackle those issues (Please refer to our detailed answer to question 10).
 2. Reconciling the inconsistency between IAS 32 on the one hand, and the revised *Conceptual Framework* and IFRS 2 on the other hand for instruments settled in shares (as well as any clarifications around the scope of IFRS 2 and IAS 32) (Please refer to our detailed answer to question 2).
 3. The accounting treatment for puts over non-controlling interests (NCI puts) (Please refer to our detailed response to question 7)
 4. Contractual terms: We also believe that the interaction between contracts and laws should be addressed in the short term. We suggest the IASB to consider guidance similar to the one stipulated in IFRS 17.2 (Please refer to our detailed response to question 11).
 5. Reconciling that an obligation to distribute future cashflows, that depend upon the entity's performance (such as revenues, EBITDA, future profits), results in the recognition of a gross financial liability before the entity has actually performed with other standards such as IFRS 15 *Revenue from Contracts with Customers* (Please refer to our detailed answer to question 3).
- (6) The issues listed below should be solved as well but are in our view less significant, and many of them, item (1) to (3) would be solved by dealing with item (2) in paragraph 5 above.
1. 'Fixed-for-fixed' principle for derivatives on own equity: We believe the 'fixed-for-fixed' principle should be clarified. In particular, guidance should be provided for: (1) common types of adjustments affecting the exchange of a fixed amount of cash for a fixed number of shares such as: (i) time value of money, (ii) anti-dilution provisions, including the effect of distribution to holders and 'down round' provisions, (iii) non-controlling interests, (iv) contingencies, (v) whether/when a foreign currency is treated as a fixed amount, as well as (2) the applicability of the 'fixed-for-fixed' principle to 'share-for-share' exchanges. The IASB's proposals stipulated in section 4 of the DP, provided in the context of the 'independent variable' principle, could be leveraged upon, except for contingencies and foreign currency where we suggest improvements to the IASB's proposals. We kindly refer to our response to question 5 for further details.
 2. Instruments that contain both contingent settlement features, that are beyond the control of both the issuer and the holder, and equity components⁴: IAS 32 is currently unclear as to whether one starts with the compound guidance (i.e. identification of equity and liability components) or alternatively with the contingent settlement guidance (i.e. liability component).. We refer to question 6 for our detailed comments.
 3. Embedded derivatives in equity hosts: We believe that the IASB should clarify the assessment of embedded derivatives in equity hosts. Embedded derivatives should not be separated from equity hosts in our view because they are part of the equity host and therefore not in the scope of IFRS 9 *Financial Instruments*.

⁴ Such issue was submitted to IFRIC in July 2013: It was related to additional Tier 1 capital issued by banks and that may convert into a variable number of the entity's own shares if the capital ratios fall below a certain level. Note that under our approach such instrument would be classified as equity in full. But we could envisage such issue to affect an instrument whose cash flows would be discretionary until the contingent settlement provisions kick in and does result in the issuer having to redeem the instrument in cash.

4. Re-classifications between liability and equity when features lapse or conditions change (e.g. functional currency change, redemption/issuance of an instrument which is linked to another instrument): IAS 32 is silent on re-classifications, except for puttable instruments and obligations arising upon liquidation. This resulted unfortunately in different interpretations in practice. We believe the IASB should require the re-assessment of classification at the balance sheet date.
5. Determination of whether parties are acting as the entity or as instrument holders/investors: IAS 32 does not address how to make that distinction. The latter is important in situations where investors, which hold instruments issued by the entity, can make decisions as part of the entity's governing bodies.

Question 2: The IASB's preferred approach

The Board's preferred approach to classification would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

(7) Overall, Accountancy Europe supports:

- the holistic approach taken by the board, which addresses presentation and disclosure in addition to classification. We agree that classification alone in a binary model does not satisfy all the information needs of users, and that additional disclosures and presentation solutions are required. Accountancy Europe supports the OCI presentation of the income and expenses arising from financial liabilities that fail the 'timing' criterion and that contain an obligation for an amount that is dependent on the entity's available economic resources (Refer to question 7). We also welcome additional disclosure by requiring more information on potential dilution effects and on some features that affect the classification (Refer to question 9).
- the list of the features of claims, described in the DP 2.3-2.12, that are relevant to the users of the financial statements.
- that the objective of the criteria should be to assess liquidity and solvency as explained in the revised *Conceptual Framework*. Although the revised *Conceptual Framework* contains a principle on stewardship as well, we believe the concept behind the 'amount' test deals more with the performance measure of the entity and should consequently be dealt with through presentation rather than classification (Refer to question 7).

(8) We believe that the 'timing' criterion, covered by both the IASB's preferred approach and IAS 32, is indeed providing some information that is relevant in assessing the liquidity of the entity. We however think that this criterion needs to be reinforced by:

- putting more emphasis on the substance of the contractual terms of the instrument. Please refer to our detailed response to question 10 on how we propose to achieve that objective;
- considering the legal environment in which the entity operates (Refer to our detailed response to question 11);

- providing guidance to determine whether parties are acting as the entity or as instrument holders/investors. IAS 32 does not address how to make that distinction, which is important in situations where investors that hold instruments issued by the entity can make decisions as part of its governing bodies.

(9) We challenge the benefits and the relevance of the ‘amount’ test, used cumulatively with the ‘timing’ feature, for classification on the balance sheet:

- The ‘amount’ test has no or little relevance with regard to the solvency objective in our opinion.

The amount test, or the ‘risk and reward performance’ test in its more general form, can easily be linked to the solvency objective as explained by the IASB when the instrument is settled in cash.

This is because when the amount of the claim is affected by the performance of the entity, instead of being fixed, it absorbs the potential losses generated by the assets of the entity and therefore doesn’t expose the entity to solvency issues. While, if it is fixed and if the entity has performed badly, the amount of the asset may not be sufficient to fulfill the claim.

But when the instrument is settled in cash, the benefit of adding the ‘amount’ criterion to the ‘timing’ feature for equity classification becomes debatable since it only captures instruments that are required to be settled in cash only at liquidation. We fail to see any benefit in classifying such claims as financial liability since upon liquidation, all claims are settled in cash. Financial statements are moreover prepared under a ‘going concern’ basis.

One good illustration is the example of common shares in the French banking mutualist market. Such shares do distribute dividends which are discretionary but the holders of such instrument only get back the nominal value of the instrument upon liquidation. Applying the ‘amount’ test would result in those instruments not being entirely classified as equity from an accounting perspective which entails the instrument failing core equity Tier 1 definition from a prudential perspective. It is still unclear whether the decision made by the IASB to maintain IFRIC 2 will exempt such instrument from the ‘amount’ test. From a liquidity and solvency perspective, those types of instruments are not identified as being problematic which clearly demonstrates that the ‘amount’ test is not highly relevant.

Where it becomes even more challengeable is when the claim will be settled using the entity’s own shares/ equity instruments. The rationale of the IASB is that still in such a case, if the entity has performed badly such that the value of its assets falls below the amount of the claim, the entity won’t be able to deliver enough shares worth the amount of the claim and will therefore go into bankruptcy. We concur with the beforementioned analysis, but we would like to note that in most jurisdictions mandatory convertible bonds must contain a cap on the number of shares to deliver, such that the entity will always have the ability to issue enough shares to settle the claim. In those cases, under the IASB’s preferred approach, the instrument will be classified as a financial liability and the cap as equity, but with little value.

Since this instrument doesn’t create any solvency nor liquidity issues, we believe such instrument should be classified as equity instead of liability. The ‘amount’ test is therefore not relevant in this particular case. Classifying such feature as equity would also be more consistent with how most rating agencies and banking supervisors look at it. Moreover, the removal of the ‘amount’ criterion regarding the classification of a variable number of shares is more consistent with the revised definition of the *Conceptual Framework* and with IFRS 2, which doesn’t make such distinction.

- The ‘amount’ test is complex to implement, which is likely to result in many application issues, as illustrated in the below paragraph.

(10) Applying this new principle (i.e. the 'amount' test) in practice would likely raise a number of new questions and problems, and would result in some unintended consequences. As such, we expect that ultimately the cost of this approach will outweigh the benefits. Some of the specific challenges that we identified in applying this criterion to existing instruments include:

- Ease of determination of the amount available: The DP states that “whether the amount... is independent of the entity’s available economic resources should be clear from the instrument’s contractual terms”. We agree that it could be clear in some cases, but it will not be clear in many other cases, particularly concerning entities with complex capital structures operating in different legal jurisdictions.
- Value ascribed to the available resources: How are unrecognized assets and liabilities taken into account? Does an entity need to fair value them to determine the amount of available resources? Do they need to be capable of being monetized in order to be considered as a resource to satisfy the claims?
- Timing of payments of claims: Is the assessment performed at every date when payments are required (or if at the entity’s discretion, when payments may be made), at liquidation of the entity (as that may happen sooner), or as if the instrument were to be settled at each future reporting date?
- Complexity of the calculation of the excess amount: Paragraph 3.20 explains that “the entity would have to consider whether the amount could exceed the entity’s available economic resources under any possible scenario”. If multiple scenarios were to be used over the entire life of an instrument, this would result in significant complexity in application (particularly in a large group structure).
- Order of assessment: How do other residual claims impact the assessment of a specific claim? What would be the order of the assessment? Since this is a forward-looking exercise, should every possible scenario for every other instrument be considered, including the interdependency between them?
- Clarity of Scope:
 - The distinction between NCI and an obligation dependent on some of the assets (DP 3.23 (b)) is not clear, and may lead to implementation questions about what constitutes an asset versus a subsidiary.
 - Liabilities dependent on net income: It is not clear whether instruments with payments based on the net income of the entity are:
 - considered dependent on the entity’s resources (as one would generally expect from a liability that is only dependent on net income); or
 - independent of the entity’s resources (because net income might exceed, in certain scenarios, the fair value of the shares of the company, for example because net income only includes the effects of recognised assets and liabilities, but excludes unrecognised assets and liabilities).

(11) We therefore encourage the IASB to consider an alternative classification principle based on the 'timing' (liquidity) criterion (i.e. the alpha approach) only. We believe that this approach would solve the conceptual issues listed in paragraph 5 item (2) above. Many of the practical issues, mentioned in paragraph 6 item (1) - (3), would be remediated as well.

- (12) If the Board however ultimately decides not to opt for our suggested approach (i.e. the alpha approach), then Accountancy Europe believes that the IASB should provide a solution for urgent issues around presentation, disclosure and application of the 'fixed-for-fixed' principle for derivatives. We believe the 'fixed-for-fixed' principle should be clarified (see also DP 1.36). In particular, guidance should be provided for: (1) common types of adjustments affecting the exchange of a fixed amount of cash for a fixed number of shares such as: (i) time value of money, (ii) anti-dilution provisions, including the effect of distribution to holders and 'down round' provisions, (iii) non-controlling interests, (iv) contingencies, (v) whether/when a foreign currency is treated as a fixed amount, as well as (2) the applicability of the 'fixed-for-fixed' principle to 'share-for-share' exchanges. The IASB's proposals in Section 4 of the DP provided in the context of the 'independent variable' principle could be leveraged upon, except for contingencies and foreign currency where we suggest improvements to the IASB's proposals. We refer to our response to question 5 for further details.

Question 3: Classification of non-derivative financial instruments

The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability.

Do you agree? Why, or why not?

- (13) We kindly refer to our response to question 2 above. Additionally, it is generally considered under IAS 32's model that an obligation to distribute future cash flows, that depend upon the entity's performance (such as revenues, EBITDA, future profits), results in the recognition of a gross financial liability and we don't believe this would change under the IASB's preferred approach (i.e. the gamma approach).

- (14) We believe the Board should reconcile that view with IFRS 15 *Revenue from Contracts with Customers* considering that this standard does not require the recognition of a liability before the entity has performed.

- (15) Accountancy Europe also would like to refer to the accounting for variable payments for the purchase of intangible assets in this context. The IFRS Interpretations Committee has declined to address this issue and concluded that the IASB should deal with the accounting for variable payments in a comprehensive manner.

- (16) Consistently with our view expressed in the response to question 10, we believe that the entity would have limited discretion to avoid delivery of economic resources. Therefore the instrument would fail the 'timing' criterion and would result in the recognition of a gross financial liability measured at the present value of the expected future cash outflows. Such financial liability, passing the 'amount' test, should also be able to benefit from the OCI presentation.

- (17) We refer to our response to question 6 for financial liabilities that have at least one settlement feature of a non-derivative financial liability.

Question 4: Puttable exception

The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

- (18) We agree that the puttable exception would be required under the IASB's preferred approach and our suggested approach.

- (19) There is however no need to have such an exception for finite life entities. Shares issued by a finite life entity should indeed meet the definition of equity regardless of whether they meet the puttable exception (i.e. allow those instruments to pass the ‘timing’ test). This is because they meet both the ‘timing’ and ‘amount’ criterion and we disagree with the IASB’s explanation that such instrument should be classified as a financial liability.
- (20) We encourage the IASB to assess whether the classification criteria from the issuer’s perspective should be the same as from the holder’s perspective.
- (21) There might indeed be valid reasons to justify a different objective from the entity’s perspective compared to the holder’s perspective. The ‘amount’ criterion could, for example, be more relevant than the ‘timing’ criterion from an investor’s perspective since investors do pay attention to the potential variability of the expected return of their investment. Indeed, investors look at liquidity from a very different perspective than the ‘timing’ criterion: Investors put more emphasis on the ability to convert the instrument into cash and they pay less attention to whether that ability results from a market mechanism or a put option. According to that view, puttable instruments that meet the ‘amount’ criterion could be eligible to be measured at fair value through OCI from an asset’s perspective.
- (22) If the IASB is not in favour of two different sets of criteria on the liability and on the asset side, we would encourage the IASB to consider whether, when an exception is provided to the principles of classifying debt and equity instruments, such exception should be brought into the definition of financial liabilities and equity in order to achieve full symmetry between the accounting classification for the issuer and the holder of the same instrument.

Question 5: Derivatives on own equity

The Board’s preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity’s own equity instruments—are as follows:

(a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

(b) a derivative on own equity is classified as a financial asset or a financial liability if:

(i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or

(ii) the net amount of the derivative is affected by a variable that is independent of the entity’s available economic resources.

Do you agree? Why, or why not?

- (23) We suggest the IASB to approach the accounting of derivatives on own shares by focusing on 2 critical objectives: does the contract raise some solvency and liquidity issues?
- a. For gross physically settled derivatives, we would differentiate:
- i. contracts for the receipt of own shares against cash which do result in the entity having an obligation to transfer some economic resources and may therefore result in a gross liability since own shares do not constitute an asset of the entity. The existence of such obligation to transfer economic resources, which would trigger the recognition of a gross liability, would then be assessed using our approach on economic compulsion (Refer to question 10) instead of only focusing on whether the contract creates a right (purchase call option) or an obligation (forward contract to purchase or written put option). Accordingly,

1. Forward contracts to buy the entity's own shares and paying cash or delivering some financial assets should result in the recognition of a gross liability.
 2. Purchased call option settled by buying back the entity's own shares and paying cash or delivering some financial assets should result in the recognition of a gross liability unless the exercise price represents fair value of the shares. This is in accordance with our answer to question 10: the entity will not have the practical ability to avoid buying back its own shares when the shares are worth less than the strike price. In the case where the strike price reflects fair value, it should be classified on a net basis in equity for a nil value, in accordance with the alpha approach (Refer to question 2), since only in such case, it doesn't create an unconditional obligation to buy back the entity's own shares.
- ii. From contracts for the delivery of own shares.
1. Forward contract to deliver own shares settled gross: We support the net presentation unless the contract upon settlement obliges the counterparty, which hasn't performed its obligation, to deliver the required asset. In the latter case we believe a gross presentation is appropriate considering that the entity has a contractual right to receive the financial asset (i.e. recognition of a gross asset).
 2. Written call option settled gross: We think that those instruments should be presented on a net basis and be classified in equity regardless of the exercise price.
 3. Purchased put option on own shares settled gross: Such contract should be presented on a net basis in equity unless the exercise price represents fair value and the contract upon settlement obliges the counterparty, which hasn't performed its obligation, to deliver the required asset. In the latter case we suggest presenting such contract on a gross basis (i.e. asset for the fair value of the shares to be delivered, and equity for the credit) with the changes in carrying value of the assets being recorded in equity.
- b. Net cash settled: we agree that net cash settled derivatives should be recognised as a derivative asset/liability.
- c. Net share settled:
- i. we concur to classify net share settled derivative contracts, that will result in the entity delivering shares, in equity for the net amount since those contracts will result in the delivery of own shares and according to our answer to question 2, we do not believe that any consideration on the strike price is relevant.
 - ii. we concur to classify net share settled derivative contracts, that will result in the entity buying back its own equity, in equity for the net amount since those contracts will not result in the outflow of any resources from the entity and according to our answer to question 2, we do not believe that any consideration on the strike price is relevant.

- d. We also support the elimination of the anti-abuse guidance in IAS 32.26 when there are settlement options.

Question 6: Compound instruments and redemption obligation arrangements

Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

(a) Do you think the Board should seek to address the issue? Why, or why not?

(b) If so what approach do you think would be most effective in providing the information, and why?

(24) We agree that a redemption obligation arrangement should be classified as a gross financial liability under both the IASB's preferred approach (i.e. the gamma approach) and the alpha approach (Refer to question 2, 5 and 7).

(25) As explained in our response to question 2, we disagree with how the DP splits an obligation to deliver a variable obligation subject to a cap and a floor: they should be classified in equity in totality.

Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)

(26) We agree that we should not factor the probability into the measurement of a contingent settlement liability that is beyond the control of the issuer or that is under the control of the holder. If however, the entity could be required to pay an amount higher than the initial proceeds following the trigger of the contingent settlement provision, then only such difference should be treated as a derivative.

(27) We question the reliability of having to discount the contingent settlement obligation when measuring the financial liability component. We believe requiring issuers to estimate the timing they expect to be liquidated and to communicate on such estimate would not work in practice. We would rather suggest that no discount effect should be factored into the measurement of a contingent settlement provision that is beyond the control of both the issuer and the holder and such measurement could be similar to the principle stipulated in IFRS 13.39 (i.e. the 'demand deposit liability' principle).

(28) As a result of the above, we believe that an instrument that comprises both a contingent settlement provision outcome and an equity outcome should be presented as a financial liability in full on the balance sheet. With regard to its effect on P&L, any distribution of cash flows that result from cash flows that the entity could have avoided should be presented as a deduction from equity. As a result, the financial liability component should not give rise to any P&L effect of itself.

Financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer)

(29) Some financial instruments have alternative settlement outcomes and give the entity (the issuer) an unconditional right to choose the settlement outcome. We disagree with the outcome of the IASB's preferred approach (i.e. the gamma approach) to classify those instruments in full as equity instruments. We refer to our discussion on economic compulsion in the response to question 10.

- (30) We also believe that the IASB should apply a principle that results in consistent classification of instruments regardless of whether they are standalone or bundled together to avoid structuring opportunities. This is unfortunately not the case under the IASB's preferred approach (i.e. the gamma approach), for example: A standalone gross physically settled purchase put on own shares that meets the 'fixed-for-fixed' / amount criterion will be classified as equity for the premium received. Whereas when this put option is bundled in a financial liability (reverse convertible) it results in the liability being reclassified in full into equity.

Question 7: Presentation of financial liabilities

Do you agree with the Board's preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

- (31) As explained in our response to question 2, we agree that the concept behind the 'amount' test, i.e. assess whether the instrument is participating in the risks & rewards generated by the entity, is a relevant feature. We however believe that this feature should better be used to assess the performance of the entity rather than its liquidity and solvency.
- (32) Accordingly, we agree to present in OCI (as opposed to P&L) the income and expenses arising from financial liabilities that fail the 'timing' criterion and that contain an obligation which participates in the risks & rewards of the entity. We however question the non-recyclability of this OCI item.
- (33) Although we believe that an obligation that is redeemable into a variable number of shares should be classified in equity, we could see some merits in presenting in P&L the effective yield associated with such an obligation consistently with IFRS 2 (i.e. by debiting an expense and crediting equity). Such obligation indeed does not participate in the risks & rewards of the entity.
- (34) We would like to highlight the following issue: A redemption obligation with an exercise price that will not pass the 'amount' test, will not be able to benefit from the OCI presentation in accordance with the IASB's preferred approach. This concerns a widespread issue for NCI whose exercise price generally consists of an EBITDA multiple when the shares of the subsidiary are not listed.
- (35) We suggest the following alternative approach, which in our view would result in more relevant information for the users:
- Measure the redemption obligation at the fair value of the written put option. This obligation would be recognised as a derivative liability measured at fair value through P&L; and
 - Recognise a gross liability for the lower of the exercise price and the fair value of the instrument absent the put option, with changes in the carrying amount recognised in OCI.

Question 8: Attribution of income to equity instruments other than ordinary shares

The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

- (a) a full fair value approach (paragraphs 6.74–6.78);*
- (b) the average-of-period approach (paragraphs 6.79–6.82);*
- (c) the end-of-period approach (paragraphs 6.83–6.86); and*

(d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25.

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

- (36) We do not support the proposal to expand the attribution of income and expenses to some equity instruments other than ordinary shares. We believe that this proposal entails a high level of complexity, might result in operational challenges and we question its relevance taking into account that total comprehensive income is not measured at fair value. The proposed allocations would potentially result in significant mismatches as a result of the latter element.

Question 9: Disclosure

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).

(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).

(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

- (37) First of all, we would like to underline that we support the IASB's efforts to improve the disclosure requirements for financial liabilities and equity instruments. Especially users of financial statements have repeatedly requested, in the context of previous consultations, that preparers be required to provide more information about equity instruments and financial liabilities in the notes to the financial statements.

Priority of financial liabilities and equity instruments on liquidation

- (38) Although we acknowledge the relevance of presenting instruments in order of priority, either on the statement of financial position or in the notes, we do not support this proposal. We believe it might be challenging to provide relevant information in such a way due to the inherent complexity of such an information on a consolidated basis. We suggest providing such information outside the financial statements, for example in a 'More' report⁵.

Potential dilution of ordinary shares

- (39) We agree with the IASB's proposal to disclose the potential dilution for all potential issuance of ordinary shares, including the issuance by non-listed entities as opposed to the IAS 33 *Earnings Per Share* scope (i.e. limited to listed entities). We however also recommend disclosing the range of additional potential ordinary shares on top of the proposed additional disclosure requirements.

Contractual terms and conditions

⁵ <https://www.accountancyeurope.eu/wp-content/uploads/170918-Publication-Core-More.pdf>

(40) Generally speaking, we do not support the proposal to disclose ‘terms and conditions’ for both financial liabilities and equity instruments in the notes to the financial statements as this might result in disclosure overload. We believe that this requirement is already covered by the existing ‘significant judgements’ guidance stipulated in IAS 1.122.

(41) If the IASB however decides to not take the ‘economic compulsion’ concept into consideration (Refer to question 10 hereafter), we recommend providing disclosures around features with insignificant fair value (i.e. limited value to the entity) but that could result in moving an instrument from liability into equity classification. Examples of such feature are as follows:

- Issuer’s option to not exercise a call option regarding an instrument whose payment would otherwise be completely discretionary;
- Option to prepay or redeem an instrument using a fixed number of shares that would be classified as a financial liability without that call option.

Question 10: Economic compulsion

Do you agree with the Board’s preliminary view that:

a) economic incentives that might influence the issuer’s decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?

(b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

(42) We acknowledge the challenges in considering economic incentives when classifying financial instruments (e.g. requires judgement).

(43) The analysis of the discretion to avoid delivering cash (i.e. the ‘timing’ feature) is generally more based on the legal form than on the substance of the contractual terms. This does not seem to be consistent with the *Conceptual Framework*. By ignoring the principle that when an entity has a choice between different settlement outcomes it will generally choose the one that consists in paying less cash, the IASB has allowed many structuring opportunities to develop. These structures consist in creating many settlement alternatives for the issuer. In the vast majority of cases, the settlement options that would result in equity classification are more costly for the entity than the ones that would result in financial liability classification. Yet the instruments will be classified as equity because the issuer has just the legal right to choose the equity settlement alternative and therefore avoid the liability outcome. The issuer will however not have the practical ability to avoid delivering cash in the vast majority of the cases where the equity settlement alternatives are more costly than the financial liability ones.

(44) In fact, those structuring opportunities have been developed as a result of IAS 32.20. When applying the principle stipulated in this paragraph, the instrument is classified as a financial liability only when the values of the equity settlement alternatives always exceed the values of the liability ones. Therefore, to avoid liability classification, the issued instrument only requires having a couple of scenarios that are genuine, for which the choice of the equity settlement alternative is preferable to the liability one. While according to the ‘timing’ feature principle, it should be the contrary: in order to avoid the liability classification, equity settlement alternatives should be preferable to the liability ones in all genuine scenarios.

(45) Below are three common types of structures where the ‘timing’ principle currently results in equity classification even though such classification does not reflect the substance of the transactions:

- ‘Hybrid perpetual bonds’ with a call option at par, that allow issuers to defer coupon payment indefinitely, but with some mechanisms to create incentives for the issuer to pay the coupons and/or redeem the instruments at the call dates: Such mechanism results in accumulation of the deferred coupons and/or step-up provisions in case the call option is not exercised. We therefore welcome the fact that the hybrid that distributes cumulative interests will now be classified as financial liability under the IASB’s preferred approach (i.e. the gamma approach). The financial liability classification should however in our view be the result of addressing the transaction’s economic substance rather than the transaction failing the new ‘amount’ criterion.
- ‘Reverse convertible bonds’ (i.e. creating a host contract that is a normal bond and including a conversion option to convert into a fixed number of shares at the issuer’s discretion): In accordance with IAS 32, it was not clear how such contract was classified since the standard did not contain any clear guidance on how to separate such contract. The IASB has clarified that such contract should be classified in full into equity under the preferred approach (i.e. the gamma approach). As explained above, we do not believe that this outcome reflects the substance of such arrangement: in all the cases where the share price of the entity will be higher than the cash alternative, it is reasonable to assume that the entity will choose to pay cash and for those where the share price will be much higher, it is reasonable to assume the entity will not have the practical ability not to pay cash. Those cases are out of the control of the entity and therefore according to the IAS 32.25, the instrument should be classified as a financial liability. From an economic perspective, this instrument consists of a financial liability and a purchase put option on own shares, whose value is very small if the strike price of the put option is set such that the option to convert is far out of the money. We believe such instruments should be classified according to their substance, i.e. as a liability for its cash outflows and as a negative equity for the purchase put option.
- ‘Mandatorily convertible bonds’: Creating a host instrument that requires the issuer to deliver a variable number of shares, subject to a cap on the amount of shares to be delivered, and inserting a call option at the issuer’s discretion to terminate the contract by delivering the maximum number of shares the issuer could be required to deliver under the cap.

(46) We would like to note that under our suggested approach (i.e. alpha approach), there would be no need for the call option for the contract to be classified as a financial liability.

(47) We ask the IASB to put more emphasis on the substance of the contractual terms by considering bringing more alignment between IAS 32.20, i.e. the indirect obligation requirements, and the contingent settlement provisions (IAS 32.25). This alignment could take the form that if an entity had a choice between an equity and a financial liability outcome in many scenarios that are beyond both its control and the holder’s control, for the contract to be classified as equity, the liability outcome should not be higher than the equity outcome in all genuine scenarios (i.e. not only in a few scenarios as currently stipulated in IAS 32.20 and interpreted accordingly). We suggest taking more time to thoroughly research the overall issue and its consistent application in the light of the ‘true and fair view’ concept and some of the new concepts in the revised Conceptual Framework, for example ‘having no practical ability to avoid’.

Question 11: Relationship between contracts and law

The Board’s preliminary view is that an entity shall apply the Board’s preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32.

Do you agree? Why, or why not?

(48) We disagree with the proposed extension of the status quo, i.e. applying the approach to the contractual terms of the financial instrument consistently with IAS 32 and IFRS 9 *Financial Instruments*.

- (49) Laws and regulations have been taken into account in recently issued standards such as IFRS 17 *Insurance contracts*, IFRS 16 *Leases* and IFRS 15 *Revenue from Contracts with Customers*. We believe that entities should also account for the rights and obligations arising from law and regulations in the context of the classification of financial instruments.
- (50) The current IAS 32 approach, i.e. limiting the analysis to the terms and conditions in the contract, results in practical application challenges based on our experience (e.g. contingently convertible bonds, mandatory tender offers, obligation to distribute dividends, obligation to redeem shares, etc.). Focusing solely on the contractual terms (i.e. the current IAS 32 approach) risks to be arbitrary given that contractual rights and obligations are often inseparable from the legal requirements.
- (51) We suggest starting with the terms and conditions stipulated in the contract but we would also consider laws and regulations that clarify, limit or explain the rights and obligations arising from the contract. A pure legal obligation, i.e. no contract exists between two parties, would not be a financial instrument to be assessed in accordance with the classification principles.

ANNEX 2 – DETAILED RESPONSE TO EFRAG'S DRAFT COMMENT LETTER

(52) We are pleased to present below our detailed responses to the questions raised in EFRAG's Draft Comment Letter (DCL).

Question A: Objective, scope and challenges (Paragraph 21)

Are constituents aware of any other challenges with IAS 32 that have not been identified by EFRAG and the IASB?

(53) We kindly refer to our response to question 1 of the IASB Discussion Paper (see Annex 1).

Question B: The IASB's preferred approach (1) (Paragraph 41)

In paragraph 33 EFRAG agrees that information provided in the financial statements about claims on an entity should help users to assess the entity's liquidity and solvency. These information needs are also identified in the Conceptual Framework for Financial Reporting. The DP suggests providing information on both these factors by considering both 'timing' and 'amount' when distinguishing equity from a liability. EFRAG has considered whether it provides the most useful information to consider both these dimensions when distinguishing equity and liabilities. Do you think that information about both liquidity and solvency should be provided through the classifications of claims on an entity? If so, do you agree with using both the 'timing' and the 'amount' features when distinguishing equity from a financial liability? If not, how should the distinction be made?

(54) We kindly refer to our response to question 2 of the IASB Discussion Paper (see Annex 1).

Question C: The IASB's preferred approach (2) (Paragraph 42)

The IASB decided that, while the objective of the FICE project is to respond to challenges in distinguishing financial liabilities from equity instruments when applying IAS 32, any potential solution should limit unnecessary changes to classification outcomes that are already well understood. Considering the IASB's preferred approach described in the DP, do you expect significant classification changes? If so, please describe the type(s) and extent of instruments affected, the existing classification in accordance with IAS 32 and why the classification could or would change in accordance with the IASB's preferred approach.

(55) We anticipate the following major classification changes due to the introduction of the IASB's preferred approach (i.e. the gamma approach):

- Hybrid corporate bonds will be reclassified from equity to liability.
- Formula based NCI put options, which are currently classified as a financial liability with fair value changes recognised in equity (entity option), will not be able to benefit from the OCI presentation because they will fail the 'amount' test.

Question E: The classification of non-derivative financial instruments (2) (Paragraph 74)

Do you consider that it is relevant to classify financial instruments that are only settled on liquidation (e.g. cumulative preference shares) as financial liabilities?

(56) We do not believe that financial instruments that are only settled on liquidation (e.g. cumulative preference shares) should be classified as financial liabilities considering that financial statements are prepared under a going concern approach when they do not contain incentives to be redeemed earlier. Please refer to our detailed answer to question 10.

Question I: Classification of derivative financial instruments (Paragraph 112)

Considering the arguments provided in paragraph 105 above, do you consider that accounting for all derivatives on own equity as derivatives assets or derivatives liabilities under the scope of IFRS 9 together with disclosures on the maturity of any redemption amount under IFRS 7 would be a simpler approach and still provide relevant information to users of financial statements?

(57) We refer to our detailed response to question 5 (Annex 1) for the majority view of our members on the accounting treatment of derivatives on own equity.

(58) A minority of our members believe that the majority of application issues in IAS 32 arise from the 'fixed-for-fixed' criterion. They share the view that the timing feature should be the only relevant criterion for distinguishing equity and liabilities for funded financial instruments. However, those members think that any instrument that is for future receipt or delivery of equity instruments should not be presented as equity and be accounted for as derivative financial assets or financial liabilities measured at fair value through profit or loss. In their view, this would better reflect the performance attribution for current providers of capital that hold a residual interest in the entity. This would also simplify the classification process for such unfunded instruments, reduce the practical application issues and avoid structuring opportunities – something the proposals in the DP would not achieve

Question J: Compound instruments and redemption obligation arrangements (1) (Paragraph 206)

To what extent are contingent convertible bonds (CoCo's) and written puts on NCI used by the entities in your jurisdiction?

(59) Written puts on NCI are widely used in Europe. Contingent convertible bonds, on the contrary, are not widely used across Europe.

Question K: Compound instruments and redemption obligation arrangements (2) (Paragraph 207)

What types of entities are using them the most?

(60) Written puts on NCI are used by many corporates across Europe.

Question L: Contractual terms (Paragraph 387)

To what extent is the IFRIC 2 interpretation being used by the entities in your jurisdiction?

(61) The IFRIC 2 principle is only applicable to very specific instruments, i.e. members' shares in cooperative entities and similar instruments.

(62) We would like to highlight the importance of cooperative shares in the French banking business. These instruments might be classified as compound instruments in accordance with the IASB's preferred approach (i.e. the gamma approach), which would result in these entities having no more core equity Tier 1. IFRIC 2 would have to be applied to those instruments to obtain a potential equity classification and the IASB would have to confirm that the 'amount' feature does not apply to these instruments.