FICE – Questions raised in the Discussion Paper

Appendix A 4 January 2019

Section 1 – Objectives, scope and challenges

Question 1

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?

AFME's Response:

AFME welcomes the IASB's overall objective to develop clear classification principles and address current conceptual and application challenges. We note that this is the approach intended to be applied in the creation of the Discussion Paper ("DP"). Members agree that the DP identifies the main challenges associated with IAS 32, in particular those related to the classification of financial instruments as financial liabilities or equity instruments. However, Members believe that some of the challenges may be better addressed through more narrow scope, targeted amendments to IAS 32, and additional disclosures, rather than broad changes to the requirements that would have a fundamental impact on the existing classification outcomes. Examples of the challenges that Members believe would be better addressed through more narrow scope amendments include the following items, which are further discussed in more detail in this document:

a. Accounting treatment of put options written on non-controlling interests

b. Clear articulation of the distinction between indirect obligations (IAS 32.20) and economic incentives or compulsion

c. Relationship between contractual obligations and law for classification purposes, including obligations contingent on a change in legal, regulatory or tax law requirements

Members note that one of the conceptual challenges with current equity/liability classification is the inconsistency of principles between IAS 32, IFRS 2 *Share-based Payment*, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (i.e., IAS 37 focuses on the probability of a cash outflow, while IAS 32 focuses on the contractual rights and obligations). Members are aware of the fact that it might be challenging to reach full consistency of the standards, however they note that the impact of the DP on other standards should be considered at an early stage of the project, rather than assessed consequently as referred to in paragraphs B5-B10 of Appendix B of the DP. Interaction with other standards and the new *Conceptual Framework for Financial Reporting* should be taken into account, as also mentioned in Appendix B; for example, IFRS 9 classification and measurement for the issuer, if the instrument is determined to be a financial liability, and IFRS 9 classification and measurement by the holder of the instrument (including whether such instruments could be carried at FVOCI) or the accounting treatment of instruments under IAS 27 *Separate Financial Statements.* Another example relates to certain investments in subsidiaries that are currently classified as equity under IAS 32 (including Additional Tier 1 ("AT1") instruments). These instruments currently form part of the investment in a subsidiary, under IAS 27, in the financial statements of the parent. If these instruments were to be classified as liabilities or compound instruments by the issuer, they would no longer be considered part of the investment in subsidiary, but rather as debt investments, which would increase the parent's leverage. As a result, the cost of providing intra-group capital may then increase respectively due to such a change in classification. This cost could be disproportionately high in relation to any benefit for users of the accounts, particularly for wholly owned subsidiaries.

The interrelation of the FICE project with other on-going projects by the IASB (i.e., Classification of liabilities as current or non-current) should also be evaluated as the projects evolve.

Members are also concerned that, while not fully resolving current issues, the Board's preferred approach poses new challenges due to its complexity and the introduction of extensive new terminology. IN9 (a) of the DP states that the preferred approach will not fundamentally change the existing classification outcomes of IAS 32. Although it might ultimately prove to be the case, Members emphasize that changes in this area could be pervasive and therefore entities would still need to undertake a comprehensive impact assessment to conclude on the magnitude of any impact on their financial statements.

As preparers of financial statements, Members reiterate the point made in the Discussion Paper, that IAS 32 is generally working and effective in practice. In particular, Members concur with the statement by the Board (par. 1.15) that it has "found little evidence that it needs to reconsider all, or even most of, the classification outcomes that result from applying IAS 32". The IASB further states (par. IN3) that it is not aware of any evidence to suggest that there were fundamental problems with IAS 32 during the financial crisis of 2007/08. Members also note that, following the crisis, the Basel III framework has been modified to strengthen the resilience of the banking sector by enhancing the regulatory capital framework. One of the modifications was aimed at raising the quality of the "capital base". Thus, Additional Tier 1 (AT1) capital must be comprised of instruments providing no incentives for their redemption. For these reasons Members would be concerned by the concepts proposed in the DP, if it were to affect the accounting classification of AT1 instruments, where redemption is prevented by law and regulation.

Members therefore do not feel that the existing guidance in IAS 32 is inadequate or unfit for purpose and question whether any perceived shortcomings at the moment would be better addressed through limited-scope revisions to IAS 32 and/or additional guidance, including additional disclosures to address information requirements identified by users. A more targeted approach of this kind would allow the IASB to allocate more resources to other projects, focussing on areas that are potentially in more urgent need of remediation. In particular, Members highlight the transition from IBORs to Risk Free Rates, the development of an effective Macro-hedging solution and the Goodwill and Impairment project as being more pressing concerns at this time.

This view is consistent with AFME's response to the Board's 2015 Agenda Consultation[1] in which our members advocated a more narrowly-focussed project which would address any specific difficulties encountered in applying IAS 32. This response was based on the premise that narrow-scope amendments to existing standards, targeted at where issues in their application are identified, are preferable to wide-ranging and fundamental changes that tend to be resource intensive and therefore have potential to divert attention from other priorities.

[1] AFME's response to the IASB's Request for Views: 2015 Agenda Consultation (23 December 2015)

Section 2 – The Board's preferred approach

Question 2

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?

AFME's Response:

AFME welcomes the IASB's efforts to resolve some of the challenges identified with the application of IAS 32 and are supportive of a result that does not fundamentally change the existing classification outcomes in IAS 32. In particular, we are supportive of providing a clear rationale for the distinction between debt and equity (par. IN9), and which strikes an appropriate balance between information provided through classification and that provided through presentation and disclosure.

Notwithstanding the above, the approach taken in the Discussion Paper does introduce a significant change to the principles of distinguishing between debt and equity, via the combination of the 'timing' and 'amount' features (par. 2.10). The change, if implemented, could have a material impact upon the financial statements of our Members.

The introduction of the 'amount' feature as 'an unavoidable obligation for an amount independent of the entity's available economic resources', introduces a series of new terms to the classification which, without clear definitions, are susceptible to interpretation differences, which may proliferate the diversity in practice that the DP is trying to reduce.

The 'timing' feature, 'an unavoidable obligation to transfer economic resources at a specified time other than at liquidation', may present challenges in defining what constitutes a 'liquidation' and how a 'resolution' or other similar events would be considered, particularly in the financial sector.

The result of the above is that a number of instruments that are currently classified as equity would be classified as liabilities, even though these liabilities are payable only at 'liquidation' of the entity. Members feel that this might be seen as creating a "mezzanine" category of instruments which we had understood the Board did not intend to do. Examples of such instruments impacted would include irredeemable cumulative preference shares (par. 3.23c) and certain perpetual cumulative hybrid securities that convert to shares if Tier 1 common equity falls below a certain level. This treatment can be viewed as inconsistent with the "going concern" basis upon which financial statements are prepared. It would also be inconsistent with the classification of the instruments for regulatory capital purposes. As mentioned above, the change in categorisation of some AT1 instruments represents a major concern for Members, with any such changes in classification having potentially material implications for the financial statements of those financial institutions that have such instruments and potentially the regulatory treatment of such instruments.

Moreover, applying the preferred approach to members' shares in cooperative entities raises concerns. Members emphasize that shares in cooperative entities that meet the criteria of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* and represent the most subordinated claims should continue to be classified as equity following the rationale used by the IASB in developing IFRIC 2. While the cooperative shares are classified as equity under IFRIC 2, the new concepts and definitions proposed in the DP create uncertainty in the interpretation and potential conflicts with the aim stated by the IASB to carry forward the accounting treatment of cooperative shares.

The Discussion Paper notes that the Interpretations Committee has been unable to resolve a number of submissions relating to IAS 32, however our Members express concerns that, given the breadth and complexity of change introduced by the new proposals, IFRIC may find that the volume of questions received will increase significantly, rather than decrease, as a result of their introduction.

Members note that presentation and disclosure are significantly impacted by the preferred approach in this DP, particularly with respect to equity instruments and that, whilst these enhancements may benefit users, they would result in a significant cost to preparers of financial statements. Therefore, Members believe that the costs to preparers for any proposals on the different types of disclosure should be thoroughly considered by the IASB.

Section 3 – Classification of non-derivative financial instruments

Question 3

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?

AFME's Response:

The Board's preferred approach has developed separate classification principles for derivative and non-derivative financial instruments.

A non-derivative financial instrument may contain more than one possible settlement outcome that might depend on future events or on the exercise of rights. If an entity does not have the unconditional right to avoid a settlement outcome that has one or both of the features of a liability, then the entity identifies that unavoidable obligation first and classifies that obligation as a non-derivative financial liability (par. 3.10).

The DP identifies that, whereas the consequence of an obligation to transfer cash or another financial asset is the same under IAS 32 and the preferred approach, in each case resulting in a financial liability classification, the second characteristic of a liability under the Board's preferred approach is based not on whether the number of equity instruments to be delivered is variable, but rather on whether the amount of the obligation is "independent of the entity's available economic resources". Members are concerned that as proposed this could be subject to different interpretations which would decrease comparability and consistency of financial information. Specifically, more guidance on the term "economic resources" would be necessary, were the preferred approach to be adopted by the Board.

Outcomes when applying the Board's preferred approach are noted in the DP to have many similarities to the requirements of IAS 32, however, the introduction of the 'amount' feature changes the categorisation of certain financial instruments, including certain AT1s and Contingent Convertibles, as previously noted.

Members suggest that additional guidance should be provided regarding the definition of a 'settlement outcome' and how the classification principles would apply for situations where the probability of one outcome happening approaches zero.

Under the proposal, an amount "dependent" on the issuer's share price would meet the equity criteria, as presumably the share price is considered to reflect the entity's "available economic resources", while an amount "dependent" on a contingency linked to a share price would not (for example, a bond that is mandatorily convertible into a variable number of shares with a cap). Such differences in classification, where the rationale for the distinction is unclear, may be misleading, both from a liquidity and a solvency perspective, and would potentially create structuring opportunities.

Furthermore, Members express concerns regarding the categorisation of instruments issued in a “foreign” currency (i.e. in a currency other than the functional currency of the entity). Members suggest that, where instruments are issued in foreign currency, the equity vs liability test should be performed in the currency of the instrument, rather than the functional currency of the entity, consistent with the SPPI test in IFRS 9. This reflects the fact that, for freely-tradable currencies, different currencies are essentially considered fungible instruments.

Members note that many entities currently issue equity instruments in foreign currency purely to allow them to access particular markets. For example, certain issuers of AT1 securities may struggle to issue in currencies other than EUR and USD, due to the lack of liquidity in a market dominated by EUR and USD issuance or because they would incur additional costs in doing so.

The difference in accounting treatment of AT1s issued in an entity’s functional currency and or in foreign currency, as equity and liability respectively, could lead to accounting classifications driving sub-optimal issuance decisions, and to increased difficulty understanding the financial statements, with similar instruments subject to different categorisation and accounting treatment. Comparability between companies could also be challenging where identically-, or very similarly-, structured instruments can potentially be treated as equity by some banks and liability by others, depending only on the functional currency of the issuer. In Members’ view, the classification of the instruments for prudential reporting purposes is considered by users of the accounts to be a more significant factor than the functional currency of the issuer. Moreover, Members find it counterintuitive that some AT1s could be classified as liabilities under the Board’s preferred approach given their economic purpose and structures preventing redemption until occurrence of certain resolution events.

The foreign currency issue is further complicated where the currency exposure in the foreign currency instrument is hedged back into functional currency, such that economically the exposure is equivalent to a functional currency issuance. Again, it is unclear why such hedged issuances would be treated differently from issuances in the functional currency of the issuer. Members are not supportive of the different treatment.

Question 4

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?

AFME’s Response:

The puttable exception was introduced in 2008 following constituents’ concerns regarding the requirement to classify certain puttable instruments as financial liabilities when they represent the residual claim to the net assets of an entity. These concerns are stated in paragraph BC50 of the Basis for Conclusions on IAS 32 and are restated in the Discussion Paper.

A limited scope exception was selected as a solution (IAS 32 BC55) to allow financial instruments puttable at fair value, that meet the specific criteria set out in paragraphs 16A and 16B of IAS 32, to be classified as equity.

A similar exclusion from liability classification was also introduced for instruments that entitle the holder to a *pro rata* share of the net assets of an entity only on liquidation, if a specific set of requirements are met.

Unfortunately, when applying the Board's preferred approach, a puttable instrument would continue to meet the definition of a financial liability, as the instrument contains an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation, with the concerns that precipitated the IAS 32 exception remaining largely unanswered.

As a result, and notwithstanding Members' concerns regarding the merits of introducing a change to IAS 32, Members feel that, to retain the consistency of classification from IAS 32, it would be important that the puttable exception be retained were the preferred approach to be introduced.

Further to Question 3 above, Members also question whether the principles proposed fundamentally achieve the desired purpose and are superior to existing classification rules, given that such an exception would remain necessary.

Section 4 – Classification of derivative financial instruments

Question 5

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?

AFME's Response:

Members are supportive of an approach under which derivatives on own equity are classified in their entirety, with individual legs not separately classified. Members feel that splitting derivatives into constituent legs would be complex and difficult to apply in practice, whilst generating comparability issues.

As with non-derivatives, the IASB's preferred approach introduces new terminology, as noted in our response to Question 2, such as the 'net amount' of a derivative. Additionally, a completely new terminology is used when referring to the classification of different types of derivatives (e.g. asset/equity exchanges, liability equity exchanges). Members generally consider that the introduction of the new terminology will create complexities to the application of existing requirements and introduce additional cost to preparers.

Whilst Members agree with the financial asset or financial liability classification for a derivative on own equity that requires the entity to deliver cash or another financial asset, and/or which contains a right to receive cash for the net amount, at a specified time other than at liquidation, they are less comfortable that this categorisation should also apply to derivatives on own equity under which the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.

For example, under IAS 32, rights, options and warrants to acquire a fixed number of an entity's own equity instruments for a fixed amount of any currency are equity instruments[2]. Under the preferred approach in the DP, classification of such a derivative where a fixed number of an entity's own equity instruments are acquired for a fixed amount of foreign currency would be categorised as a derivative asset or liability. This is because the net amount of the derivative is affected by the exchange rate, a variable that the DP considers to be independent of the entity's available economic resources and indicative of a liability. Members note that, although conceptual grounds for the different treatment are understandable, the outcomes in practice may present structuring opportunities and affect capital market decisions. Overall, Members are not clear why the classification should be driven by the currency of issue of the equity and why the proposed approach appears to reverse the previous decision to grant the foreign currency rights issues exemption in IAS 32. Members suggest that, were the preferred approach to be implemented, an exemption similar to the

[2] Providing the entity offers the rights, options or warrants pro-rata to all its existing owners of the same class of its own non-derivative equity instruments IAS 32 BC 4G

one on foreign currency rights issues might need to be introduced in relation to classification of derivatives with foreign currency being the only independent variable (par. 6.34), allowing issuers to classify such derivatives as equity instruments.

Members note that EFRAG's Draft Comment Letter[3] urges the IASB to reconsider the possibility of accounting for all derivatives on own equity as either assets or liabilities under the scope of IFRS 9, citing the simplification benefits of such an approach. AFME Members do not support this approach and consider that there is a class of derivative financial instruments that should be classified as equity.

Members feel that the IASB's preferred approach would replace something relatively simple with something that is complex, with Members noting that the existing fixed-for-fixed condition under IAS 32 is well understood and generally works in practice.

[3] https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520DCL%2520IASB%2520DP%25202018-1%2520FICE.pdf

Section 5 – Compound instruments and redemption obligation arrangements

Question 6

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?

AFME's Response:

Members have concerns about the treatment of certain financial instruments under the Board's preferred approach on compound instruments.

In particular, AT1 instruments with write down triggers would meet the definition of compound instruments under the Board's preferred approach, which might create additional complexities and diversity in practice.

There is a view that the liability component of an AT1 instrument would be materially equal to zero on a going concern basis at initial recognition, due to its perpetuity feature and that the value of the instrument would thus be fully attributed to the equity component. However, on meeting a "non-viability trigger event", as generally dictated by the breach of a CET1 ratio established by a Regulator, some AT1 instruments may be partially written down, creating a residual unavoidable obligation for an amount independent of the entity's available economic resources, which would appear to meet the definition of a liability component under the preferred approach. This might create complexities in relation to the subsequent measurement of such liability component. It is unclear whether it will still be possible to argue that the value of the liability component is materially equal to zero due to the remote probability of non-viability events or whether an ongoing assessment would need to be performed to determine the value of the liability component. Additionally, it is not clear whether, or how, the expectation of a call exercise on an AT1 instrument should affect the measurement of the liability.

Members also consider that clarification would be required more broadly on whether, and how, Regulators' viability decisions should be considered in classification of financial instruments in the scope of IAS 32. Members believe that divergence may arise in practice with regard to how "bail-in" features are considered in determining the classification of financial instruments by entities across different jurisdictions, given that some jurisdictions may require the non-viability triggers to be incorporated as part of the documented terms of the instrument, whilst for other jurisdictions the same viability covenants may exist only under legislation. More focused guidance would therefore be welcome in relation to classification of financial instruments in circumstances when regulatory bail-in features are required to be included in the terms of the financial instrument, which may make the feature contractual in form although only enforceable by the regulator in substance. Members' view is that a resolution situation is akin to a non-going concern basis and, as a consequence, bail-in provisions, whether they are statutory or regulatory or contractual, should not affect the accounting representation of these instruments as they are accounted for on a going concern basis.

As mentioned previously, Members note that the definition of "liquidation" in the context of the DP lacks clarity. In particular, it is unclear how it interrelates with regulatory viability events that may precede an entity's liquidation.

Members note that the concerns raised above with regard to financial instruments issued in a currency other than the functional currency of the entity would be equally relevant to the assessment of classification of compound instruments.

Overall, Members believe that the current IAS 32 principles on classification of compound instruments are relatively easy to understand and have served their purpose effectively. The attempt to re-articulate the existing IAS 32 requirements appears to be causing additional challenges as noted above. Members therefore suggest that a better approach would be for IAS 32 to be amended, with additional guidance accompanied by application examples addressing common questions or issues resulting from the evolution of financial products since the standard was initially issued. Members also believe that enhanced disclosure requirements providing details of the liability and equity components of the compound instruments along with the key contractual terms would be the optimal way to provide relevant information to the users of the financial information and improve its comparability.

Regarding the Board's preliminary views outlined in paragraphs 5.48(a)–(b), Members disagree with the outcome if the application of 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 par. 5.30 and as illustrated in paragraphs 5.33–5.34. Members understand that the Board's goal is to achieve consistency in accounting treatment between a compound instrument and a redemption obligation arrangement as described in par. 5.32. However, in Members' view the two instruments are fundamentally different economically, therefore it is not clear why same accounting treatment should apply.

Members also appreciate and welcome the efforts made by the Board to deal with the issue of written put options on NCI. However, as noted further in this document, Members are not comfortable with extending the use of OCI and it is not clear why these transactions would not be more appropriately considered as transactions with owners acting in their capacity as owners, and hence reported purely within equity. There is also a question why minority interests should be derecognised when a written put option is granted to NCI, as neither the right to dividends, nor the voting rights of the minority holders have been extinguished.

Section 6 - Presentation

Question 7

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?

AFME's Response:

Members have concerns regarding the Board's preliminary views stated in par. 6.53 (b), specifically in relation to the use of OCI with no recycling to the income statement arising from the financial instruments noted in 6.53 (b)(i-iii). Members understand that the use of the OCI category is considered to meet users' demand for information on the liability and equity components in compound instruments. However, Members note that increasing the use of the OCI category would exacerbate the inconsistency with IASB's new *Conceptual Framework for Financial Reporting* as it is arguable whether extending the use of OCI for the instruments referred to above would make profit and loss more relevant. Members see merit in the use of OCI to account for changes in own credit risk on financial liabilities designated under the fair value option, in accordance with IFRS 9 [IFRS 9.5.7.7], as this approach avoids counter-intuitive reporting of gains and losses arising from the changes in the entity's credit risk when re-measuring such liabilities at fair value. Additionally, the effect of the remeasurement of own credit risk reduces over time. In contrast, using the OCI category to reflect income and expenses from the financial instruments described in par.6.53 (b)(i-iii) will create further mismatches from the holder's perspective with IFRS 9, under which derivatives are recognised at FV though P&L and certain debt instruments can be accounted at FVOCI with recycling to P&L.

Members also feel that the OCI category is not well understood by many users of financial statements in comparison with P&L, therefore increasing the use of OCI is not likely to be beneficial for users of the financial statements and, if the rationale for this approach is not clearly set out, it may increase confusion over the significance of amounts reported in OCI.

Consistent with previous discussions, Members believe that introducing more granular disclosures on compound instruments, and on income and expenses attributed to their liability and equity components, would enable preparers to provide more relevant information to users of financial statements than would be achieved through changes in presentation of these instruments on the face of financial statements. Members note that par. 6.54 of the DP states that the additional presentation requirements, including the use of OCI, were developed to address information requirements associated with the 'amount' feature introduced by the DP as one of the criteria for classification of financial liabilities vs. equity. This links to previous points raised above in relation to the complexity of the concept and poses a question of whether introducing the new criterion is justifiable, particularly if it requires reporting of gains and losses through OCI to implement.

Regarding the question on whether separation of derivatives from the host contract would be required for the purposes of the presentation requirements per paragraphs 6.37-6.41, Members generally believe that the separation process would be complex, costly and thus impracticable for many instruments. This concern is consistent with the treatment of financial assets under IFRS 9 under the fair value option, whereby financial assets are classified in their entirety, rather than being subject to bifurcation requirements. IFRS

9 BCZ4.60 specifically notes that the ability for entities to use the fair value option is intended to mitigate some anomalies that result from the different measurement attributes and that it eliminates the burden of separating embedded derivatives. Members therefore welcome more granular disclosures on hybrid instruments reflecting their complexity and the increased need for relevant information about them. For example, Members believe that highly unusual instruments, in particular those falling under exceptions from the general requirements of the standard (such as put options written on non-controlling interests), should be disclosed separately from other categories of hybrid instruments. However, as discussed, separation of embedded derivatives from the host contract for presentation purposes is considered overly burdensome without improving the information available to users of the accounts.

Question 8

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?

AFME's Response:

Members generally agree that there could be some benefits to users of financial statements in assessing the distribution of returns among equity instruments in expanding the attribution of income and expenses to equity instruments other than ordinary shares. Whilst Members note that there are good academic arguments for developing such an attribution approach, they are concerned about the costs of such attribution compared to any benefits which might arise. In particular, Members think that the attribution of returns to other classes of equity might prove misleading, as it would not necessary reflect the real scenarios of distribution on liquidation. To avoid such misleading disclosures, greater clarity as to which instruments and under which assumptions the attribution of returns would be required. To fully apply this approach and ensure comparability of the attribution outcomes it could therefore require multiple scenario analysis and disclosures, which would then be very burdensome for preparers and difficult for users to understand.

Members are not in favour of the attribution mechanisms proposed by the DP for non-derivative and derivative equity instruments for the following reasons:

a) *Non-derivative equity instruments*. IAS 33 *Earnings per Share* is currently required to be applied only by listed companies. Parent companies who prepare combined consolidated and separate financial statements may prepare EPS disclosures on a consolidated basis only. The scope of the proposed attribution requirements appears to be broader than the scope of IAS 33. It is therefore unclear whether, and to what extent, entities which are currently not in scope of IAS 33 would need to apply concepts from IAS 33 and whether IAS 33 would need to be amended to reflect the extension of its scope to cover those requirements.

b) *Derivative equity instruments*. In Members' view, any of the attribution approaches proposed by the DP would be costly and complex to apply in practice, which also was acknowledged by the IASB in par 6.87 of the DP. Specifically, the proposed approaches would require entities to update the carrying value of the derivatives on own equity, which might not be practical and would create operational challenges when fair values cannot be reliably determined based on observable inputs. Furthermore, clarification would be necessary on whether the new requirements would be applicable to public companies only or would extend to other non-listed entities.

Members strongly support the view that the most appropriate approach would not be to attribute amounts to classes of equity but rather to enhance existing disclosures around the rights of different equity classes. Any expansion of the scope of these requirements would need a full assessment of costs versus benefits, as Members do not consider it appropriate to apply these requirements to all entities, particularly to wholly owned subsidiaries.

Members support the IASB's view, that providing more information about the different features of equity instruments would be useful for users of financial statements in assessing the distribution of returns among those equity instruments. Members therefore welcome the DP's discussion on enhancing the information about presentation of equity instruments with different classes and different features. However, there was a strong preference for this additional information to only be mandatory within the notes and optional on the face of the statement of financial position. Members note that the examples of such features provided by the DP in par. 6.56 (the priority of the claim on liquidation; pay-offs and contingencies; restrictions on dividends, buy-backs or other distributions) can be considered as suitable criteria to aggregate equity instruments into additional subclasses for the purpose of subsequent presentation and disclosure.

Section 7 - Disclosures

Question 9

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?

AFME's Response:

Members welcome the IASB's proposal to expand disclosures on financial liabilities and equity instruments with information about the priority of claims on liquidation, potential dilution of ordinary shares and information about terms and conditions of the financial instruments.

Members agree that the DP's proposals will help users of financial statements to better understand the entity's capital structure and the impact of financial instruments with characteristics of equity on the capital structure and returns.

a) *Priority on liquidation*. Members are in favour of the ability to elect to provide this information on the face of the statement of financial position, or in the notes to the financial statements. Members also generally support providing the information stated in par. 7.8 of the DP, however, equally agree with all the challenges identified in par. 7.10, especially for entities with a large number of financial instruments in scope and with complex capital structures. Members encourage the IASB to explore further the scope of these requirements and the best approaches for providing such information. Members note that the framework for Pillar 3 disclosure requirements contains templates for providing information on creditor ranking at legal entity level, from the most junior to the most senior exposures and requiring information about creditors including jurisdiction specifics. Members suggest that this framework be considered by the IASB in further work on developing disclosure requirements for priority of claims on liquidation. Members are in agreement that such disclosures should reflect the carrying amounts per the statement of financial position and that there is no need for additional fair value disclosures as the fair values will not reflect the real distributions at liquidation. Additionally, Members note that, for non-listed entities, measuring the fair value of derivatives on own equity may present significant challenges.

b) *Disclosures about potential dilution of ordinary shares.* Members believe that enhancing presentation (refer to section above on the aggregation of equity instruments on the statement of financial position based on different features) and disclosures about sources of potential dilution of the capital would be beneficial for users of the financial statements, providing forward-looking insight into potential changes in the capital structure, especially given the limitations of IAS 33 as mentioned in paragraphs 7.13 - 7.15 of the DP. Consistent with the comment mentioned in section above, clarification would be necessary whether the additional disclosure requirements would be required only for consolidated financial statements or whether they would also be required in separate financial statements of wholly-owned subsidiaries.

c) *Information about terms and conditions.* Members are generally supportive of expanding information on terms and conditions of financial liabilities and equity instruments. Members encourage the IASB to further explore approaches in arranging this information. It was noted that extensive information about terms and conditions is already provided as part of Pillar 3 reporting, and thus can possibly be leveraged in preparation of the respective disclosures for financial reporting purposes.

Although Members are generally supportive of the extension of disclosure requirements on financial instruments with characteristics of equity outlined in section 7 of the DP, they note that the proposed disclosures will incur additional costs to prepare the necessary information. Members therefore believe that it would be useful to understand from users of financial statements which information would be most useful for them and which could be viewed as less important and thus might not be mandated. In particular, it is considered that information would be most useful if provided in group financial statements at the parent entity level and that appropriate exemptions should be provided for wholly owned subsidiaries. However, it is also recommended that the IASB consider at what entity level certain information should be given (i.e., a legal entity is liquidated in practice not a group) and on what basis (i.e., going concern basis) it would be appropriate to provide such information as it can change significantly if certain triggers or legal protections, such as resolution, occur.

Section 8 – Contractual terms

Question 10

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?

Question 11

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?

AFME's Response:

Members welcome the IASB's discussion on the role of contractual terms for the purpose of classification of financial instruments. Members generally support the Board's view, stated in par. 8.3, that classification principles should be applied to the rights and obligations established by the contractual terms of a financial instrument, including obligations that are established indirectly through the terms of the contract. This is consistent with the requirements of IAS 32 and Members believe that the requirements have been well understood and applied in practice and are consistent with other standards, such as IFRS 9. Members agree with the Board's arguments set out in par. 8.21, noting that attempting to consider economic incentives in the analysis may raise more questions than it answers and they therefore concur with the Board's view that 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 equity instrument.

Members are also supportive of the view that the requirements in par. 20 of IAS 32 for indirect obligations should be retained. It was agreed that retaining these requirements would reduce structuring opportunities to achieve desired outcomes when classifying financial instruments, in circumstances in which the contractual terms make exercising a certain option always favourable (par. 8.24). Nevertheless, Members encourage the IASB to consider providing additional clarification and/or guidance on factors outside the contractual terms, but which may prevent certain settlement options from being exercised in accordance with the law or regulation (for example, restrictions on share issuance imposed by a shareholder agreement). Members also note that this issue should be considered taking into account IFRS 9 requirements and that it should be considered whether conclusions reached previously, as noted below, may no longer be appropriate in certain situations where there are explicit cash flow restrictions imposed by law or regulation. As noted in par. 8.35, in developing IFRS 9, the Board acknowledged that, as a result of legislation, some governments or other authorities have the power in particular circumstances to impose losses on the holders of some financial instruments. However, it was specified in IFRS 9 that when an entity assesses the classification of a contingent convertible financial asset it should limit the analysis to the terms and conditions in the contract. In other words, the holder would not include in its SPPI analysis the payments that arise only as a result of the government or other authority's legislative power, because that power and the related payments are not part of the contractual terms of the financial instrument [IFRS 9 BCZ4.60].

Members further highlight other aspects of the relationship between contractual obligations and law that would require additional research and guidance from the IASB. In particular, Members reiterate the challenges mentioned above within the response to Question 6 and associated with the “bail-in” instruments, whereby in certain jurisdictions entities are required to incorporate law or regulatory requirements in the documented terms of an instrument. There is a risk of the same financial instruments being treated differently from financial accounting and reporting perspective, depending purely on whether the law is reflected contractually, although the actual requirements applicable to the instrument will be the same. Members also note that the IAS 32 requirements follow the assumption that transactions occur based on agreement between parties to a contract, whereas law and regulation can be changed unilaterally by an authority without agreement from the counterparties. Clarification would thus be required for the instances where certain contractual terms need to be included in an agreement to comply with the legislative or regulatory requirements.

Members strongly recommend the IASB to further research the relationship between contracts and law as well as the associated issues and provide additional guidance on the distinction between contractual obligations and obligations arising through operation of law for the purpose of financial accounting and reporting.

Finally, Members welcome the fact that the IASB decided to retain IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments*. It should be noted that IFRIC 2 is widely used in Europe by cooperative banks. Although IFRIC 2 refers to relevant local laws and regulations in effect at the date of classification, Members agree that it was developed for a very specific fact pattern and should continue to be applied for the scope it was originally designed for.