International Accounting Standards Board

30 Cannon Street

London EC4M 6XH

United Kingdom

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Discussion Paper Draft DP/2018/1

Financial Instruments with Characteristics of Equity

Thank you for the opportunity to comment on the DP. Even though the current classification requirements in IAS 32 works fairly well for non-financial companies according to our experience, we agree that some of the issues described in the DP motivates standard-setting activity. However, we believe that the Board’s preferred approach is too far-reaching as it would require re-classification of certain instruments whose current classification is not considered a problem by the market. We can’t see that this consequence is justified. In addition, we are not in favour in the additional presentation and disclosure requirements proposed in the DP.

Yours sincerely,

CONFEDERATION OF SWEDISH ENTERPRISE

Sofia Bildstein-Hagberg
Senior Adviser Financial Reporting
Secretary of the Swedish Enterprise Accounting Group

+46734222617

The Swedish Enterprise Accounting Group (SEAG) represents more than 40 international industrial and commercial groups, most of them listed. The largest SEAG companies are active through sales or production in more than 100 countries.

Appendix

Comments on some of the specific questions posed in the DP.

Q1
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?

(a) We agree that classification of complex financial instruments under IAS 32 can be challenging and may lead to diversity in practice.
(b) We believe that the issues described are pervasive enough to require standard-setting activity. However, we are hesitant regarding the need for the far-reaching proposals in the DP. The issue of innovative exotic and compounded financial instruments are rare among Swedish non-financial listed companies. In our experience, such issues are more frequently found outside the publicly listed sphere of companies, typically in pre-IPO processes. Therefore, we do not believe that changes that would cause an unnecessary administrative burden on companies are justified.

Q2
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 summarized 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?

We believe it is possible to provide information about other features of claims through disclosures. However, we are not convinced that the Board’s preferred approach is the right way forward, see our response to question 3.

Q3
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?

From a theoretical perspective, the approach looks appealing via its simplicity. However, its application in practice would force entities to reconsider current classifications of financial instruments and may, from the perspective of the issuer, lead to undesirable effects. We don't believe these effects are justified, given the assumption of going concern and the economic substance of the financial instruments in question.

For example, the legal form of an issued preference share is that of an equity instrument and it is registered by the local authorities as such. There is no contractual obligation to pay any dividends, and just like ordinary shares any dividends paid are subject to a decision on the shareholders annual general meeting. There is neither a contractual obligation for the issuer to buy-back the instrument, nor any right for the investors to request buy-back, the instrument is thus perpetual. The preference share can be converted to ordinary shares, given that the shareholders annual general meeting decides to convert. In the case of liquidation, the claims of the holders of the preference share have priority over the claims of the ordinary shareholders, typically corresponding to the invested capital and compounded not paid out dividends. Such a preference share would, in our view wrongly, be classified as a liability under the Board's preferred approach, in contrast to the current classification as equity. Under the assumption of going concern, there is no contractual obligation to deliver cash or another financial asset to the investors. Such an obligation occurs only in the event of default, and any amount to be transferred at default will be dependent on available resources and liquidity at that point of time. Given the circumstances in a default situation, and the low priority of the preference share in relation to other claims, it is far from certain that the available resources are sufficient to settle the claims of the holders. On the contrary, in a default situation financial resources to settle claims on the issuer are likely to be scarce and it is reasonable to assume that the instrument in full, or partly, would never be settled. The current classification of preference shares with the above features as equity has, to our knowledge, not caused confusion or been considered a malpractice by the market. Thus, the motive for re-classification is difficult to see.

Q4
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?

We agree.

Q5
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:
(c) 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
(d) 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?

We believe that it is correct to maintain the current practice to classify derivatives in their entirety. Separating the individual legs is complex and would be difficult to explain to the users of the financial report. Concerning the classification criteria, we believe they should be consistent with the classification criteria for non-derivative instruments.

Q6
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 the most effective in providing the information, and why?

With regard to the preliminary view expressed in 5.48(a)-(b) we agree that the basis for an assessment should be the package of contractual rights and obligations.
We have no additional comments on question 6.

Q7
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?

We do not agree with the Board’s preliminary views. From our perspective, the current presentation requirements in IAS 1.55 are sufficient. We don’t think the proposed changes in the presentation requirements are justified from a cost-benefit perspective.

Q8
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?

We do not consider that there is any information gap in relation to this. The underlying information (dividend policy etc.), is already available. The amounts to be distributed among different equity instruments would be hypothetical. Further, such measurement would typically not only be dependent on IFRS group results but also from the accounts of the parent applying national GAAP. The inclusion of the information suggested could therefore be misleading and difficult to compare, thus triggering a need for reconciliation between IFRS and national GAAP. This would increase the amount of disclosures and cause an unnecessary administrative burden on companies, without any apparent advantage.
We agree that IAS 33 should be applied unaltered.
Other than that, we have no additional comments to this question.

Q9
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?

According to our view, sufficient information about the seniority of liabilities and equity is usually already provided to the holders of the instruments. In addition, significant terms and conditions are already subject to disclosure requirements under current IFRS standards. We therefore question whether additional information requirements are justified.

Q10
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?

(a) We agree with the Board's preliminary view. If economic incentives should be considered, it would trigger questions on the relative significance of those incentives. This in turn would increase uncertainty regarding the classifications as liability or equity and, most likely, trigger divergence in practice. In addition, if economic incentives were to be included as a basis for assessment, it would require frequent reassessments and reclassifications as incentives may change over time.
(b) We don't think it is a problem that the requirements in IAS 32.20 are retained.

Q11
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?

We agree with the Board's preliminary view that the classification criteria should deal with the contractual terms only, as we appreciate that including rights and obligations that arise from law would mean fundamental changes to the scope of IAS 32 and IFRS 9. Having said that, we think it would be beneficial to have more guidance on this matter to prevent divergence in practice.