Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2019:01

International Accounting Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Sirs,

Re: IASB Discussion Paper DP/2018/1 Financial Instruments with Characteristics of Equity

The Swedish Financial Reporting Board is responding to your invitation to comment on the Discussion Paper Financial Instruments with Characteristics of Equity.

Our overall position is that we support minor technical adjustments in IAS 32, but are hesitant to major revisions or changes in definitions and terminology if no changes in accounting treatment are intended:

We support the IASB efforts to identify and seek improvements of obvious flaws in IAS 32 but believe that the DP is too far-reaching and is also complicating an adoption to a revised standard by introducing changes in definitions and terminology that may cause changes beyond the intention of the revision. Our main concerns are:

- We support that the IASB continue to define equity as a residual interest, but the DP is taking it a step too far by increasing the focus on contractual terms and by that ignoring law, expectations and economic compulsion
- We do not support the DP when focusing the classification principles on liquidation when the underlying assumption is going concern
- Finally, the DP includes some more fundamental revision which we consider must be better anchored in the conceptual framework and be consistent with other standards

Below you find our detailed comments.

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Objective, Scope and Challenges

We support the IASB efforts to identify and seek improvements of obvious flaws in IAS 32, however we do not support major revisions. When making a more fundamental revision it must be anchored in the conceptual framework and consistent with other standards.

The proposals in the DP is too far-reaching by trying to find conceptual arguments for previous choices made. Descriptions and changes in terminology and definitions together lead to more far-reaching changes in IAS 32 than we support. The implications for preparers are that areas in IAS 32 that the IASB had not intended to change, still will need to be reviewed due to the changes in terminology and definitions, to make sure that no changes are needed in the present treatment of those items.

There is a need to review IAS 32. Financial instruments are more advanced today than when IAS 32 was issued. The development stems partly from financial engineering in general, but also from changes in regulation for regulated entities (e.g. BRRD and CRR/CRD IV). The frequent discussions within both IFRS IC and the IASB is another indication that a review is necessary. Therefore it is necessary to review IAS 32 with a certain regularity and, if needed, adjust the standard. However, this periodic revision needs to be made slowly and with care. Changes should only be made if being supported from a clear cost–benefit perspective.

The IASBs Preferred Approach

The DP rightly proposes definitions that at first glance seems to be close to present definitions in IAS 32. However, the actual usage in the DP of the proposed definitions and terminology indicates that the DP is more far-reaching than we support. Furthermore, some of the conclusions from using the definitions and terminology leads to counterintuitive classification as debt or equity that do not correspond to the substance of the instrument in question. We believe that such counterintuitive outcome is caused by the following basic choices in the DP:

- It is sufficient that just one parameter is not dependent on the residual value of the entity to classify that instrument as debt
- Law, economic compulsion and probabilities/expectations are ignored

One of the issues that we have identified is the focus on obligations at liquidation. We support the classification, that if an issuer is contractually obligated to repay an instrument at liquidation, that instrument is classified as a liability. However, since the DP only focus on contractual terms, ignoring economic compulsion and expectations from the market, the instrument will be recognized as equity anyway, since the present value of a payment of a notional amount when there is no intention to liquidate is zero.

This measurement methodology is in contrast to IFRS 9, which focus on the fair value of a host contract (in this case the notional amount) when separating a compound instrument into its components at first recognition. The fair value of the host contract is based on market expectations which the FICE DP proposes to be ignored.

A second issue with the focus on liquidation is applying the DP for residual interest. Firstly, such principles in the DP would be complex to apply since it may be difficult to conclude what relative interest a certain criterion has at liquidation. Depending on other facts and circumstances a criterion might give more or less rights to the residual interest than the rights of ordinary shareholders at liquidation. Therefore, it could be expected that such criteria would lead to variations in practice. Secondly, it is counterintuitive to classify instruments with less right to the residual interest than ordinary shareholders as equity and classify those with more rights to the residual interest than ordinary shareholders as liabilities, if the liability may be larger than the equity. Only instruments with equal rights to the residual interest should be classified as equity instruments.

Puttable Exception

We support the proposal in the DP to maintain the puttable exception. Furthermore, the exception could be widened to also include cases when law requires an entity to pay a minimum dividend to its shareholders.

Classification of Derivative Financial Instruments

We believe that the DP in some cases give an incorrect outcome, the reason being that it is developed based on simplified examples. One of these cases is the proposal that a derivative contract should be classified as debt or equity in its entirety. If maintaining that conclusion, there would be need to work with the definition of contract boundary. Even though we normally do not support focusing on the risk for abuse in standard setting, the risk for abuse in this case needs to be managed. A derivative contract may contain several different derivative contracts explicitly mentioned in the contract with characteristics either as debt or as equity. If that is the case, they may need to be separated when being classified.

Furthermore, the definition as debt or equity should take the reason for entering into the contract into consideration. The possibility to avoid paying for a liability by delivering the entity's own shares should not be considered when classifying an instrument as an equity instrument, if either paying or delivering shares leads to a value transfer between the present shareholders and the receiver of the shares.

Therefore, we propose that derivative contracts on own shares should be classified as liabilities if:

1. They are used as part of an investment bank activity (buying and selling on behalf of clients, market making, or trading activity) regardless of if these contracts are settled in cash or by delivering shares
2. If the shares are used as means of payments to a third party
3. If the number of shares being delivered are floating, representing a fixed notional amount, either in the functional currency of the entity or another currency

We support a classification of derivative contracts on own shares as equity if they are part of a share buy-back program.

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Presentation and Classification

We support the views in the DP that equity will continue to be a residual category. However, due to the difficulties to come up with an unambiguous definition, we suggest that the IASB should evaluate if one possibility could be to introduce a third category; hybrid capital, as a complement to the debt and equity categories.

The DP implicitly introduces further categories than debt and equity, by proposing different presentations. However, these proposed implicit categories are complex and will be difficult to apply in practice. We therefore propose that the IASB evaluates if one solution could be to introduce three explicit categories in IAS 32. Instruments that have both debt and equity characteristics are common. Furthermore, an instrument may have characteristics of debt at initial recognition but obtain equity characteristics if the solvency of the issuer declines. Such hybrid instruments may also be loss absorbing under the assumption of going-concern. They may even absorb losses before equity holders, but also contain rights to the residual value upon liquidation, before the equity holders.

Having a third category will presumably reduce the need for accounting for components separately as well as reduce the need for reclassifications. Only instruments for long-term financing should be classified in this third category. Speculative holdings would be accounted for as liabilities. Instruments in this third category should normally not be revalued. In many cases the value changes would be difficult to interpret. E.g. an increase in value attributable to an equity characteristic would have a negative effect on equity, while a decrease in value attributable to a debt characteristic would have a positive effect.

We do not support a revaluation in OCI of derivative instruments classified as debt instruments. They should be revalued in P&L. We do not consider that instruments classified as equity should be revalued at all.

The DP introduces similar evaluation criteria for derivative contracts and compound instruments. We do not agree. We see a fundamental difference between a derivative contract in which the net value of the contract is exchanged between the issuer and the holder and an instrument in which the full fair value is exchanged. Furthermore, in terms of loss absorption, a compound instrument bears losses in a fundamentally different way than a derivative contract.

Finally, the model developed in the DP seems to be based on simple compound instruments. To identify and measure several different embedded derivative contracts is complex and the fair value of each separate component may be arbitrary and dependent on in which order they are separated from the host contract. Therefore the final standard should be developed with care, as there is an obvious risk that the model will be too complex to apply compared to the benefits of applying it in terms of increased transparency. To introduce a hybrid category and complement that category with detailed disclosure requirements, including disclosures of the loss absorbing capacity of hybrid instruments in going concern, resolution and liquidation, may be both more transparent and more cost effective.

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According to the DP, equity instruments may contain different rights and obligations for the issuer and holder of that instrument. These differences may result in the allocation of different amounts of the residual return to different classes of equity instruments based on features that are not reflected by their classification as equity. These arguments may be right in theory, however any allocation model to capture this would be arbitrary in nature and the costs would exceed the theoretical benefits if being required. Instead relevant disclosures should be required to capture this.

Disclosures

We consider that the disclosure requirements proposed are reasonable and understandable. However, further disclosures are needed.

As mentioned earlier, the instruments are becoming more complex. Furthermore, laws and other regulations also affect the characteristics of the instruments. Therefore, there is a need to disclose the priority of financial liabilities and equity instruments both in liquidation, resolution and as going concern. There is also a need to disclose in which order these liabilities and equities have right to the returns of the entity.

The above requirements are especially relevant for regulated entities, as such entities are significant issuers of hybrid instruments and due to the fact that both BRRD and CRR/CRD IV affect the priority of loss absorptions and restrict the possibilities to pay coupons on these instruments. However, nothing hinders unregulated entities to issue instruments with similar characteristics as an alternative to share issuance.

With regards to information about potential dilution of ordinary shares, we believe the disclosures to be insufficient. More information is needed related to possible dilution compared to current requirements.

Finally, regarding information of terms and conditions. Regulated entities already have detailed comprehensive disclosure requirements. Therefore, it is important that the focus will be on principles rather than detailed requirements since there is a risk for overlapping requirements.

Contractual terms

Contractual terms cannot be used in isolation to conclude on the characteristics of an instrument, law must be considered. Firstly, the legal enforceability of contractual terms is dependent on law. Secondly, contractual terms normally complement law and may also replicate what already follows by law.

Further, economic incentives need to be considered when evaluating the characteristics of an instrument. E.g. contractual terms that are inserted in a contract just to fulfill legal requirements, that are genuine, but considered remote and therefore is not considered significant when calculating the fair value of an instrument, should not be decisive when classifying an instrument as either debt or equity.

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Finally, expectations need to be considered. Expectations are built into many financial reporting standards as well as the intentions of the holder or the issuer. It would be a significant step in the wrong direction to disregard expectations and intentions.

Stockholm 2019-01-02

Yours sincerely,

Anders Ullberg
Chairman

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