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International Accounting Standards Board
30 Cannon Street
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Berne, 21 January 2019

Comment Letter on the Discussion Paper "Financial Instruments with Characteristics of Equity"

Dear Madam, dear Sir

SwissHoldings, the Swiss Federation of Industrial and Services Groups in Switzerland, represents 57 Swiss groups, including most of the country's major industrial and commercial enterprises. We very much welcome the opportunity to provide comments to this Discussion Paper (DP).

Our detailed response (in the appendix) has been prepared in conjunction with our member companies.

We very much welcome that the IASB is addressing this topic. Whilst we have many comments to the Discussion Paper, and some criticisms of the current situation, we are very much appreciative that the IASB is taking concrete steps to improve matters and is engaging preparers and other stakeholders in this discussion. We would be more than happy to further contribute to this topic in due course.

Yours sincerely

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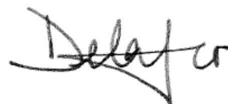
Federation of Industrial and Service Groups in Switzerland



Dr Gabriel Rumo
Director

Denise Laufer
Member Executive Committee

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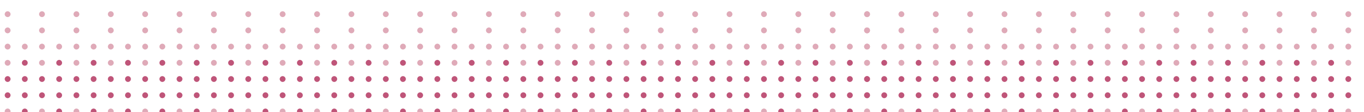

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APPENDIX

ANSWERS TO SPECIFIC QUESTIONS IN INVITATION TO COMMENT

SECTION 1 – Objective, 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?

We agree that it is complex to classify certain complex financial instruments issued by entities in a way that both meets IAS 32 requirements and provides financial statement users with relevant and understandable financial information. We welcome the Board's efforts to improve the existing guidance and consider that the challenges described in the DP justify the Board developing a standards-level solution.

We agree that improvements to presentation and disclosure are needed and that additional information would help users to understand better complex financial instruments issued by reporting entities, but we also urge the Board to consider the potential impact of the possible additional disclosures mentioned in Section 7 of the DP on the disclosure overload problem and on those projects in the Board's work plan which seek to address that problem.

SECTION 2 – The Board's preferred approach

Question 2

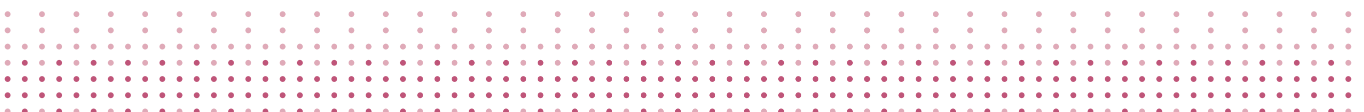
The Board's preferred approach to classification would classify a claim as a liability if it contains:

(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 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?



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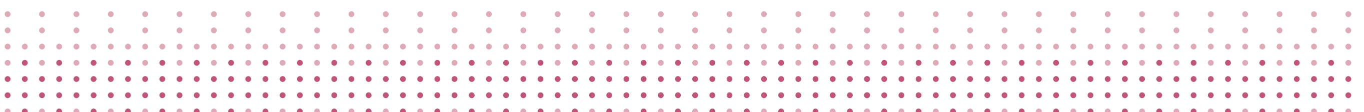
In our view, the Board's proposal:

- Has the following advantages:
    - It is underpinned by a rational and understandable principle which the DP then consistently applies to various issued financial instruments in Sections 3 and 4; and
    - the current classification of most instruments would not change under the proposal.

- Has the following disadvantages:
    - the Liability treatment proposed in the DP (see paragraph 2.36) for instruments that contain an obligation for an amount independent of the entity's available economic resources, but that do not contain an obligation to transfer cash or another financial asset at a specified time other than at liquidation, is inconsistent with the definition of a liability in the *Conceptual Framework for Financial Reporting* (the Framework) issued by the Board in March 2018. The Framework paragraphs 4.27-4.28 state that for a liability to exist, the entity must have an obligation to transfer an economic resource and paragraph 4.32 states that *"in some situations, an entity's duty..to transfer an economic resource is conditional on a future action that the entity itself may take…in such situations, the entity has an obligation if it has no practical ability to avoid taking that action".* A perpetual bond which has a fixed principal amount on issuance and in which all subsequent cash flows, including repayment of principal and interest, are at the issuing entity's discretion except when that entity is liquidated, is not a liability according to the Framework paragraph 4.32 because the entity does have the practical ability to avoid transferring resources to meet the claims of the instrument if the going concern assumption is applied in the entity's financial reporting. In our view, instruments of that type should continue to be classified as equity and to that extent, we do not agree with the Board's preferred approach.
    - the DP acknowledges that the instruments described in the immediately above bullet are different from other instruments that would be classified as Liabilities under both the DP and the Framework Liability definition. It proposes to distinguish these different types of instruments from each other only through specific presentation and disclosure requirements. That approach is rejected elsewhere in IFRSs, for example in IAS 1.18, and applying it to perpetual instruments with cash flows at the issuer's discretion would make their presentation more complex for a user to understand and would add to the overall disclosure burden. For that reason, we do not agree with the Board's preliminary view that an issuer of perpetual instruments with a fixed nominal amount but without non-discretionary cash flows should classify those instruments as liabilities and clarify only through presentation and disclosure in its financial statements that it can avoid transferring any resources in respect of those instruments.
    - it does not solve the problem which led to the creation of the 'puttable shares' exemption in IAS 32.16C-16D.
    - preparers and auditors would have to reconsider current classification decisions of complex instruments, a process that would incur additional costs and lead to uncertain consequences for those entities that have issued instruments



classification of which would change under the DP proposals, especially perpetual instruments.

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?

See our answer to Q2 above.

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?

We agree, for the same reasons that led the Board to propose the puttable exception to IAS 32 originally.

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?

In our view, the Board's approach has the following advantages:

- it applies the same principle as the DP applies to non-derivative financial instruments;
- by classifying derivatives in their entirety, it avoids the complexity that would inevitably result if a single derivative were required to be separated into two or more components; and
- classifying derivatives in their entirety is consistent with the guidance on unit of account in the Framework, especially Framework paragraph 4.53.

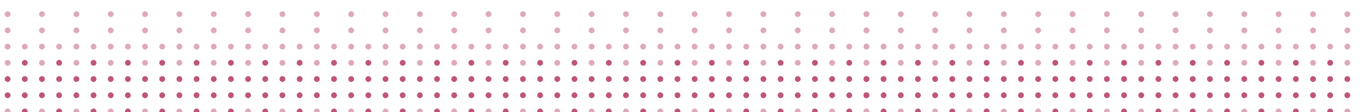
For the above reasons, we agree with the Board's proposals in respect of both points a) and b) as described above. In our view, the issue of perpetual instruments we raise in our response to Q2 above does not apply to derivatives because the definition of a derivative in IFRS 9 includes the requirement that it be settled at a future date.

SECTION 5 - Compound instruments and redemption obligation arrangements

Question 6

Paragraph 5.48 states that applying the Board's preferred approach, an entity would:

(a) for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the non-derivative equity instrument that will, or may, be extinguished. Once identified, the package of the contractual rights and obligations would be analyzed for classification purposes consistent with a compound instrument.



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(b) for a compound instrument or a redemption obligation arrangement, classify separately the financial liability and equity components. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:
(i) classify that unavoidable contractual obligation as a non-derivative financial liability, applying the non-derivative classification principle of the Board's preferred approach; and
(ii) classify any remaining rights and obligations as an equity instrument, a financial asset or a financial liability, applying the derivative classification principle of the Board's preferred approach.

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 accounting for a written put option as follows:

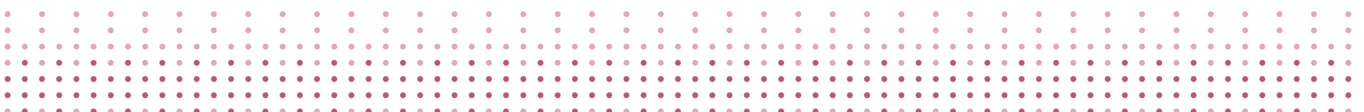
(a) a financial liability would be recognized for the present value of the put option strike price.
(b) the units of the entity's own shares under option would be derecognized at fair value at the date when the written put option is issued.
(c) the remaining rights and obligations (the difference between the sum of the amounts (a) and (b), and the premium received for the written put option) would represent the option of the holder to waive their right to exercise the put and receive the amount recognised in (a) in exchange for the ordinary shares remaining outstanding. Such an option is similar to a written call option or conversion option in a convertible bond. An entity would classify this component as a financial asset or a financial liability, or an equity instrument in accordance with the derivative classification principle.

Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not?

We agree because under this approach, instruments with differing legal form but the same economic outcome, as discussed in the DP paragraphs 5.3-5.5, will be classified and accounted for in the same way. In our view, this advantage justifies a departure from the Framework unit of account guidance mentioned in our response to Q5 above. Under that guidance, the derivative would not be separated in the way proposed in the DP paragraph 5.48(b).

Paragraph 5.48(c) states that if an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that have the feature(s) of a financial liability, the financial instrument does not contain a financial liability component. 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?



We are not aware of practical problems in accounting for the type of instrument described in paragraph 5.48 (c), but we agree that the Board should address the issue in order to provide comprehensive guidance.

Section 6— Presentation

Question 7

Paragraphs 6.53-54 state that In the Board's preliminary view, to facilitate assessments of balance-sheet solvency and returns, an entity should:

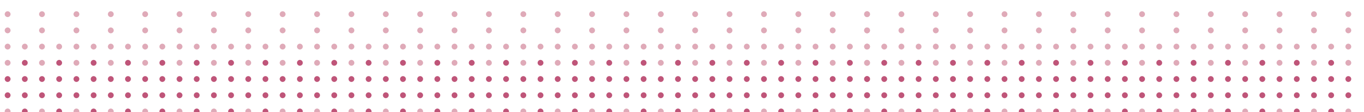
(a) in the statement of financial position, present separately carrying amounts of:
(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;
(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and
(iii) partly independent derivatives that meet the criteria in paragraph 6.34.
(b) in the statement of financial performance, present in OCI, without subsequent reclassification, income and expenses arising from:
(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources.
(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and
(iii) partly independent derivatives that meet the criteria in paragraph 6.34 (the only independent variable is a currency other than the entity's functional currency; the foreign currency exposure is not leveraged and does not contain an option feature; the denomination in the foreign currency is imposed by an external factor)

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

In our view, the correct approach to such instruments, which differ from other liabilities, is to provide the relevant information through their classification and disclosure of their nature and terms, and not to complicate further the presentation requirements of IAS 1.55. We doubt the value of having detailed separate presentation requirements for very specific and complex instruments which are not so widespread in practice. The more complex the presentation of these instruments, the less understandable the information they convey will be to financial statement users. We doubt whether adding yet further income and expense items to the growing list of items already presented in OCI would enhance the overall quality of financial statement information, especially as the DP proposes that these items not be subsequently reclassified into profit or loss, regardless of the principle stated in paragraph 7.19 of the Framework that items presented in OCI should be so reclassified.

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?

If separate presentation requirements are to be applied to any type of instrument, we prefer alternative A in paragraph 6.38 under which such requirements would apply only if the embedded derivative is separated for measurement or if the associated hybrid contract as a whole meets the



DP criteria for separate presentation. In our view, the cost and effort needed to separate embedded derivatives for the purposes of applying the DP's presentation requirements even though the hybrid contract containing them is measured as a whole at fair value through profit or loss, would exceed the associated benefits.

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?

We are of the view that separate attribution of the aggregate income and expense to parent company equity holders as a whole and to holders of non-controlling interests as a whole is sufficient. Amounts actually distributed to holders of different classes of equity are often determined from financial statements prepared under local statutory accounting principles which differ from IFRS. To provide information of any practical value about likely future distributions to holders of different equity classes, it would be necessary to present in the IFRS financial statements a full reconciliation between income, expense and equity in accordance with IFRS and in accordance with the applicable statutory principles which determine distributable profits.

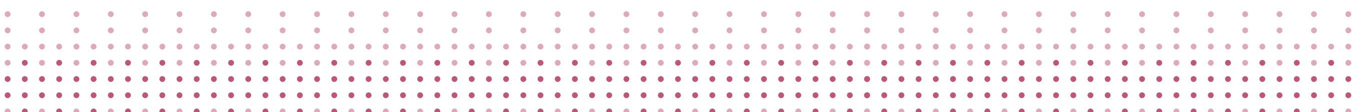
The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

We agree.

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?

In our view, none of the above three approaches to attributing the entity's comprehensive income would provide useful information because they attribute a purely notional share in that income to convertible or derivative instruments that would not be entitled to that attribution if they were converted or exercised. It merely shows opportunity costs which general purpose financial statements are not designed to show. For this reason, we favour approach (d).



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Section 7—Disclosure

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?

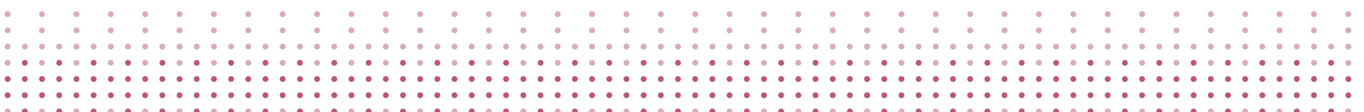
How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

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

We agree with the proposed priority disclosure ((a) above) although we believe that the value of such disclosure is likely to be confirmatory, because many holders of financial instruments will already have obtained the priority information they need when subscribing for or purchasing the instrument.

We agree with the proposed dilution disclosure.

We agree with providing information about contractual terms of issued financial instruments on condition that the level of detail required is proportionate to the complexity of the instrument. Extensive disclosures should not be required for "plain vanilla" debt instruments.



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?

We agree with the Board's preliminary view. We believe that considering economic incentives would increase uncertainty regarding whether financial instruments have been classified correctly. The judgements made about classification would have to be reconsidered at each reporting date because the entity's circumstances, and therefore the impact of economic incentives relevant to its decisions, will change with time. This could lead to certain instruments being reclassified frequently from liability to equity and vice versa. This would tend to make the financial statements less understandable. In our view, the correct approach to depicting such instruments in financial statements is to require disclosure of their contractual terms and the associated economic incentives.

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?

We agree in principle that an instrument should be classified based on its contractual terms. However, as the issue of mandatory tender offers has led to some debate we believe that the Board should provide specific guidance on such situations to ensure consistency of IFRS practice. It seems reasonable to us to interpret the requirements of a contract with regard to the context of the law that applies to the contract at the reporting date, because a change in that law can effectively modify a contract. IAS 32 paragraph 16F(a) does envisage that an instrument that meets the criteria for classification as equity when it is issued might subsequently cease to meet those criteria and consequently be reclassified as a liability. Therefore, if the law gives non-controlling shareholders a right to put their shares to the entity or requires the entity to offer to purchase their shares, the entity implicitly has a present obligation at the reporting date, even though such an obligation is not an explicit part of the contractual relationship with the non-controlling shareholders and has arisen only because of events that occurred in the current accounting period. In our view, in that situation the entity should recognize a liability.