Comments on DP/2018/1 Financial Instruments with Characteristics of Equity

Thank you for the opportunity to comment on DP/2018/1 Financial Instruments with Characteristics of Equity. We appreciate the effort of the IASB to develop a more rigorous and consistent definition of equity. In this comment we focus on consistency in the definition of equity, and therefore we respond only to Questions 1 and 2 in the Discussion Paper (DP).

As a background, the question of how to distinguish between liabilities and equity has recently been much debated in Sweden in the context of IFRS 17 and mutual insurance entities, owned collectively by their policyholders. In IFRS 17, the Board argues that insurers that are mutual entities normally do not have any equity (BC 265). This view is inconsistent with current accounting practices in Sweden, where mutual insurance entities distinguish between policyholders’ guaranteed and non-guaranteed claims, and classify the former as liabilities and the latter as equity. Current accounting practices are supported by the notion that equity is synonymous with loss-absorbing capital that entities are required to hold by financial regulations such as Solvency II (Directive 2009/138/EC). The Swedish mutual insurance entities find it ‘strange’ that what is defined as capital in Solvency II would not be considered equity in accordance with IFRS.

In the DP, the Board’s preferred approach relies upon the existence or non-existence of an obligation in relation to specified amount and timing features. Classification as equity will only result if there is no obligation in relation to both features. In the process of developing IFRS 17, on the other hand, the Board proposed an approach in which the existence or non-existence of an obligation is not decisive for the distinction between liabilities and equity. It then advocated an approach whereby the cash flows included in the measurement of the liability should not be limited to those for which a legal or constructive obligations exists (ED, 2010, BC 70). In other words, the non-existence of an obligation does not preclude a classification as liabilities.

The logic of classification as equity in IFRS 17 is based on the definition of insurance liabilities. As all reserves reported by mutual insurance entities will be distributed to existing or future policyholders, it is—with the definition in IFRS 17—logical that all reserves are classified as liabilities. It is, however, inconsistent with the Board’s preferred approach in the
DP. Mutual insurance entities have reserves where there is no present obligation to transfer economic resources at a specified time. In addition, these reserves involve no obligation to transfer a specified amount that is independent of the entities’ performance. Therefore, based on the Board’s preferred approach mutual insurance entities may very well report positive equity.

Our responses to Questions 1 and 2 in the DP are:

- **Question 1**: We agree that the objective to achieve consistency in the definition of equity is an important one.
- **Question 2**: While we support the Board’s preferred approach based on its practical applicability, we see it as problematic that the approach leads to inconsistencies with IFRS 17.

To the extent that the scope of the DP only encompasses financial instruments, insurance contracts are outside the scope. Still, we find it problematic that there are conceptual inconsistencies between the proposed approach and the latest standard issued by the Board.

A possible solution could be to provide additional discussion and examples of the meaning of the term ‘obligation’, both legal and constructive, for example as it pertains to the case of mutual insurance entities.

Sincerely Yours,

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