DRSC e.V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

United Kingdom

Berlin, 14 May 2008

Dear David,

IASB Discussion Paper Financial Instruments with Characteristics of Equity

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Discussion Paper "Financial Instruments with Characteristics of Equity". We appreciate the opportunity to comment on the discussion paper and its main content, the FASB Preliminary Views on this subject.

We consider the distinction between equity and liabilities to be one of the most important issues that are currently on the IASB's agenda. Developing a successor of IAS 32 is a task of high importance for the IASB, as we believe IAS 32 to be fundamentally flawed, although we acknowledge that the amendments to IAS 32 of 2008 accommodate some of the most apparent problems. In our view, the project's aim is to discuss different starting points for developing a successor of IAS 32 and that successor should improve financial reporting by

- discussing potential criteria on which a principle to distinguish equity from debt could be based on,
- developing an approach to distinguish equity from debt based on a principle that is applicable by a broader range of entities in different legal forms and across jurisdictions and that leads to decision-useful information for a broader range of users,
- while avoiding the deficiencies of IAS 32.

We would thus have expected the FASB Preliminary Views to start with a comprehensive discussion of different criteria and whether or not an approach to distinguish equity from liabilities, if based on one or more of those criteria, leads to decision-useful information. The FASB Preliminary Views however do not contain such a discussion. Even the principle behind the chosen criteria is not explained, let alone discussed. Why, for example, is the definition of a basic ownership instrument based on the level of subordination in a hypothetical liquidation, while redeemable ownership instruments are required to be redeemed at the fair value of the instrument? Where is the principle that reconciles those two criteria to each other?

The issue is also of a cross-cutting nature, as the distinction between equity instruments on a standard level, the definition of a non-financial liability in IAS 37 and generally equity and liabilities on a Framework level all interact and need to be consistent. Due to this interaction, we think that the scope of the project is not appropriate.

- On the one hand, the FASB Preliminary Views are limited to financial instruments (i.e. equity instruments). We would have thought that any new approach to distinguish between equity and debt should contain an answer for *all* kinds of capital and not only for financial instruments. A number of items, such as retained earnings, might currently not be classifiable on a standard level (i.e. IAS 32), due to not meeting the definition of a (contractual) financial instrument. Their classification is based on the Framework alone.
- On the other hand, the FASB Preliminary Views touch a number of issues, (such as measurement, accounting for derivatives and earnings per share), which we deem to be outside the scope of the project. We do acknowledge that these issues need to be addressed later on. However, in our view, this project should focus on discussing the *classification* of capital as either equity or debt and not *accounting* for financial instruments.

We think that in the FASB Preliminary Views and the IASB Discussion Paper more consideration should have been given to two other areas:

- the application of the discussed approaches within a group context and
- the implications of choosing either the proprietary view or the entity view for financial reporting (this question interacts with the Framework project as well).

Overall, we are disappointed that the FASB Preliminary Views fail to discuss a number of questions that we think are essential when evaluating alternative starting points for developing a new approach to distinguish equity from liabilities. Conversely, we think that the PAAinE Discussion Paper on the same topic not only gives more consideration to those issues we deem to be essential, but also develops, from first principles, the Loss Absorption Approach and explains why this approach provides a broader range of users with decision-useful information for entities in different legal forms across different jurisdictions. While we acknowledge that both the FASB's approaches and the Loss Absorption Approach are not yet fully developed, we are convinced that the IASB should give more consideration to the Loss Absorption Approach as a starting point.

Please find our detailed comments in the appendices to this letter. If you would like to discuss the issues set out in this comment letter, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr

President

General comments

Evaluation of the proposals within the context of IFRSs

We comment on the IASB Discussion Paper referring to the FASB's approaches within the context of IFRSs. This has two implications:

1) We evaluate the FASB's approaches in the light of whether or not they are suitable starting points for developing a successor of IAS 32.

2) As we are looking for a successor of IAS 32 within the context of IFRSs, the approach must be applicable by entities in different legal forms across different jurisdictions. This includes not only listed entities, the shares of which are publicly traded, but also entities that, for example, foresee put rights of the members in lieu of a trading mechanism for the shares. In the context of US-GAAP, this question may be of secondary importance or largely irrelevant, as US-GAAP are primarily intended to be used by listed companies. We do also acknowledge that FASB Board Member M. Crooch noted during the FASB Board Meeting on 30 May 2007 that "the approach would have to be adjusted for certain entities who may not have issued any instruments that meet the definition of equity under the ownership approach as it is currently described. For example, certain entities only issue 'equity' instruments which are redeemable at other than fair value upon the death or termination of employment of the holder. Often these entities are small, family-owned private companies."

   The IASB puts the FASB's approaches up for discussion whether they are suitable starting points for developing an approach to distinguish equity from debt in an *international context*, for entities in different legal forms, some of those entities potentially being unlisted. We would therefore have expected more consideration being given to this issue in the context of the IASB Discussion Paper.

As already stated in our accompanying letter, developing a successor of IAS 32 based on a suitable starting point is a task of high importance for the IASB, as we believe IAS 32 to be fundamentally flawed. While we acknowledge that the amendments to IAS 32 of 2008 in relation to "puttable instruments" and "liabilities arising on liquidation" accommodate some of the most apparent problems, they also demonstrate

- that the principle in IAS 32 has flaws that may lead to a lack of relevance and understandability in certain situations (see par 51 of the Basis for Conclusions of IAS 32 (rev.2008)),
- how difficult it is to derive exemptions from a general principle, and
- that a fundamental review of the principle itself is warranted.

Zimmerstr. 30 · 10969 Berlin · Telefon +49 (0)30 206412-0 · Telefax +49 (0)30 206412-15 · E-Mail: info@drsc.de
Bankverbindung: Deutsche Bank Berlin, Konto-Nr. 0 700 781 00, BLZ 100 700 00
IBAN-Nr. DE26 1007 0000 0070 0781 00, BIC (Swift-Code) DEUTDEBB
Vereinsregister: Amtsgericht Berlin-Charlottenburg, VR 18526 Nz

Decision-useful information?

In our view, the first questions to ask would be

a) what the conceptual grounds are for choosing certain criteria (and thus, for the approach) for distinguishing equity from liabilities, and

b) whether an approach, if based on those criteria, provides the users of financial statements with decision-useful information.

Regrettably, the FASB Preliminary Views are silent as to what are the conceptual basis underlying the detailed requirements and the chosen criteria. As already set out in our accompanying letter, we were disappointed to see that the FASB Preliminary Views contain hardly any arguments as to why the FASB approaches are deemed to provide decision-useful information. We would have expected an in-depth discussion of different criteria on which an approach for distinguishing equity from debt could be potentially based. We would have expected a thorough discussion of why one criterion (one approach) would lead to information that is more decision-useful than information provided by an alternative approach based on other criteria. Without such a discussion, one cannot evaluate whether or not there might be other approaches that provide the user of the financial statements with more decision-useful information.

A closer look in the Basis for Conclusions reveals, in par. 51, the reasons why the FASB has chosen to state a preference for the Basic Ownership Approach, with simplicity being an overriding consideration for some Board members:

> *a. It classifies all derivatives on an issuer's basic ownership instrument as liabilities or assets.*
>
> *b. An instrument's form of settlement is not considered in determining classification.*
>
> *c. It provides the users of the financial statements with a clear distinction between the interests of different classes of stakeholders.*
>
> *d. It classifies only claims that fully participate in the residual as equity, which some Board members believe represent the ownership interests of the entity.*

While we acknowledge that simplicity is some sort of a constraint, it is certainly not the overriding consideration. Rather, the aim of any approach should be to provide the users of financial statements with decision-useful information. Unfortunately, the FASB Preliminary Views are silent on why the approach meets this aim. Reason c) above is a paraphrase of the aim itself and not a reason. Reasons a) and b) are merely results of the chosen approach. Whether or not reaching those results enhances the decision-usefulness of the approach would be the relevant question, but the FASB Preliminary Views do not discuss this. Reason d) can hardly be considered an argument, rather is it expressing a belief. Again, we would have thought that this assertion should be supported by comprehensive, plausible argumentation.

Applicable to a broad range of entities in different legal forms?

If one reaches the conclusion that an approach provides the users of financial statements with decision-useful information, one may ask whether the approach is applicable by a broad range of entities in different legal forms and thus, feasible to be implemented in an international context. We can imagine at least one situation in which the approaches discussed in the FASB Preliminary Views would be difficult to implement.

In a number of jurisdictions, members' shares of entities in certain legal forms are puttable at the option of the holder (e.g. France, Germany, the Netherlands, New Zealand, Poland, Spain, United Kingdom, USA). In some jurisdictions, the shares are puttable by law. The law does not foresee this put right as an additional benefit for the investor, but - absent a trading mechanism - as the (only) possibility of the holder to reverse his/her investment decision. Sometimes, applicable law foresees the interests to be puttable at an amount determined based on the separate financial statements of the entity. In some jurisdictions the redemption amount is determined by reference to the *separate financial statements* and those statements might be prepared *in accordance with local GAAP.* This may even be a legal requirement in some jurisdictions. Although we acknowledge that allowing the book value to be determined in accordance with "any GAAP" without giving any consideration as to how this GAAP measures book value seems not appropriate, we are also concerned that any requirement based on redemption to be determined with a view to IFRSs is potentially conflicting with applicable law in many jurisdictions.

Application of the approaches within a group context

Par. 29 of the FASB Preliminary Views state that "instruments would retain their basic ownership nature in the consolidated financial statements unless their characteristics are different in the context of the consolidated financial statements."

The example given is not helpful, though. The more important issue is that some criteria, such as subordination, may work well within the context of a single entity, but become far more complex when applied within a group context. The definition of a basic ownership instrument is based on subordination and thus is fundamental for all of the three approaches. The problems that arise when subordination and other criteria are applied within a group context are twofold: Structuring opportunities and inconsistencies. The FASB Preliminary Views discuss neither.

In addition, we would like to highlight that the IASB reached the opposite conclusion in its re-deliberations of the Exposure Draft on "puttable instruments": While the FASB takes the view that instruments that embody the "lowest priority claim" (i.e. are in the most subordinated class, par. 18a) retain that classification in consolidated financial statements (par. 29), the IASB takes the view that "such instruments [are] not the residual interest in the consolidated financial statements." (see par. 68 of the Basis for Conclusions of IAS 32 as revised 2008). Those two conflicting views clearly demonstrate that much more consideration needs to be given to this issue than is currently contained in the FASB Preliminary Views.

Furthermore, "subordination" is, according to the FASB Preliminary Views, to be determined *legally* (see footnote no. 2 on page 5 and par. 18 of the FASB Preliminary Views). This requirement, when applied within a group context, is not workable in those jurisdictions where law foresees liquidation to be performed on an entity-by-entity basis, such as Germany. It is unclear to us how this requirement would be applied to a group, since the group is not subject to liquidation procedures. Only single legal entities can be liquidated, and the level of subordination can only be determined with a view to the single entity. If applied within an international context, we note that, since „subordination“ is to be determined legally, the very same instrument could be classified differently across jurisdictions, depending on the applicable law.

Implications of choosing either the proprietary view or the entity view for financial reporting

We think that choosing either the proprietary view or the entity view for financial reporting is fundamental for a number of areas of accounting. Those areas are not restricted to consolidation or additional disclosures to be given in separate financial statements, but include distinguishing equity from debt. For example, the classification of obligations to issue own equity instruments depends largely on the chosen view. Choosing one of those two views and consistently applying the chosen view is also fundamental in achieving consistent accounting results. In this respect, we disagree with the last sentence in par. 60 of the FASB Preliminary Views: The classification of obligations to issue own equity instruments is based largely on this very view, the approach to distinguish equity from debt is of secondary importance in this respect.

FASB's questions to respondents

Part 1: Questions on the Basic Ownership Approach

Question 1
• Do you believe that the basic ownership approach would represent an improvement in financial reporting? • Are the underlying principles clear and appropriate? • Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

In order to assess whether an approach represents an improvement in financial reporting, one must first

a) define the starting point against which the improvement is to be evaluated and

b) define criteria against which "improvement" can be evaluated.

The starting point

We think that, within the context of US-GAAP, a single standard that covers the classification of all financial instruments represents an improvement when compared with the present situation, in which the classification is dealt with in over 60 pieces of literature. However, as set out in our general comments, we are going to comment on the FASB Preliminary Views and on the Basic Ownership Approach within the context of IFRSs, i.e. whether the approach would be suitable for developing a successor of IAS 32.

Improvement compared to IAS 32?

As already set out in our general comments, any approach to distinguish equity from liabilities should

- be based on a principle,
- provide decision-useful information for a broad range of users for entities in different legal forms across different jurisdictions,
- meet the qualitative characteristics of the Framework,
- avoid the deficiencies of the present approach in IAS 32.

In this respect, while we concur with the FASB's stated preference for the Basic Ownership Approach over the other two approaches, we are not convinced that the Basic Ownership Approach would represent an improvement to financial reporting. As already set out in our general comments, we would have expected a thorough discussion of different criteria on which an approach for distinguishing equity from debt could be potentially based on, followed by convincing arguments as to why the chosen criteria are preferable over other criteria that have not been chosen and why the FASB approaches are deemed to provide decision-useful information.

Regrettably the FASB Preliminary Views are silent as to what the conceptual basis underlying the detailed requirements and the chosen criteria are.

With regard to the *second question*, without such a discussion, we feel unable to comment on the *appropriateness* of the chosen criteria. We are not convinced that the *criteria* chosen to define a basic ownership instrument are *clear*, for example, we asked ourselves whether

- the Basic Ownership Approach would allow for two different classes of instruments be classified as equity, with one class being redeemable, the other being non-redeemable, provided both instruments' claims on liquidation would have the lowest priority and are of equal priority compared to each other? If yes, we note that this conclusion contradicts IAS 32 (rev. 2008), which denies this possibility.
- how the term "impair" would be interpreted in this context: Par. 20b states that „the terms of the instrument prohibit redemption if redemption would impair the claims of any instruments with higher priority than other basic ownership instruments".

Furthermore, we feel unable to identify the *principle behind* the chosen criteria. If, for example, subordination is the principle behind the criteria for basic ownership instruments – how does this principle relate to the result in par. 21 that a redeemable instrument must be redeemable at the fair value of the instrument? In our view, the

- fair value of the instrument,
- the pro-rata share of the fair value of the entity and
- the share of the issuer's net assets to which the holder would be entitled if it were to liquidate

represent three completely different amounts. While we can see the relation between the subordination-principle and the third of those three amounts, we fail to see the relation between subordination and the first two.

With regard to the *third question*, we are not convinced that the Basic Ownership Approach itself would simplify accounting. Even if this is the case, simplicity is a constraint, but no overriding consideration. Simplicity is preferable, but not sufficient by itself. Similarly, avoiding structuring opportunities is desirable, but an approach to distinguish equity from debt that provides decision-useful information may not be discarded simply because it may open up structuring opportunities in some situations. Put differently, only if there are alternative approaches that all provide decision-useful information at a similar degree, a simple approach that does not open up structuring opportunities would be preferable. The criterion of providing decision-useful information is the most essential one, however, it is neither discussed nor supported by a plausible line of argument in the FASB Preliminary Views.

Perpetual Instruments, Question 2:
Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities.

- What potential operational concerns, if any, does this classification present?

We assume that the term “preferred shares” as used in the FASB Preliminary Views refers to a certain financial instrument common in the US and other jurisdictions, although the particular characteristics of this type of preferred shares are not explicitly stated. Clearly, the classification is based on the nature of the preference, which is why it would have been helpful if the exact terms and conditions of the “preferred shares” had been explicitly stated.

Assuming that an approach to distinguish equity from liabilities is based on a sound principle and is found to provide decision-useful information, we fail to see why anybody could have concerns if a certain type of instrument is classified as either equity or debt under that approach. If the classification arrived at by application of the principle is believed to be “wrong”, this would give the opportunity to analyse either

- why one “believes” the classification is “wrong” and/or
- whether or not the principle is suitable in the first place.

We fail to see why perpetual instruments should always “deemed” to be equity. Furthermore, there are certain types of perpetual instruments that economically compel the entity to redeem the instrument (ref. par. 24 et seq. of the IASB Discussion Paper). Some take the view that, due to the lack of a contractual obligation, those types of perpetual instruments are to be classified as equity under IAS 32. As redemption of the instrument is almost certain, the classification arrived at seems not to result in a meaningful representation. This evidences that the principle (or the application of this principle as interpreted by some) has shortcomings and allows for structuring.

Perpetual Instruments, Question 3:
The Board has not yet concluded how liability instruments without settlement requirements should be measured.

- What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

We think that this question is not related to the classification of financial instruments as either liabilities or equity instruments. In our view, measurement issues are beyond the scope of this project.

Redeemable Basic Ownership Instruments, Question 4.

Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20.

- Are the criteria in paragraph 20 operational?
- For example, can compliance with criterion (a) be determined?

We are not convinced that the criteria in par. 20/21 are operational. Our concerns are threefold:

- Whenever the ownership interests are puttable, it is likely that the exception in par. 21 would be applicable rather than the general definition of redeemable basic ownership instruments in par. 20.

  Under this exception, redemption at the book value is acceptable. Assuming that this requirement refers to the book value of the net assets determined under IFRSs, we note that in many jurisdictions, the redemption amount is legally determined with a view to local GAAP (ref. our general comments.) Any requirement that the redemption amount would have to be determined in accordance with IFRSs (or US-GAAP) would be potentially conflicting with applicable law.
- The structure of the exception seems to contain an inconsistency. Whereas condition 1 in par. 21 requires that the redemption formula “is designed to approximate fair value of the instrument or the share of assets to which the holder would be entitled”, the conclusion of meeting this condition is that “redemption based on book value is acceptable”. We are wondering how a redemption formula can, concurrently, be designed to approximate fair value or the share of net assets (= amount A or B, condition) and be based on book value (= amount C, consequence). If C equals A or B, the condition is superfluous, if it does not, the consequence and condition are inherently inconsistent.
- In addition, the definition of redeemable basic ownership instruments is based on the condition that “the redemption amount is the same as the share of the issuer‘s net assets to which the holder would be entitled if it were to liquidate on the classification date”. As highlighted in the deliberations of the Exposure Draft on puttable instruments, using an amount that is determined with a view to liquidation (i.e. net assets upon liquidation, a liquidation surplus) in a going concern situation is complex and gives rise to the question which amount is meant:

  – Assuming that the owners liquidate the entity by selling it, the amount would potentially include unrecognised intangible assets and self-generated goodwill. Thus, “the share of the issuer‘s net assets to which the holder would be entitled if it were to liquidate” would be a pro-rata share of the *fair value of the entity.*

  – Assuming that the owners liquidate the entity by liquidating the entities’ assets and settling its liabilities, the amount would potentially not include all unrecognised assets. Thus, “the share of the issuer‘s net assets to which the holder would be entitled if it were to liquidate” would be some sort of liquidation surplus. If all assets and liabilities were measured at exit prices, that amount would equal *book value*.

The FASB Preliminary Views are not clear (just as the Exposure Draft on "puttable instruments" has not been clear) which of the two amounts is meant and how the amount is to be determined conceptually.

Separation, Question 5

A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner.

- Has the Board properly interpreted the facts?
- Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

While we concur with the conclusion that a dividend, once declared, meets the definition of an obligation, we fail to see the relationship to the criteria chosen for distinguishing equity from debt under the basic ownership approach. Unlike the current IFRS approach, the basic ownership approach is *not* based on the definition of a liability as an obligation of the entity. It almost seems as if the FASB Preliminary Views flip between the traditional "obligation"-based approach for liabilities and the basic ownership approach which is based on subordination.

Substance, Question 6

Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach.

- Is the substance principle necessary under the basic ownership approach?
- Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach?
- Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

Some jurisdictions foresee legal requirements that are unstated in the terms and conditions of a financial instrument, but are nevertheless part of the contractual arrangement. For example, the law of obligations generally impinges on the contractual terms of a financial instrument.

Linkage, Question 7
Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

Linkage of instruments is an issue under *any* approach to distinguish liabilities from equity that is based on the *type of return of an instrument*. This is because an instrument can always be structured in a way that the criteria for equity classification under any approach can be met, while at the same time structuring a second instrument that, when considered together with the (first, equity) instrument, will significantly modify the return, so that none of the two instruments would meet the definition of an equity instrument.

Thus, we agree that guidance on linkage needs to be included in any approach that is based on the type of return. Application of linkage is straightforward, if the terms and conditions of the related instruments refer to each other, but would require more thoughts if that were not the case. While we agree that guidance on linkage is necessary to prevent structuring, we have not yet fully deliberated how guidance on linkage should be structured to prevent structuring if the terms and conditions of the instrument do not refer to each other, the two transactions are not entered into at or around the same time or if the two transactions are with different, but probably related counterparties. We are not convinced that the proposed guidance will effectively prevent structuring in all of those situations.

Measurement, Question 8
Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements.

- Do you agree with that result?
- If not, why should the change in value of certain derivatives be excluded from current-period income?

We agree with the analysis that more derivatives would potentially be measured at fair value through profit or loss. However, this result is not an argument per se for or against any approach. Judging an approach to distinguish equity from debt against the approach's result that more or less derivatives would be measured at fair value through profit or loss seems highly questionable from a conceptual point of view - even more because the accounting treatment of the derivatives is outside the scope of the project, subject to another standard and within the scope of another IASB/FASB joint project and under re-deliberation.

With regard to the second question, we generally consider measurement issues to be beyond the scope of this project, which is concerned with developing a principle to distinguish equity from debt and not with accounting for financial instruments.

Presentation Issues, Question 9

Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity.

- Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements?
- For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

We generally deem presentation to be beyond the scope of this project. We think that, in relation to redeemable (puttable) instruments, information on when the put rights could be exercised and when those puts become effective are useful.

With regard to the second question, we agree that separate display of those obligations that require a settlement in cash or other assets and those that can be or are to be settled by delivering equity instruments would provide additional decision-useful information.

However, we would like to highlight that under the current Framework, obligations to deliver own equity instruments, regardless of whether it is a fixed number or a variable number, do not meet the definition of a liability (ref. our general comments).

Presentation Issues, Question 10

Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value.

- Should the amount be disaggregated and separately displayed?
- If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

As already stated in our answer to question 9, we deem presentation to be beyond the scope of this project. We do agree however that, the more balance sheet items (or financial instruments) are carried at fair value, the more net income will need to be disaggregated. Under fair value measurement, the line item "changes in fair value" on the one hand become extremely important and on the other hand clearly warrants additional disaggregated information.

As far as we are aware of related academic empirical research, a disaggregation based on income components *associated and not associated with a cash flow* should be preferred in providing information with a predictive value. We are sceptical about a disaggregation of changes in fair value by causes of the change. This method raises complex computational challenges.

Presentation Issues, Question 11
Earnings per Share (EPS). The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation.
• How should equity instruments with redemption requirements be treated for EPS purposes? • What EPS implications related to this approach, if any, should the Board be aware of or consider?

We think that this question goes beyond the scope of this project.

Part 2: Questions on the Ownership-Settlement Approach

Question 1
• Do you believe the ownership-settlement approach would represent an improvement in financial reporting?
• Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

Please refer to our answer to question 1 on the basic ownership approach. Although we are not convinced that the basic ownership approach would represent an improvement in financial reporting, we would prefer the basic ownership approach over the other two approaches. Thus, we are even less convinced that the ownership-settlement-approach represents an improvement.

In particular, we think that, allowing for two criteria each thought to be a substantive feature of equity means, in essence, allowing for a "pick and choose" approach that is open to accounting arbitrage. Both definitions are based on two different criteria, the

- (non-)existence of a settlement obligation (perpetual instruments) and
- the type of claim (basic ownership instrument).

Thus, a financial instrument would be deemed an equity instrument if it met the first criterion, the second criterion or both. Such an approach will lead to four classes of capital and three classes of equity, and these three classes cannot be reconciled to each other.

We also concur with the analysis in par. 69 of the FASB Preliminary Views. Assuming that the equity instruments that need to be delivered to settle the obligation are traded in an active market, they could be readily converted into cash, while a cash settlement could easily be converted into shares. Thus, in this situation, the two settlement alternatives are economically comparable, which should result in consistent classification.

With regard to consistency with the Framework, we are not convinced that both perpetual instruments and indirect ownership instruments do meet the definition of a liability as stated in the Framework. Classifying instruments as equity if the instrument's return profile is similar or based on the return profile of an equity instrument seems not to be consistent with the Framework. Perpetual instruments, according to par. A3 of the FASB Preliminary Views, may entitle the holder to "dividends and other distributions". Thus, they may embody a claim. This entitlement also opens an opportunity for structuring, since the "most subordinated claim" in liquidation associated with a basic ownership instrument can be diluted by issuing perpetual instruments that entitle the holder to substantial distributions before liquidation. We wish to draw your attention to paras. 16B and 16D of IAS 32 (rev. 2008), aimed at preventing this kind of structuring.

We note that the ownership-settlement approach (as well as the REO approach) classifies certain derivatives on equity instruments at the reporting date as if both, those derivatives and associated obligations had already been fulfilled as of the reporting date. This accounting may be inconsistent with the principle to account for transactions and events *as of the reporting date,* unless an event is deemed as "adjusting" in accordance with IAS 10.

Par. A8 of the FASB Preliminary Views states that, if an option on the entity's own equity instruments issued by the entity is "in-the-money", the return to the holder has the same profile as the return to a holder of the related basic ownership instrument and is thus classified as equity, provided it is net-share or physically settled. Does this conclusion imply that, if the option were deep out-of-the-money, it would not be classified as equity due to the lack of a similar return profile? If yes, does it imply that the option is reclassified every time it gets into or out of the money?

Question 2

- Are there ways to simplify the approach? Please explain.

Since we do not think that the ownership-settlement approach represents an improvement to financial reporting and because we are not convinced that it provides the users of financial statements with decision-useful information, we deem ways to simplify it irrelevant.

Substance, Question 3

Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument.

- Is this principle sufficiently clear to be operational?

Please refer to our answer to question 6 on the basic ownership approach.

Presentation Issues, Question 4

Statement of financial position. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity.

- What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements?
- For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

Please refer to our answer to question 7 on the basic ownership approach.

Separation, Question 5

- Are the proposed requirements for separation and measurement of separated instruments operational?
- Does the separation result in decision-useful information?

Please refer to our answer to question 8 on the basic ownership approach.

Earnings per Share, Question 6

The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail.

- How should equity instruments with redemption requirements be treated for EPS purposes?
- What EPS implications related to this approach, if any, should the Board be aware of or consider?

We think that this question goes beyond the scope of this project.

Settlement, Conversion, Expiration, or Modification, Question 7

- Are the requirements described in paragraphs A35–A38 operational?
- Do they provide meaningful results for users of financial statements?

Again, we would like to stress that we deem the development of a principle-based approach to distinguish equity from debt to be the main task of the project, not the accounting for certain financial instruments. This question is however directed at follow-up issues that might be discussed once a suitable principle has been identified.

Part 3: Questions on the REO Approach

Question 1
- Do you believe that the REO approach would represent an improvement in financial reporting?
- What would be the conceptual basis for distinguishing between assets, liabilities, and equity?
- Would the costs incurred to implement this approach exceed the benefits? Please explain.

The REO approach results in a consistent classification and accounting for all hybrid instruments.

However, the REO does not classify redeemable basic ownership instruments and hybrids consistently. Whereas classifying the latter require a re-assessment of the

- probability of occurrence, the
- probability-weighted amount and the
- probability-weighted date of occurrence,

those probabilities are not assessed (or even re-assessed) in relation to redeemable basic ownership instruments. In particular, basic ownership instruments puttable by the holder are measured as if the put right had been exercised although in fact, the put right neither has been exercised nor has it become effective. No consideration is given to either the probability of the put right being exercised or the point in time exercise is likely.

Similar to the ownership-settlement approach, classifying hybrid instruments as equity based on their return profile seems not to be consistent with the Framework.

In addition, the REO relies, to a considerable extent, on probabilities, which may be difficult to assess reliably. Thus, the results, i.e. the amounts “allocated” to the equity and the liability “bucket” may be arbitrary to a certain extent.

We also note that, due to the necessary re-assessments of the probabilities mentioned above, entities may incur significant costs when applying the REO approach, while it remains an open question whether the approach will lead to decision-useful information that justify these costs in terms of the cost/benefit-constraint.

Separation and Measurement, Question 2
- Do the separation and measurement requirements provide meaningful results for the users of financial statements?

Please refer to our answer to question 8 on the basic ownership approach.

Earnings per Share, Question 3

The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation.

- How should equity instruments with redemption requirements be treated for EPS purposes?
- What EPS implications related to this approach, if any, should the Board be aware of or consider?

We think that this question goes beyond the scope of this project.

Appendix B – FASB's original questions to respondents
Part 4: Other Alternatives

Question 1
Some other approaches the Board has considered but rejected are described in Appendix E.
- Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider?
- How would the approach classify and measure instruments?
- Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?

As already stated in our answer to question 1 of the IASB's invitation to comment, the FASB Preliminary Views contain no comprehensive discussion or argumentation why the basic ownership approach (or the other two approaches) and the criteria chosen for defining equity instruments would result in decision-useful information for a broad range of users, for entities in different legal forms and across jurisdictions.

Conversely, the PAAinE Discussion Paper contains a comprehensive discussion of those issues. Although we would consider neither the approaches contained in the FASB Preliminary Views nor the Loss Absorption Approach to be fully developed, we think that, overall the Loss Absorption Approach would be the preferable starting point.

In our view, the loss-absorbing capability of capital is the characteristic of capital that, if distinguished from other non loss-absorbing capital, provides the most decision-useful information. Similar to the basic ownership approach, loss-absorbing claims are residual claims, both upon liquidation of the entity, redemption of a capital instrument and with regard to ongoing servicing. Classifying those claims as equity is consistent with the notion of equity as a residual contained in the current Framework. Please refer to the PAAinE Discussion Paper for supporting argumentation.

In the longer term, the "no-split/just list claims"-solution could be another promising starting point. This approach would be free from arbitrarily picking and choosing criteria while at the same time rejecting others. Although we think that much more time is needed to fully evaluate all the consequences that fall from this approach, we think that the resources would be well invested. We note that the FASB pursued this route in early 2007 as part of the re-deliberations of the Framework project phase on elements. We were disappointed to see that IASB and FASB did choose not to pursue this approach further.

IASB's additional questions for respondents

Question 1

Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?

(a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

(b) Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?

As already set out in our general comments, we would have expected the FASB Preliminary Views to

- discuss potential criteria on which a principle to distinguish equity from debt could be based on,
- develop an approach to distinguish equity from debt based on a principle that is applicable by a broader range of entities in different legal forms and across jurisdictions and that provides a broader range of users with decision-useful information,
- while at the same time avoiding the deficiencies of IAS 32.

The FASB Preliminary Views do not contain such a discussion, nor does it contain plausible arguments why the chosen criteria (or the approach, respectively) lead to decision-useful information. The FASB Preliminary Views do also not give sufficient consideration to the question whether the approaches would be applicable within an international context. In addition, as already set out in our general comments, the FASB Preliminary Views fail to give sufficient consideration to a number of other essential issues as well. Thus, with regard to the first question, we are not convinced whether the FASB approaches are feasible to implement.

With regard to the question raised under a), one would need to be convinced that one of the approach represents as suitable starting point for developing a successor to IAS 32. With regard to the question raised under b), we refer to our answer to part 4, question 1. We think that the loss-absorption approach and the so-called "no split/just list claims" approach are two superior starting points.

Question 2

Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?

Both IAS 32 and the FASB Preliminary Views focus on financial instruments. We are not convinced that this scope is appropriate and are surprised that neither the IASB

Discussion Paper nor the FASB Preliminary Views discuss the (limited) scope of the project.

We acknowledge that most items which have to be classified as either financial liabilities or equity will meet the definition of a financial instrument and will thus be covered by the scope of the project. However, in particular in relation to classifying capital as either liabilities or equity, a number of items, such as retained earnings or capital reserves, are currently not classifiable on a standard level (i.e. IAS 32), i.e. no guidance exists in an IFRS for classification of these items. Instead, if these items do not meet the definition of a financial instrument, their classification is based solely on the Framework. Consequently, one would still have to look to both the Framework and the standard (i.e. IAS 32 or the upcoming successor developed in this project).

We would have thought that any new approach to distinguish between equity and debt should contain an answer for *all* kinds of capital and not only for financial instruments. We would have thought that the interaction between the Framework project and this project are taken into consideration. Because all of the FASB approaches try to define equity positively, we would have thought that *any* claims on the credit side of the balance sheet (and not only financial instruments) can be classified based on this definition.

The limited scope of the FASB Preliminary Views on financial instrument could cause issues in a situation in which other IFRSs require recognising certain items “directly in equity”, for example currency translation adjustments or changes in the fair value of hedging instruments in a cash flow hedge. Those items are considered “accounting figures” and, since they do not meet the definition of a (contractual) financial instrument, are classifiable only under the Framework or other applicable standard, respectively. However, they do form a part of capital interests and there is a claimant to these amounts. If an approach requires redeemable ownership interests to be measured at the current redemption amount (such as redeemable basic ownership instruments under all of the three FASB approaches) and those interests/claims comprise the accounting figures mentioned above, the same amount is actually reported twice: Firstly as part of the redemption amount in accordance with the classification standard and secondly as a particular accounting figure under another standard (IAS 21, IAS 39 etc.).

Question 3

Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

The basic ownership approach requires classifying redeemable basic ownership instruments as equity if certain conditions are met. As we highlighted in the deliberations in relation to the IASB’s project on “puttable instruments”, the ownership interests in entities in certain legal forms are puttable by law in a number of jurisdictions, including Germany. Often, the ownership interests can or must not be traded. Thus, the only way for the holder to reverse his/her decision to invest in an entity would be to put the instrument back to the entity. In this instance, the put right does not serve the purpose of giving a provider of capital an additional benefit which otherwise would not be present, but to substitute the trading mechanism associated with common shares.

Consequently,

- for those entities, the owner's capital would be the only capital that could potentially classify for equity classification,
- this capital is puttable and would need to meet the definition of a *redeemable basic ownership* instrument, but, due to the put right, would generally fail to meet this definition*,*
- those entities are likely forced to look to the exception in par. 21 of the FASB Preliminary Views, as there is no active market for the instrument or the instrument can be exchanged only with the reporting entity.

If those conditions are met, a redemption based on book value is acceptable. Assuming that this wording is intended to refer to the book value *of the net assets* (which is not made explicit in the FASB Preliminary Views' definition), and assuming that this amount was required to be determined in accordance with IFRSs[1], we conclude that many entities would not be able to ever meet this condition. In some jurisdictions, including Germany, the redemption amount is determined by reference to the *separate financial statements* prepared *in accordance with local GAAP*. In some jurisdictions, this may even be a legal requirement and thus, the IFRS definition would require a redemption that applicable law forbids.

Although we acknowledge that allowing the book value to be determined in accordance with "any GAAP" without giving any consideration as to how this GAAP measures book value seems not appropriate, we are also concerned that any requirement based on redemption to be determined with a view to IFRSs is potentially conflicting with applicable law in many countries.

Question 4

Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance.) If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

Linkage of instruments is an issue under *any* approach to distinguish liabilities from equity that is based on the *type of return of an instrument*. This is because an instrument can always be structured in a way that the criteria for equity classification under any approach can be met, while at the same time structuring a second instrument that, when considered together with the (first, equity) instrument, will significantly modify the return, so that none of the two instruments would meet the definition of an equity instrument.

[1] Ref. IAS 32. which contains a similar reference to accounting performance and change in book value being measured in accordance with IFRSs.

Thus, we agree that guidance on linkage needs to be included in any approach that is based on the type of return. Application of linkage is straightforward, if the terms and conditions of the related instruments refer to each other, but would require more thoughts if that were not the case. At present, we have not yet deliberated how an entity would apply the concept. We are thus unsure whether the proposed guidance on linkage would effectively prevent structuring.

Question 5

Please provide comments on any other matters raised by the discussion paper.

Two other areas to which we would have expected more consideration be given to in the FASB Preliminary Views are

- the application of the approaches within a group context and
- the implications of choosing either the proprietary view or the entity view for financial reporting.

Please refer to our general comments section of our letter.

The PAAinE Discussion Paper

As already stated, we think that the PAAinE Discussion Paper gives consideration to a number of issues, and the loss absorption principle and the Loss Absorption Approach discussed and developed in the paper is the superior starting point.

We also note that the PAAinE Discussion Paper contains a comprehensive discussion of different criteria on which a principle to distinguish equity from debt could be based on. The FASB Preliminary Views lack a similar discussion. In addition the PAAinE paper also explains

- *why* the loss-absorbing capabilities of capital is the criterion that is preferable over other criteria and should thus be used for distinguishing equity from liabilities and
- *why* the Loss Absorption Approach based on this criterion provides a broad range of users with decision-useful information for entities in different legal forms across different jurisdictions.

In contrast, the FASB Preliminary Views lack a plausible line of argument why the chosen criteria lead to a distinction that provides decision-useful information.

The PAAinE Discussion paper also contains a discussion of the interaction of items classified in accordance with the Framework and financial instruments (ref. par. 1.1 and 4.38). We would like to note that the Loss Absorption Approach and the definition of loss absorbing capital is applicable to all claims and thus is not limited to financial instruments only. The approach could therefore serve as a starting point for *comprehensive* standards under which all claims could be classified as either equity or liabilities which is also consistent with a revised Framework

The PAAinE Discussion Paper also discusses extensively two issues which we believe to be essential in this context: The application within a group context and the question of whether the proprietary view or the entity view is employed:

- Section 5 of the PAAinE Discussion paper is entirely concerned with the application of different approaches in a group context.
- The classification of obligations to issue own equity instruments depends largely on the chosen view (ref. par. 1.40 et seq.). Choosing one of those views and consistently applying the view is also fundamental in achieving consistent accounting results (ref par. 2.35 et seq., which contain an analysis of the inconsistencies that arise from “swapping” those two views in the context of the current IAS 32.) Under the current Framework, obligations to deliver own equity instruments, regardless of whether it is a fixed number or a variable number, do not meet the definition of a liability. This fact is acknowledged in par. D6 of the FASB Preliminary Views as well as in par. 31 of the IASB Discussion Paper.