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Sir David Tweedie
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Berlin, 4 September 2008

Dear David,

IASB Discussion Paper Financial Instruments with Characteristics of Equity
Analysis of the comment letters received on the PAAinE Discussion Paper "Distinguishing between Liabilities and Equity"

On behalf of the German Accounting Standards Board (GASB) I am pleased to forward you an analysis of the comment letters received on the recent Discussion Paper "Distinguishing between Liabilities and Equity", published under the PAAinE initiative by the German Accounting Standards Board, the European Financial Reporting Advisory Group and other European national standard-setters. We hope you will find this analysis useful when considering the comments on the IASB's own recent Discussion Paper, both with a view to which approach is a suitable starting point for a potential review of the current IFRS distinction and with regard to the conceptual issues involved in relation to other approaches.

Generally, the Discussion Paper was viewed as a useful contribution to the current discussion. The analysis in the Discussion Paper, both of the different potential criteria that could be used for distinguishing equity from debt and of the shortcomings of the current IAS 32, was generally viewed as being of high quality. The conceptual issues (application within a group, the question of perspective) that the Discussion Paper touches upon were viewed as relevant. We note that these issues are relevant in the context of other approaches as well.

With regard to the Loss Absorption Approach, the majority of comment letters supported the Loss Absorption Approach and gave various reasons, such as simplicity, the principle-based nature, the focus on capital-at-risk reflecting user needs and business reality and the consistency with the prudential view on capital. Although supportive, a number of comment letters agreed with the authors acknowledging in the Discussion Paper that further work on the approach is necessary, both conceptually and practically. However, some of the conceptual issues would equally need to be considered in relation to other approaches, for example the Basic Ownership Approach.

Some commentators did not find IAS 32 to be fundamentally flawed, although they agreed with the analysis of the shortcomings of the current IAS 32 in the Discussion Paper. Some commentators noted that a fundamental review of the distinction is essential for the FASB, but not for the IASB. If however the IASB would chose to re-deliberate the distinction, approaches other than those proposed by the FASB including the Loss Absorption Approach need to be considered. Some comment letters suggested considering a combination of the Loss Absorption Approach and Basic Ownership Approach. Some commentators also believed that the current shortcomings of IAS 32 could be better accommodated by amending the standard and noted that the Loss Absorption Approach, although not suitable as an approach to replace IAS 32, might solve the issue of redeemable/puttable instruments in a principle-based and simpler way as compared to the recent amendments to IAS 32. Please find a detailed analysis of the comments received in the Appendix to this letter.

Apart from the comment letters covered by the analysis, we received comments in public discussion rounds, presentations and vis-à-vis talks. The comments raised included the following: Other approaches might be more developed, but the FASB Preliminary Views leaves a number of important issues untouched, such as the application within a group context. In this regard, the commentators expressed the view that they generally felt fine with the classification arrived at the level of a single entity under the Loss Absorption Approach being retained within the group, but had reservations against retaining the classification reached at the single entity level for the group level under the Basic Ownership Approach. The reason they gave was that, since the Basic Ownership Approach is based on subordination upon liquidation (and this criterion being defined legally only with a view to a single entity), retaining the classification within a group violates the principle behind the Basic Ownership Approach and opens significant structuring opportunities.

If you like to discuss the comments raised or if you wish the team that prepared the PAAinE Discussion Paper to explore any issues further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr

President

An analysis of the comments received on the

PAAinE Discussion Paper "Distinguishing between liabilities and equity"

Content:

Responses received

Comment letter No.	Institution
01	The Union of Co-operative Enterprises
02	Conseil National de la Comptabilité
03	Freudenberg & Co.
04	The Institute of Chartered Accountants
05	Accounting Standards Board
06	General Confederation of Agricultural Co-operatives in the EU
07	Association of British Insurers
08	Cooperatives Europe
09	Swiss Holdings
10	International Co-operative Alliance
11	Crédit Mutuel
12	European Association of Co-operative Banks
13	VÖB, DGRV, BDI, BStBK, BVR, DIHK, DSGV
14	ACCA
15	Crédit Agricole
16	Association Actuarielle Internationale
17	Nestlé
18	Unified Grocers
19	National Cooperative Business Association
20	KPMG LLP

Respondents by group

Group	Number
User	0
Accounting Standard Setters	2
Accountancy Institutes and Regulators	2
Accounting Firms	1
Preparers (including preparers' associations)	14
Others	1
Total	20

Note: Apart from the comment letters, we received comments in public discussion rounds, presentations and vis-à-vis talks. These comments are not reflected in this analysis. This analysis is limited to the comment letters received.

General Comments

The Discussion Paper

Almost all comment letters found the Discussion Paper a welcomed, useful and promising contribution to the current discussion. In particular, the comment letters noted the high quality of the analysis, of different potential criteria on which an approach could be based and of the conceptual issues involved, based on original thinking. In this area, some comment letters highlighted the relevance of the perspective (entity vs. proprietary view).

The Loss Absorption Approach

A large number of comment letters specifically supported the approach, on the grounds that

- it is principle-based,
- it is neutral with regard to the legal form of the entity,
- it is simple,
- the classification of instruments intuitively feels correct,
- the focus on capital-at-risk reflects business realities and information needs of the users of financial statements,
- it fits well with the perspective of the insurance industry,
- it reflects the prudential view.

The Loss Absorption Approach compared to other approaches

Although the shortcomings of **IAS 32** were generally acknowledged (and agreement with the respective analysis in the Discussion Paper was expressed), the views were divided on the question whether IAS 32 is in need of a **fundamental review**:

- Some comment letters agreed that a fundamental review of the distinction is essential for the FASB, but not for the IASB and if, this was not considered to be an urgent priority for the IASB. One comment letter therefore suggested that the FASB adopt IAS 32 until such a time as a revised international standard can be developed (and if the IASB would start the fundamental review, the Loss Absorption Approach would be worthy of consideration and this review should not be limited to IAS 32, but should encompass the Framework).
- Similarly, some commentators took the view that IAS 32 has shortcomings, but the main shortcoming lies primarily in the area of puttable/redeemable residual claims. This shortcoming could be better addressed by specific rules within the existing standard than by a fundamental review. As the recent amendment is rules-based and

provisional, the Loss Absorption Approach may overcome those shortcomings in a more principle-based way.

Compared to the **current proposals worked out by the FASB**, the views were equally divided:

- From those comment letters that specifically expressed a view on this issue, the majority of comment letters took the view that due to being principle-based and neutral the Loss Absorption Approach is superior to the other proposals currently in the arena.
- Some noted that the fundamental review of the conceptual issues involved included in the Discussion Paper would be a more suitable starting point than the proposals in the FASB's Preliminary Views paper.
- A number of comment letters noted that the IASB should consider all other approaches in the arena, including the Loss Absorption Approach, before reaching any consensus.
- Some comment letters suggested that the Loss Absorption Approach and the Basic Ownership Approach could be combined, as the logic underpinning the Loss Absorption Approach would be an improvement to the Basic Ownership Approach and that the Loss Absorption Approach may help overcome the shortcomings of the Basic Ownership Approach. This comment letter explicitly referred to the loss participation element being more appropriate than the participation in profits and losses.
- Two comment letters found the Basic Ownership Approach to be more intuitive and more consistent with the idea that the owners' interest is constituted in the residual claims with no upper or lower limit other than the amount of assets. They pointed out that the Basic Ownership Approach complies better with the needs of the investors.

Open conceptual and practical issues

A large number agreed with the statement in the Discussion Paper in saying that more work is both welcome and necessary. Some comment letters noted the theoretical nature of the Discussion Paper and emphasized that a number of questions, both conceptual and practical still need to be answered.

The ***conceptual*** issues included:

- The interaction of balance sheet classification and recognition of distributions in profit and loss;
- basing the definition on accounting losses results in the distinction being a function of the accounting (measurement) principles. In addition, it was argued that this view needs a stronger conceptual basis, given that the discussion on circularity (in section 4 of the Discussion Paper) is more based on practical considerations. The option to base the definition on economic losses should be further explored;

- the focus on liquidation may violate the going-concern principle (note however that the Loss Absorption Approach does, contrary to other approaches, not focus on liquidation);
- the general implications of applying the Loss Absorption Approach to a group, in particular to SPEs. Specifically, the following concern was raised: If applied to a group, there could be no instruments that are ultimately loss absorbing for the consolidated companies, but only those that are loss absorbing for some but not all of the companies;
- liabilities and not equity should be defined positively, as the current Framework does;
- the notion of a continuum (and related reclassifications) can impair the comparability;
- the concept of loss-absorbing capital cannot be reconciled to the intuitive idea that equity relates to ownership interest. (Note however that this concern relates more to the perspective rather than to the approach itself: From an entity view, the features of the capital are relevant, not who provided the capital.)

The ***practical*** issues included

- instruments that absorb losses only for a certain amount of time – would the Loss Absorption Approach envisage reclassification?
- instruments that absorb losses only for a short term (i.e. IE 11) – what would be a practical mechanism of allocating losses to an instrument?
- in the case of profit or loss transfer agreements, there is no possibility of a loss arising – how would the Loss Absorption Approach be applied in this situation?
- how would forward contracts to buy own equity instrument be accounted for?
- how exactly would split accounting work, for example in the case of the remuneration (but not the prepayment of principal) of an instrument being discretionary and is loss-absorbing?
- how could the loss-absorbing features of an instrument be assessed (loss absorption on repayment/liquidation vs. loss-absorption throughout life of instrument)?

Answers to the Invitation for Comment

Question 1

Do you believe that defining two different classes of capital on the credit side of the balance sheet does provide decision-useful information, even if the entity's capital structure is in fact multi-dimensional (the so-called "list claims"-approach, pars. 1.3 ff.)? If not, why?

All proposed approaches (IASB, FASB, PAAinE) and the current IAS 32 are based on the notion of a dichotomous structure of the credit side of the balance sheet. Question 1 thus asked whether a twofold structure is regarded as a "must" by constituents.

Twofold structure

In all comment letters (but one), a twofold structure was supported. The arguments varied from "general agreement" ("common, intuitive and generally well understood", "meaningful information") to more diverse arguments, such as

- that other approaches would lead to ***more complexity*** (by defining more than two classes of capital),
- it reflects the ***different economic characteristics*** of members/owners and financial institutions/suppliers (note that the argument implicitly employs an ownership notion to equity),
- it is thus ***aligned with general economic and financial market theory***,
- it gives an overview of the liquidity situation and liquidity requirements (however, it remains unclear if this is viewed as the purpose of the distinction and, if yes, how this can be archived).

Defining more than two classes

was rejected, on the grounds that

- although it might have the merit of providing sophisticated information, ***it still raises the question of where to draw the line*,**
- practicability for common financial statement analysis would be significantly restricted.

"List claim"-approach

was also rejected, because

- only note information is ***potentially misleading***,
- ***in principle a dichotomous structure does provide decision-useful information.*** "Where instruments have multi-dimensional characteristics, appropriate disclosure, which allows users to make informed decisions, gives substance to the two-tier credit side of the balance sheet";
- it ***increases complexity and impairs understandability*,**
- a more multidimensional approach would require ***much more detailed notes***.

Question 2

Do you believe that listing all claims to the entity's assets, ranking those claims by a certain criterion and providing additional information on all other characteristics of the claims in the Notes to the financial statements would have merit (pars. 1.3 ff)? Why? If not, why?

Question 2 asked specifically whether a "list claims"-approach would have merit, thus enabling PAAinE and the IASB to evaluate whether further work on the "list claims"-approaches would have merit in the view of the constituents.

Intriguingly, the answers differed slightly from those given to question 1. For example, one comment letter stated that this approach would raise transparency, "as it clearly describes the financial obligations of the various instruments and claims on the entity". One comment letter noted that the answer depends on the criterion which would be used to rank the claims on the balance sheet (and that the level of subordination seems to be a proper one while another comment letter argued that listing claims in order of priority in bankruptcy provides only limited decision-useful information about an entity that is a going concern). That comment letter also noted that the approach would have some merit, as it would ***be less simplistic and more accurate than an approach with two classes of capital only***.

However, in the majority of comment letters, although acknowledging some benefits, the view was taken that a twofold structure, supported by additional note disclosures on certain claims, would be the better way.

In particular, ***practical concerns*** were stated, such as that

- the ranking criteria would have to be ***standardised and steadily adjusted*** to the ongoing development of financial instruments, and that this would be ***impracticable*** and managing the disclosure requirements would be difficult,
- it would require an ***impact analysis*** to check whether it provides clear and decision-useful information,
- even more, because that approach would lead to completely abandon the distinction between equity and liabilities and would constitute a complete revolution in our accounting representation of capital structures

One comment letter even stated that a "list claims"-approach would even be confusing to users, as it would ***require multiple decisions about classification***. (Note however that this is exactly the thinking underlying this approach: As the economic calculus is different for every user, so must be the classification employed.)

Question 3

Do you agree with the analysis of the different characteristics of capital as the basis for distinguishing between equity and liabilities (pars. 1.14 ff.)? If not, why? Do you think that any other characteristics should be considered? If yes, which?

Chapter 1 of the PAAinE Discussion Paper contains a comprehensive analysis of different criteria that forms the basis on which the loss absorption principle is developed. Question 3 thus asked whether this analysis is relevant and correct.

All comment letters agreed with the analysis and with the relevance of the criteria that are analysed in this chapter. One comment letter in particular noted that the analysis is thoughtful and insightful.

Some comment letters noted that chapter 1 often refers to common stock and thus a certain legal form. Those comment letters expressed the view that chapter 1 should have been written in a more neutral way. In particular, the paper should have been written in a way that neither conclusions on individual legal forms nor on certain instruments may be drawn.

One comment letter implicitly argued for an ownership notion of equity (equity instruments as the shares received in exchange for the capital laid in when founding the entity) and stated that consistency between accounting and the legal view should be kept in mind. Any approach that neglects this principle (and is thus oriented towards a certain, distinct type of share, quoting IAS 32 as a bad example) would lead to some entities having no equity, a result that was deemed “absurd”.

Two comment letters suggested

- extending the analysis to implied or explicit return promises to the holder of the instrument; and
- that the analysis is made more precise in terms of when the financial instrument is issued.

One comment letter stated that, since only one class of capital can be defined (with the other one being the default), it follows that, since the paper defines equity, the liability class is the default class, but that this conclusion could have been made more explicit. That comment letter also noted that it is not apparent that all capital that is not equity will meet the criteria for recognition as debt, which seems incongruous. The classification of debt as credits that are not equity may not be reconcilable to the concepts of debt and the guidance related to recognition and measurement of debt in other standards, in particular in IAS 39.

One comment letter suggested a hierarchy of criteria and took the view that the feature of “conferring social rights” (participation, control) should take prevalence over financial criteria. In addition, any instruments that, although conferring only financial rights, have no redemption features or are redeemable only out of a liquidation surplus have predominantly equity characteristics.

Question 4

Do you agree with the analysis in the paper on whether to base a capital distinction on one or more than one criterion (pars. 1.33 ff.)?

Some comment letters took the view the capital distinction should be based on ***one core characteristic***. While not disagreeing with this view, some added that, if more than one criterion is used, the ***criteria must be met cumulatively*** *(rather than alternatively)*. Other comment letters added that it is sensible to rely on as few criteria as possible.

The reasons given for supporting a single criterion was that one sole criterion has the advantage of simplicity. It was also noted that, when basing the approach on a single criterion, the key question is whether an approach is practical and provides for appropriate results. Those comment letters noted the advantage of loss-absorption as the general principle. Conversely, one comment letter noted that an approach is not superior just because it is based on one criterion only.

Two comment letters highlighted that, if equity is distinguished narrowly based on a singular criterion, the result would be ***having various dissimilar items being grouped into liabilities***.

Yet another comment letter took the view that an approach based on ***multiple criteria*** would have better chances to give an accurate representation of reality and to qualify as equity instruments with equity characteristics and as debt instruments with debt characteristics. This comment letter argued that there are different characteristics of capital and that it seems not appropriate that a financial instrument which would have almost all the characteristics of equity would finally be accounted for as debt because a single criterion is not met. (Note, however, that this would be the result of applying a cumulative definition, which contradicts the first view supporting an approach based on multiple criteria.)

One comment letter noted that the loss absorption criterion would in fact comprise two criteria, being that an instrument

1. is loss absorbing, and

2. that it absorbs the ultimate losses of the entity.

This comment letter noted that many contracts, such as those with incentives or experience participation features, provide buffers that can be loss absorbing but do not absorb the losses of the entity and referred to certain insurance contracts that my have participation features that provide a buffer. This comment letter also noted that similar instruments, such as PFs in life insurance, may be classified differently for a stock company than a mutual company, and concluded that this possibility should be discussed further and the PAAinE should decide whether this is the intended and desirable result of its proposal.

An alternative view that was taken by one comment letter in this context was that any approach needs to be ***practical and lead to appropriate results***.

Question 5

Do you agree with the analysis in this paper that, in order to classify capital, either an entity view or a proprietary view has to be applied (pars. 1.40 ff.)? If not, why not? Do you agree with the paper's description of the implications of each approach (pars.2.35 ff., 3.22 ff.)? If not, why?

All comment letters agreed that taking a perspective as to the underlying view of the accounts (whether they are prepared under an entity or proprietary view) is essential. One comment letter agreed with the analysis in particular in saying that otherwise inconsistent treatment of equity/liabilities as demonstrated in the paper by its analysis of current IFRS is likely. However, this comment letter also expressed doubts whether it is possible to produce a set of standards based wholly on one view or the other that are totally consistent.

Nearly all comment letters also agreed with the implications of the two alternative views as analysed in the Discussion Paper. One comment letter noted that the Discussion Paper does not provide a sufficient analysis of all relevant aspects of the different views.

In this context, some comment letters noted that even the discussion in the (IASB/FASB) Discussion Papers on the conceptual framework is not based on an adequate conceptual basis for a capital classification concept. Another comment letter referred to the IASB Discussion Paper on "The Reporting Entity", based on an entity perspective and concluded that a preference for the entity perspective appears to be expressed because of consistency with the current treatment of rights to put in IAS 32. This comment letter also noted that neither this DP nor the Conceptual Framework project provides very convincing conceptual arguments for such a choice. (Note however that the PAAinE Discussion Paper on equity/Liabilities does not state a preference as such, but employs this view only for exploring the results of the approach further.)

Some comment letters also expressed a view in favour of a certain perspective. These views were divided: Some comment letters supported the entity view (with additional information for an owner or an investor provided in the notes), one comment letter supported the proprietary view and the creditor's view (this view was not explained further).

A large number of comment letters highlighted that more discussion on this subject would be desirable, both in the (general) context of distinguishing equity from debt and in the context of financial reporting, i.e. by the IASB within the conceptual framework project.

Only one comment letter did not agree with the analysis. The reason given was that "the FASB has used an ownership, or proprietary approach, and has reached a characterization of equity that, in our view, will result in a classification of capital as liabilities or equity that is likely to be no different from what would result from the use of the entity view and the loss absorbing concept. The Basic Ownership Approach is a superior concept because it does not rely on the accounting concept of losses to make the determination and avoids the circularity indicated in the DP." (Note however, that the FASB Preliminary Views Basic Ownership Approach simply "states" that redeemable instruments and obligations to deliver basic ownership instruments are classified in a certain way. Whether or not this classification is consistent with a certain perspective is not discussed, as is the perspective in general.)

Question 6

Do you agree with the analysis of the needs of the users of financial statements?

in the context of classifying capital (pars. 3.1 ff.)?

All comment letters agreed with the general analysis.

Some comment letters highlighted the legal and regulatory importance of the distinction between debt and equity. In this context, the analysis could have been expanded, e.g. in relation to contracting (debt covenants, preferred instruments), capital maintenance rules and limitations on distributions to shareholders. Some comment letters explicitly referred to regulators, public authorities, debt rating agencies and the general public also use the distinction between debt and equity and questioned whether their needs have been properly addressed.

Two comment letters, although expressing agreement in general, noted that the analysis is not relevant for specific entities. Those comment letters referred to co-operatives, noting that the members are generally less concerned with their return, because this return usually is limited (while the risk is not) or because the services provided to them is more important than any financial return.

One comment letter, although agreeing with the analysis, found the conclusion that risk capacity and loss absorption meets the needs of users better than alternatives has not been supported.

Question 7

Do you agree that basing the distinction between equity and liabilities on risk capital would provide decision-useful information to a wide range of users of financial statements about entities in different legal forms (pars. 3.5 ff.)? If not, why? Is there any other basis for the distinction that you would consider providing more useful information? If yes, which and why?

All except one comment letter agreed that basing the distinction between equity and liabilities on risk capital/loss absorption provides decision-useful information to a wide range of users of financial statements.

A number of comment letters further noted that basing the distinction on risk capital/loss absorption will lead to useful information across different types of entities. A number of comment letters stated that the definition of risk capital and the loss absorbing function should be neutral regarding entities in different legal forms and deemed this essential.

Additional arguments supporting this view included that:

- this distinction constitutes the fundamental basis of the equity classification concepts of various jurisdictions;
- the distinction is still a cornerstone of modern finance theory;
- it is consistent with the prudential approach.

One comment letter questioned the notion that the individual classification should be maintained in consolidation, as in this case legal form would appear to overrule substance. (Note however that the Discussion Paper does not employ this notion. On the contrary, it points out that this notion would lead to inconsistencies and structuring opportunities).

Only one comment letter disagreed with basing the distinction on loss absorbing capabilities. This comment letter argued that “the concept of basic ownership instruments is a more intuitive approach because it links the equity to the economic consequences of ownership. We also do not see it as more difficult to apply and we believe that the use of the Basic Ownership Approach fits better with mutual company financial statements.”

Question 8

Do you agree with the analysis of losses as either economic losses or accounting losses in the context of classifying capital as equity or liabilities (pars. 4.1 ff.)? If not, why? Would you agree that the Loss Absorption Approach should focus on accounting losses?

The majority of comment letters agreed with basing the distinction on accounting losses, as defining losses as economic losses would

- have practical impediments and is of a theoretical economic nature,
- be confusing and
- damage comparability between entities.

Besides, it was argued that one would expect most economic losses (as described in the DP) were accounted for in the financial statements in any case.

Other comment letters expressed concerns with basing the definition on accounting losses, on the grounds that

- a circularity problem arises;
- the distinction may depend on measurement principles rather than on the nature of the capital, being a consequence that was deemed unintended and undesirable. (Note however, that this comment letter also noted that it is not apparent that use of economic losses offers a better solution, as the classification then may depend on effects that are not recognized in financial statements);
- in case of a deviation between accounting losses and economic losses a meaningful and substance-based classification would hardly be possible; this comment also added that the outcomes of the "Revenue Recognition-Project" are not foreseeable yet;
- currently there is the possibility not to include losses in the profit and loss account but to recognize them directly in equity (note however, that the Discussion Paper is based on the notion of "comprehensive income", so this comment seems to not be entirely valid);
- the restriction on loss absorbing in the current reporting period suppresses the participation in losses in case of liquidation. This comment letter referred to profit transfer agreements, under which minority participators do not participate in the losses of the current period, as the majority participators bear these, but would bear losses upon liquidation;
- the payments of dividend and compensation of minority shareholders are subject to legal protection provisions, triggering unavoidable obligations for the entity;

One comment letter added that focussing on accounting losses is not unnecessarily complex, while another one highlighted that it is important to refine this approach in the detail, in order to deal with a number of "special situations". A third letter questioned the robustness of the approach and referred to the need to make the approach operational.

Question 9

Do you think that the Loss Absorption Approach is explained sufficiently clear in this paper (Section 4)? Do you agree with the definition of loss-absorbing capital in par. 4.16? If not, why? How could this definition be improved?

All comment letters (but one, see below) generally found the Loss Absorption Approach to be clearly explained in the Discussion Paper.

However, in addition, some comment letters noted that

- the justification and underlying rationale is complex and if possible should be simplified;
- although the Loss Absorption Approach is "a proper approach", it could be explained even more elaborately and defined in more detail;
- some further explanations could be provided, with examples on how the circular element, which is the main limit of the Loss Absorption Approach, could be dealt with;
- (further) analysis of current instruments could be useful;
- there are questions concerning the definition of loss absorbing capital results from the existence of factual or actual loss-absorption. The comment letter refers to capital contributed within a silent partnership agreement and suggests this should be mentioned. In the situation explained, the capital provider participates in losses to the full extent of his paid-in capital and does not have a right of cancellation of his own. (Note however that, based on the additional details given in relation to this example, the comment letter reaches the conclusion that this capital is loss-absorbing);

Regarding the question how the approach could be improved, one comment letter suggested incorporating the most subordinated class of capital within the definition. Another comment letter suggested that profit participation should be taken into account as well, but added that this might lead to an additional criterion for equity classification and therefore reveal further opportunities for structuring practices.

One comment letter noted that "while we were not enthused by any of the proposals in the PV, we saw a benefit of the Basic Ownership Approach as offering a clear principle to determine equity. Likewise, we believe that the Loss Absorption Approach proposed in the DP also offers a clearer alternative to IAS 32 and a logical explanation of equity." This comment letter found it premature to use "from an entity's perspective" in the definition.

One comment letter acknowledged that definition and concept are clear, but found the arguments for the Loss Absorption Approach not compelling.

One comment letter did not find that the Loss Absorption Approach is explained clearly enough, on the grounds that it is unclear why the participation in profits has not been considered. This comment letter further argued that the definition cannot be asymmetrical, since this would introduce an inappropriate bias towards conservatism and does not reflect the economic substance of the legal rights conferred by the equity instruments that participate in profits and losses.

Question 10

Do you agree that classification of an instrument as equity or liability should be based on the terms and conditions inherent in the instrument? Do you agree that the passage of time should not be the trigger for reclassification of an instrument (pars. 4.22 ff)? If not, why?

All comment letters agreed that the passage of time should not be a trigger for reclassification. In addition, all comment letters agreed that the classification of an instrument should be based on the terms and conditions inherent in the instrument and that the classification is done only once, except in case of changes in contractual terms.

Some comment letters noted that, while the remaining term of an instrument should not be a driving factor in the classification of the instrument, the information on the settlement period of an instrument (regardless of classification) is useful to decision makers.

One comment letter stated that the approach is, in fact, dependent not only on the nature of the instrument but on the measurement principles as well. This comment also expressed concerns that a reference to purely legal terms might be insufficient for those cases where significant constructive obligations exist.

One comment letter added that**,** depending on the definition of losses a substance-based classification might be difficult to apply, and therefore some underlying principle should provide the opportunity to depart from that classification when certain conditions are met.

Question 11

Do you agree with the discussion on linkage (pars. 4.13 ff.)?

Most comment letters agreed with the analysis, on the grounds that it is a necessary measure against structuring opportunities (and added that further work is necessary.)

A few comment letters did not agree with the analysis, giving the reason that issuing instruments is not normally done to answer structuring opportunities, but in order to correspond to the demand of the market. (Note that this argument is valid in the context of the FASB approaches as well. One comment letter explicitly highlighted this fact in saying that linkage and separation are relevant to any approach to distinguish equity from debt and therefore guidance on these areas would be vital to any considered approach.)

Question 12

Do you agree with the discussion on split accounting (pars. 4.36 ff.)?

All comment letters agreed with the analysis, although a few comment letters noted that the question cannot be finally answered, as there currently is a lack of guidance on the question under which circumstances certain instruments should be split off. One comment letter, although expressing agreement with the analysis, expressed concern with regard to the practicability.

Question 13

Do you agree with the discussion of the different approaches to distinguish equity from liabilities within a group context in general and with regard to the Loss Absorption Approach in particular (section 5)? If not, why? Would you prefer the approach set out in par 5.1(a) or the approach in par. 5.1 (b)? Why?

The comment letters generally expressed agreement. One comment letter in particular noted that the discussion within the context of the group offers an important perspective, and one that has not been considered by the FASB or IASB papers.

A few commentators found themselves not in a position to answer this question, as further explanation of this topic and other issues (the examples given comprised minority interests and profit transfer arrangements) would be needed.

Another comment letter expressed doubts whether all instruments issued by subsidiaries should be classified as equity in the consolidated statements.

Some comment letters argued that it is crucial that the definition of equity does not differ from entity to group level. (Note that the definition does not differ, the issues arise when applying the very same definition to the group.) Those comment letters also concluded that an equity instrument on entity level should not lose its equity classification on the group level.

With regard to the specific question in relation to either 5.1(a) or (b), only two comment letters expressed an explicit view. Those comment letters supported (b), re-assessment at the group level. One comment letter argued that, as insurers often are capitalized at a subsidiary level through debt of the parent, it would be misleading to characterize loss absorbing capacity of the entity level as debt at the subsidiary level. (Note however that by choosing approach 5.1(b), this could be the very result.)

One comment letter did not agree, on the grounds that a clear statement on consolidated accounting can not be made, as "in highly branched group structures the consequences of applying the LAA are not yet foreseeable".

Overall, the team was encouraged to explore this issue further.

Question 14

Do the examples in section 6 illustrate the loss-absorption principle well? Would you have reached a different conclusion (or classification)? Why? Are there any other aspects of the Loss Absorption Approach that need to be illustrated?

All except one comment letter found the illustrative examples useful. The vast majority of comment letters noted in addition that the examples all appear to be appropriate, illustrate the loss absorption principle and approach well and are easy to follow.

While one comment letter took the view that no other aspects of the Loss Absorption Approach need to be illustrated, some comment letters found the number of examples limited. In particular, one comment letter suggested that the 25 examples proposed in the FASB preliminary be analysed under the Loss Absorption Approach, while two other comment letters suggested that “preferred shares” should be analysed. Another comment letter expressed hope that the implications for insurance contracts and insurers be specifically considered before such an approach is adopted.

One comment letter specifically expressed the view that the examples do illustrate the most common forms of financial instrument contracts, and the accompanying analysis does allow for the derivation of conclusions on other forms of instruments. It was further noted that, although the organisation would not disagree with any of the conclusions made, a comparison and explanation of any differences between the classification achieved under the Loss Absorption Approach and IAS32 would have been helpful in assessing the impact of applying the former approach.

Only one comment letters explicitly expressed concern, on the grounds that the examples are only an explanatory description and that therefore in practise cases may exist which cannot be subsumed under the examples described. This comment letter concluded that firstly the questions and notes contained in the comments on the other preceding questions need to be clarified.

Question 15

Do you believe that the Loss Absorption Approach is sufficiently robust to be prescribed in an accounting standard? If not, why? If you are concerned about structuring opportunities what would be your suggestion to limit the structuring opportunities?

Only three comment letters specifically answered the question on the robustness of the Loss Absorption Approach, but each of these letters expressed a positive view. One noted that, in guidance terms, the rules of linkage in particular and split accounting could be developed further to restrict structuring opportunities. The other comment letter, while explicitly taking the view that it is sufficiently robust, also noted that it has shortcomings and requires further research in order to prove that the benefits the approach aims at are achieved. This comment letter also emphasised that the primary objective of standard setting should be to develop consistent and principles-based standards for financial reporting and not to avoid abusive structuring practices, which need to be addressed by appropriate enforcement measures.

The other comment letters expressed a general agreement with loss absorption. For example, in one letter it was noted that "the Loss Absorption Approach is simple and economically sound" and should be considered seriously by the international accounting standard setters. This comment letter also referred to the unsolved questions raised in this Discussion Paper (circularity, application within a group context), which need to be elaborated further. Other letters expressed similar views. In particular, one letter expressed the view that the commentator is strongly positive about the approach and its principles, on the grounds that

- the focus is on loss-absorption, i.e. the risk-bearing character of capital, which is also the element decisive for the prudential approach to this matter;

- the approach is neutral and thus reflects the large variety of businesses beyond listed companies.

On letter expressed doubts whether the Loss Absorption Approach might be suitable as a general definition of equity and that the approach has too many shortcomings to be a viable solution. Interestingly, this comment letter also expressed also strong disagreement on the opinion (note that this opinion is not taken in the Discussion Paper and it is the FASB Preliminary Views that gives extensive consideration to this issue) that it is the "role of accounting standard setters to limit structuring opportunities". Conversely, the aim should be to issue standards that are practicable for preparers, understandable by users and enforceable by regulators, developed on the presumption that the standards will be applied in good faith.

Question 16

Do you think the Loss Absorption Approach should be simplified? If yes, how could the Loss Absorption Approach be simplified?

No letter took the view that the Loss Absorption Approach could be simplified. While some comment letters simply stated that they would not see any possibility to simplify the approach, other gave reasons, such as:

- the approach is simply enough as it is;
- the Loss Absorption Approach is in a too early stage or that, since "concrete criteria concerning the final distinction of equity" were missing to a large extent, it would be impossible to oversee possible simplification;

One comment letter referred again to the conceptual issues and to the possible implications for mutual insurers, while another letter referred to the need for more application examples.

Question 17

This Discussion Paper is based on the view that the current IFRS approach to distinguish equity from liabilities has shortcomings. Do you agree with the analysis of the current IFRS approach to distinguish equity from liabilities (section 2)? Do you agree that the current approach has shortcomings as identified in this paper (pars. 2.17 ff.)? If not, why? Do you see any other shortcomings? Do you see advantages of the current approach?

All comment letters agreed with the analysis of IAS 32's shortcomings. One comment letter emphasized the confusion of view between the proprietary and entity view is a shortcoming and noted that, in addition, the level of complexity in the current approach as a shortcoming. Conversely, the same comment letter saw the consistent definition and treatment of liabilities as advantage.

Another comment letter took the view that the 'puttables amendment' of 2008 should have solved some of the problems analysed in this paper but noted that this could only be achieved by a rule-based approach with casuistic exceptions and thus called for a new approach in the medium term that allows a "meaningful classification" regardless of the legal form or industry of the entity. Conversely, another comment letter suggested extending the analysis in the Discussion Paper to the 'puttables amendment' in order to demonstrate that this amendment will note solve the problem of all affected entities. (Note that the 'puttables amendment' was published a few weeks ***after*** the PAAinE Discussion Paper.)

Two comment letters from cooperative organisations noted that the cooperative community has made significant efforts to comply with IFRIC 2, and has now reached a solution that is acceptable to them. (Note however that, as the IASB has moved the liability/equity project to its active agenda, this "solution" may not be retainable under a revised IFRS approach.)

With regard to advantages of the current approach, one comment letter noted that, since liabilities are less divergent between entities than equity, basing the approach on a definition of liabilities is easier.

Question 18

Do you believe that the Loss Absorption Approach would represent an improvement in financial reporting over the current IFRS approach? Do you think that the distinction based on this approach provides decision-useful information? If not, why? Do you have any other comments?

The majority of comment letters took the view that the Loss Absorption Approach would represent an improvement.

Some of these letters gave an **unreserved opinion**.

Some emphasized that the improvement would **particularly apply to entities other than stock corporations** or for cooperatives.

Two comment letters, although viewing it as an improvement in the long term, highlighted the shortcomings and the need to further develop the Loss Absorption Approach. One of these letters noted that the Loss Absorption Approach requires further research concerning the benefits and costs of the approach as well as the coherences with other matters, in particular that the ongoing projects of the IASB, especially the “Conceptual Framework-Project”, have to be considered.

Another comment letter viewed the Loss Absorption Approach as a useful way to solve the issue of puttable instruments, but not as a general approach.

Two comment letters did not think that the Loss Absorption Approach would be superior to the current IFRS approach, but superior to the FASB approaches / the Basic Ownership Approach. Conversely, one comment letter took the view that “while the Loss Absorption Approach would represent an improvement over the current IFRS approach, we do not see that it is better than the improvements being suggested by the IASB itself.” (Note however that the IASB did not suggest any improvements by itself.)