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Mr Bob Herz
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Berlin, 11 November 2005

Dear Bob

Comments on the 'Equity and Liability Milestone One Draft'

Although the FASB does not officially seek comments on the 'Equity and Liability Milestone One Draft', we understand that feedback is welcome. We appreciate the opportunity to provide some views on the draft and we hope you will find them useful. When discussing the proposals for amending IAS 32 the German Accounting Standards Committee also considered the Milestone One Draft. Our following comments are based on these discussions.

General Remarks

In our opinion an approach aiming at classifying capital as either equity or liability should be based on conceptual grounds. Without a conceptual basis or a principle, finding or deducing a solution or judging whether a particular instrument is to be classified as equity or liability is likely to result in arbitrary requirements. Regrettably, the Milestone One Draft is silent as to what the conceptual basis underlying the detailed provisions is. As the conceptual basis is not described or discussed in the draft, it is difficult to provide feedback on conceptual questions.

Apart from this issue, we are concerned about the inherent conflict between the conceptual framework and the basic approach taken in the draft: Equity is defined as a residual in par. 49 of the Statement of Financial Accounting Concept 6.[1] Therefore, we believe that it would be conceptually inconsistent to base the differentiation on a definition of what is regarded a residual. Instead, we suggest defining the characteristics of a liability is a preferable way going forward.

Conceptual questions of the Milestone One Draft

Our comments on the conceptual aspects of the Milestone One Draft are based on the draft's fundamental decision to define equity (instead of the liabilities, as we believe would be consistent with the conceptual framework).

Apparently, two different criteria were selected to define instruments as equity, whereby one is based on a possible obligation to deliver cash or another form of consideration over the life of the instrument and the other is based on the kind of claim the holder of the instrument has against the entity. Unfortunately, the draft does not contain any discussion related to the selection of these criteria. It seems to us that some instruments were prejudged to *be* equity, because they contain features and characteristics that are commonly perceived to be prevalent in equity instruments; accordingly, these features and characteristics were chosen. However, such an approach results in two completely different kinds of instruments being classified as equity. Although GASB acknowledges that there may be arguments not to remeasure direct ownership instruments in subsequent reporting periods, such arguments cannot substitute a discussion of the conceptual questions involved. Before certain criteria are selected to define an instrument as either equity or liability, GASB suggests discussing and coming to a mutual understanding of the underlying conceptual issues is of utmost importance.

In addition to that, GASB believes that there might be one or more common characteristics to equity (and thus, to *all* instruments being classified as equity). For example, a common characteristic could be the subordination of the holder's claim in the event of liquidation, or the holder's sharing of the risks and rewards of the entity.

In contrast, the instruments classified as equity under the draft have very different characteristics (and their definition is thus based on alternative criteria). As we mentioned above, there would also be the possibility to define a liability. However, as the draft chooses to define equity instead, there should at least be one underlying principle for *all* instruments classified as equity. We are concerned that the apparent lack of an underlying principle might be disadvantageous, as it prohibits or complicates deducing a classification for instruments not explicitly addressed in this draft. Although the Milestone One Draft does not address multi-component instruments, we would like to point out that this will probably become an issue at a later stage of the project.

[1] "Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities."

Some instruments classified as equity under the draft appear to have the underlying notion of a hypothetical liquidation, as they refer to the claim of the holder of the instrument in question having priority over any other claims *if the issuer were to liquidate*. However, the draft neither discusses whether this might be a suitable underlying principle, nor is it applied consistently to all kinds of instruments.

Another notion of the draft seems to be a the analysis of the counterparty payoff. We are unable to identify the rationale behind this criterion. In addition, we note that it may lead to unfavourable results. We explain this point in par. 4 of our letter.

Comments on some details of the Milestone One Draft

Apart from conceptual remark above, we identified some issues in the draft where we would like to submit our comments:

1. Footnote 3 on page 13 of the Milestone One Draft mentions that the option premium initially paid is ignored when analyzing the counterparty's payoff. We note that in the case of deep-in-the-money options the counterparty's payoff may, in fact, resemble that of the underlying share. Accordingly, we are not convinced by the principle to ignore the premium with respect to deep-in-the-money options.

2. Par. 19 of the draft defines a perpetual instrument as an instrument that, inter alia, entitles the holder to a portion of the issuer's net assets in liquidation. It is not clear to us what kind of claim may meet this definition. Is it supposed to be a proportional claim? If a proportional claim was not mandatory (i.e., *any* claim would be sufficient), we would be concerned that the definition leaves room for abuse. If *any* claim would result in the instrument being classified as a perpetual instrument (assuming all other criteria being met), but *no* claim would result in the instrument being classified as a liability, we believe this choice would open up structuring opportunities. We suggest the FASB considers clarifying this definition.

3. As we understand par. 23b of the draft, the classification of indirect ownership instruments depends, inter alia, upon the counterparty payoff. We feel that from the perspective of the counterparty (that is, the holder of the option), the payoff of a share-settled option and a cash-settled option is economically the same at settlement date, provided the share is traded on an active market. It does not make a difference whether the <u>option holder</u> is granted the share directly or a cash amount equal to the fair value of the share, which s/he would then buy him- or herself. Thus, we would question the counterparty payoff notion. From the perspective of the <u>option writer</u>, however, the distinction does matter, because a share-settled option may lead to a capital increase,

whereas a cash-settled option does not lead to an inflow of capital. We would, therefore, question the conceptual grounds of the counterparty payoff criterion.

4. In addition, the definition of 'counterparty' seems to assume a peer-to-peer relationship between two contractual parties. We are uncertain whether or not this notion will be applied in arrangements involving more than two parties as well and whose counterparty's payoff profile would then have to be analysed. It seems clear to us that adding parties to an arrangement should not (and probably would not) influence the accounting by the issuer. However, it may change the accounting by the holder of the instrument, depending on who the counterparty would be, and might, thus, lead to measurement consequences.

5. Par. 24 deals with net-share-settled written call options. These would be generally classified as a liability. In addition, par. 24 addresses net-share-settled written call options based on one class of shares and settled with a different class. We are unable to identify the rationale behind this rule, as we believe that a settlement in shares belonging to a different class of shares does not change the underlying economics: The option will still be settled by delivery of a direct ownership instrument, regardless of the class of the direct ownership instrument. In our view, settlement in a different class of equity instruments would only change the terms and conditions of the holder's claim, not the claim as such. Furthermore, if *all* net-share-settled written call options were classified as a liability, we would see no reason to explicitly address this kind of net-share-settled written call options separately.

If you would like to discuss the issues set out in this comment letter, please do not hesitate to contact me. Again, I would also like to emphasize that GASB would be happy to contribute to and assist further in this project.

Yours sincerely,

Prof. Dr. Klaus Pohle
President