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COMMENTS

4 September 2008

IASB Discussion Paper Financial Instruments with Characteristics of Equity

Introduction

BUSINESSEUROPE appreciates the opportunity to respond to the Discussion Paper (DP) *Financial Instruments with Characteristics of Equity.* The distinction between liabilities and equity has far reaching consequences for accounting and financial reporting and merits a comprehensive and principle based solution. In this period of increased focus on convergence of accounting standards such a solution should be principle-based and applicable across jurisdictions. In that respect we welcome that the IASB is addressing the subject together with the Financial Accounting Standards Board (FASB). However, we also have an important concern because the DP does not provide a comprehensive discussion of the subject and does not start with an evaluation of the purpose of the distinction between equity and liabilities and the determination of general criteria for such distinction. We are disappointed that we have to conclude that the proposed approach to the project is fundamentally flawed and unable to produce a high quality solution to such an important issue that has long been subject to debate, both at the level of accounting standards and in accounting theory.

To arrive at a high quality principle-based answer to the problem IASB together with FASB should undertake a joint project to comprehensively consider the model for distinguishing equity and liabilities. Such a project has to result in clear and consistent definitions of both equity and liabilities that can be applied to both financial instruments and non-financial instruments. It needs to be clarified whether an entity view or a proprietary view has to be applied. Furthermore, the related measurement and financial statement presentation questions need to be addressed in that project. Clearly the importance of the matter and the cross-cutting nature of the issues involved require that such a project is dealt with in the ongoing Framework project. In addition to that the project should look at all options and not simply dismiss a number of possible approaches without full discussion of their merits and shortcomings. We find it disappointing that the Loss Absorption Approach is not further addressed although EFRAG and the German Accounting Standards Committee have produced a commendable position paper on the subject. Also the claims approach and the possible advantages of a third "mezzanine" category are summarily rejected although they merit careful consideration in the context of an in-depth project.

BUSINESSEUROPE understands the desire of the IASB to arrive at a converged answer to some of the existing shortcomings with respect to the distinction between equity instruments and non-equity instruments but we are concerned that neither the approach that is being followed nor proposals in the DP will lead to a principle-based

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and high quality solution. We note that FASB has issued its Preliminary Views (PV) document because classification issues for financial instruments have become more prevalent and because the current US standards depend more on legal form than on economic characteristics (Par. 5). These issues could (largely) be addressed by the FASB adoption of the principles of IAS 32, *Financial Instruments - Presentation* as an intermediate step. In view of the fact that these issues are not prevalent for IFRS reporting companies a change of IFRS to one of the three approaches developed by FASB would not be appropriate under the current circumstances.

The DP points to a number of weaknesses in the existing IAS 32. Those are related to the practical application of the principles of IAS 32 and inappropriate classification arising in certain cases where the contractual obligation to deliver cash overrides other characteristics of financial instruments for the purpose of classification (Par. 15 - 34). We acknowledge that IAS 32 is certainly not perfect but we question whether a solution can be found by simply adopting an approach developed by FASB with a completely different purpose. Furthermore, the most pressing problems with IAS 32 have been resolved by the amendments to IAS 32 of 2008 that deal with "puttable instruments" and "liabilities arising on liquidation". The remaining issues should be addressed in a successor of IAS 32 that can only be issued after a comprehensive discussion in the context of the Framework. Introduction of a new approach to classification presently would be costly and not justified by the remaining weaknesses that are quite peripheral for the large majority of companies reporting under IFRS. We are of the opinion that a fundamental change should only be made when the benefits clearly outweigh the costs. The Discussion Paper does not convince that this is the case for any of the new approaches.

The DP proposes a standalone definition of financial instruments with characteristics of equity which is difficult to judge in isolation. In our view a meaningful discussion requires that both equity and liabilities are discussed in general. When robust principles can be developed on this basis these should also be applied to financial instruments.

Taking the above arguments into consideration we conclude that the shortcomings in exiting IFRS may be better addressed by specific amendments (or interpretations) to IAS 32 and that an overall revision of the standard can only be undertaken after the completion of study at the conceptual level into the distinction between equity and liabilities.

Our detailed comments on the questions raised in the DP are presented below.

Detailed comments and questions

B1 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?

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(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?

With respect to the first part of the question BUSINESSEUROPE would like to make a general observation first. 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.
We are not convinced that any of the three approaches meets these requirements.

The **Basic Ownership** approach is not an appropriate solution because it introduces a too narrow definition of equity. We are not convinced that the "having the most residual claim on liquidation" is the best starting point for a distinction, notably under going concern circumstances where the chances of liquidation are remote. This approach will result in many instruments being classified as liabilities that in substance have some characteristics of equity. The only merit of the approach is that it reduces complexity for the determination of equity. However, this goes at the expense of the decision-usefulness of the information that will be produced. Furthermore, it introduces more complexity in that classification and measurement of liabilities because many instruments will be classified as liabilities that are fundamentally different from "normal" liabilities and in a number of cases contain embedded equity features. For these instruments split accounting will need to be introduced so the apparent simplification with respect to equity classification is shifting difficulties into liabilities. That is not a solution that meets the above criteria. Furthermore the approach appears to be an attempt to introduce a very arbitrary bright line in the definition of equity for simplicity sake without any regard for the substance of the instruments concerned.

We also note that the basic ownership approach would preclude share-based payment transactions from being classified as equity which would be a fundamental change for share-settled instruments. This would create an important change in IFRS 2 *Share-based Payment* which standard has only recently been introduced. Changing the controversial accounting for share-based payments once again, shortly after the introduction of IFRS 2 is not appropriately timed in our view and is likely to confuse users of financial statements.

The introduction of the Basic Ownership approach would be a significant change compared with current IAS 32 that would result in a significant increase in liabilities for IFRS reporting entities. Such change can only be justified in case it results in more useful information being provided in the financial statements. Arguments to support such a conclusion are not provided in the DP and we do not expect that they can be found. We point-out that the distinction between debt and equity has significant legal and regulatory importance. Legal aspects that should be addressed to come to complete analysis relate to contracting (e.g. debt covenants), capital maintenance rules and limitations on distributions to shareholders. Regulators in a number of industries and debt rating agencies also use the distinction between debt and equity. A move to the basic ownership approach will significantly increase the level of liabilities for most

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companies reporting under IFRS and such a change would require a thorough impact assessment together with a careful analysis of the benefits that such a change would provide to users of the financial statements.

In case any of the three approaches needs to be selected we would express a preference for the **ownership-settlement approach** because it is most similar to existing IAS 32. However, as we clearly argued in our introduction there is no urgent need to change IAS 32 and therefore our preference is only of theoretical relevance. We note that this approach combines the subordination requirements from the Basic Ownership approach with the lack of settlement requirements characteristic for certain perpetual instruments. The combination of two criteria creates a concept of equity that is a blend of instruments which are not necessarily sharing the same characteristics. Such a solution is not principle-based and will not improve current IAS 32. It may resolve a few of the weaknesses that IAS 32 has but we expect that it will create as many new weaknesses which the DP fails to identify.

The **reassessed expected outcome approach** has to be rejected. It is far too complex to apply in practice and will result in continuous reassessment of the probability of certain occurrences. This is costly and highly subjective. Furthermore, it will lead to reclassifications that will be difficult to explain to the users of the financial statements.

As we already indicated in the introduction we urge the IASB (and FASB) to start a comprehensive project on the distinction between liabilities and equity and to include the Loss Absorption Approach, the Claims Approach and the possibility of a tripartite structure (equity, mezzanine and liabilities) in such a project.

B2 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?

The scope of the project is not appropriate. A principle-based solution can not be found when only financial instruments are addressed. BUSINESSEUROPE is convinced that the conceptual work needs to be done at the level of the Framework first, resulting in criteria that would apply to all balance sheet items. In addition the consequences of balance sheet classification for performance reporting need to be included in the scope for a complete analysis.

B3 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?

As we have already explained, we are not convinced that the basic ownership approach is the solution to the issue of distinguishing equity from liabilities. We are unable to perform a full analysis of all possible jurisdictions and entity types to determine whether the basic ownership approach might be inappropriate. However, such a review should be performed and areas that should be addressed are the

interaction between the basic ownership approach (or any other approach) and the legal requirements that govern subordination and ability to distribute profits. Also the consequences for co-operative entities and for partnerships warrant further analysis. BUSINESSEUROPE notes that the treatment of redeemable shares at nominal value of certain cooperative and mutual entities can create issues in this respect, that have been addressed in the recent amendment of IFRS 32, which amendments should be retained.

B4 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?

Please refer to our answer to B3.

B5 Please provide comments on any other matters raised by the discussion paper.

The DP states as a starting point that the liability or equity determination that is determined at the subsidiary level is maintained in the consolidated financial statements. Although that appears to be logical on first sight we think it is not sufficiently elaborated in the DP and we question whether it can be justified. The subordination of certain claims is an important distinguishing feature for equity instruments but that feature is difficult to project to the level of the group that is producing consolidated financial statements. In a hypothetical case the group holding company might go into liquidation while subsidiaries remain solvent. It is not clear what the relevance of subordination at the level of the subsidiary is for the consolidated financial statements of the group in such a case. The consequences of any new equity liability distinction need to be thoroughly analyzed both for separate financial statements and for consolidated financial statements. Both the DP and the Preliminary Views document fail to provide such an analysis.