

Date  
21 October 2008

Le Président

Fédération  
des Experts  
Comptables  
Européens  
AISBL

Avenue d'Auderghem 22-28/8  
1040 Bruxelles  
Tél. 32 (0) 2 285 40 85  
Fax: 32 (0) 2 231 11 12  
E-mail: [secretariat@fee.be](mailto:secretariat@fee.be)

Mr. Stig Enevoldsen  
Chairman  
Technical Expert Group  
EFRAG  
Avenue des Arts 13-14  
B - 1000 Bruxelles



E-mail: [commentletter@efrag.org](mailto:commentletter@efrag.org)

Ms. Liesel Knorr  
DRSC  
Zimmerstrasse 30  
D-10969 Berlin

E-mail: [info@drsc.de](mailto:info@drsc.de)

Dear Mr. Enevoldsen,  
Dear Ms. Knorr,

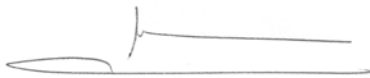
**Re: Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper – Distinguishing between Liabilities and Equity**

1. FEE (Fédération des Experts Comptables Européens, Federation of European Accountants) is pleased to submit its comments on the Discussion Paper on Distinguishing between Liabilities and Equity ("the DP"), led by the German standard-setter, the accounting Standards Committee of Germany (ASCG)/Deutsches Rechnungslegungs Standards Committee e.V. (DRSC), as part of the Pro-active Accounting Activities in Europe (PAAinE) initiatives.
2. We welcome this PAAinE initiative as a valuable contribution to the debate on distinguishing between equity and liabilities. We agree that there are limitations in the existing IFRS on this topic and that a European contribution to this debate is helpful.
3. We welcome the development of the new approach presented in the DP, the so-called Loss Absorption Approach, as a means to challenge the existing financial reporting and raising relevant questions that need to be addressed. In our opinion, the discussion in the DP comes at the right time further to the developments by the IASB and FASB on this subject and it should be considered in conjunction with the Preliminary Views published by the FASB on Financial Instruments with Characteristics of Equity and the IASB pronouncements on equity and liabilities.
4. Some of the difficulties with the "original" definition of equity and liabilities have already been raised in the FEE Comment Letter on the IASB Discussion Paper on Fair Value Measurements (dated 12 June 2007).
5. In practice, there is a need for a better understanding of how the loss-absorption would apply. In the illustrative examples, we note that it would have been useful to cover at least all the common types of capital in order to offer a better understanding of a wider range on instruments. Additional practical examples would help. For example, illustrating how the Loss Absorption Approach would apply to preference shares.

6. Consolidation is also an issue, which we believe should be addressed at this stage of the debate. We support the importance of requiring an approach that will work for both separate financial statements and consolidated financial statements.
7. Our responses to the questions in the Invitation to comment Section of the DP are contained in the Appendix to this letter.

We would be pleased to discuss any aspect of this letter that you may wish to raise with us.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jacques Potdevin', with a long horizontal stroke extending to the right.

Jacques Potdevin  
President

Ref: ACC/JP/SS/LF

**Appendix 1: Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper – Distinguishing between Liabilities and Equity**

**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. 1.3ff.)?**

**If not, why?**

8. Yes. Distinguishing between classifications as part of capital or as part of liabilities has, so far, had a real meaning for users of financial reporting.
9. We believe that there should be only two categories on the credit side of the balance sheet and clear definitions of equity and liability that are not overlapping. We doubt whether the introduction of a remaining category will improve the transparency of the financial information. For this, additional information in the Notes will also add more value to users.
10. Therefore, we favour keeping the two classes in the balance sheet and adding detailed disclosures on the claims in the Notes. Nevertheless, this will require clear principles in order to define and clearly distinguish one classification to another to ensure comparability between entities is possible.

**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?**

11. As mentioned earlier, we would prefer having only two classes of capital on the balance sheet. Nevertheless a separate line of presentation of these two classes should be favoured and this should be based on suitable criteria either in the notes or the financial statements.
12. We favour having better and more relevant information rather than simply more disclosures. This would enable users to better understand the information reported in the balance sheet.
13. As we are confronted with the reporting of more and more complex financial instruments, providing detailed disclosures in the Notes to the financial statements can become very relevant and meaningful. See also our response to Question 1; we favour keeping the two classes in the balance sheet and any relevant additional information in the Notes.

**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?**

14. We agree with this analysis. However, the debate should not exclude the possibility of other criteria, which may be developed in the Framework project for what are liabilities and equity.

**Appendix 1: Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper – Distinguishing between Liabilities and Equity**

**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.)?**

15. The DP suggests that having fewer criteria is best. In our opinion, a distinction should be made between principles and criteria. Conceptually, we favour having a general principle to identifying what is a liability and what is equity. To allow this to work in practice, the characteristics of some financial instruments should be tested against this general principle to determine whether it is robust enough as means of defining a proper classification. On this basis, a limited number of criteria should be developed to facilitate the application of the general principle.

**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?**

16. In our opinion, the response to whether an entity view or a proprietary view has to be applied should consider the work carried out on the Conceptual Framework projects. The decision of how to classify capital should be in line with the approach favoured in the Conceptual Framework.
17. The Exposure Draft "An improved Conceptual Framework for Financial Reporting - Chapter 1 and Chapter 2" expresses the view that financial reporting should reflect the entity perspective rather than the perspective of the owners of the entity. In our comment letter on this ED, we strongly support EFRAG's view that a full debate is needed on the perspective from which financial statements should be prepared, before a conclusion can be reached at this stage of the Framework project. In particular, we are like EFRAG not supportive of the proprietary approach.
18. However, although we see more merits in the entity approach since this is a principles-based model, we believe that the practical consequences of such a model need further thought in particular on issues like the dividing line between equity and debt and the treatment of goodwill under IFRS 3. Also the practicalities of such a model need further consideration.
19. Having said this, we could agree with the paper's description of the implications of each approach.

**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.)?**

20. In principle, we agree with this analysis. Also, we note that in the context of classifying capital, some users other than investors can have an important information need. While we feel that the needs of investors are properly addressed in the DP, we are not sure that other relevant users' needs in this context (such as debt rating agencies) have been given the same consideration in the discussion regarding capital classification.

**Appendix 1: Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper – Distinguishing between Liabilities and Equity**

**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?**

21. Risk capital is an element, which should be considered for distinguishing debt and liabilities. However, we question whether this should be based on this element alone if we want to ensure a sufficiently clear distinction.
22. In addition, we note that the DP distinguishes between “risk capital” and “capital at risk”. However, while for the latter we can have an instrument of debt, this is not the case for “risk capital”. We find the distinction between these two terms very thin and we recommend that this be clarified further.

**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?**

23. We agree with this analysis but to focus on accounting losses for the Loss Absorption Approach may not always be relevant. For instance, a “risk capital” instrument (which would be defined as equity according to the DP) is based rather on “economic value” than on “accounting value”. Hence, we do not feel that focussing on accounting losses for the Loss Absorption Approach helps developing a solid general principle.

**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?**

24. In practice, there is a need for a better understanding of how the loss-absorption would apply. In the illustrative examples, we note that it would have been useful to cover at least all the common types of capital in order to offer a better understanding of a wider range on instruments. Additional practical examples would help. For example, illustrating how the Loss Absorption Approach would apply to preference shares.
25. As noted earlier regarding the definition, we find the distinction between “risk capital” and “capital at risk” very thin and we recommend that this be clarified further.

**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?**

26. In principle, we agree that the passage of time should not change the classification of an instrument as equity or liability if the contractual terms and conditions do not change.

**Appendix 1: Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper – Distinguishing between Liabilities and Equity**

**Question 11**

**Do you agree with the discussion on linkage (pars. 4.31 ff.)?**

27. The linkage analysis appears relevant and useful to proper classification of the instruments. Nevertheless, we find the approach presented at least as complex as in the existing IAS 32, in particular with the introduction of linkage to the splitting analysis.

**Question 12**

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

28. We agree in principle. We would favour additional examples to show how this would work in practice.

**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?**

29. We favour the approach set out in par 5.1(b) but we are not sure how it will work in practice.

**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?**

30. We are not totally convinced by the illustrative examples, as we do not find them sufficiently clear to enable a proper understanding of how the loss-absorption would apply in practice. We question whether this may mean that the Loss Absorption Approach is not easy to apply or perhaps the examples presented are simply not enough to illustrate its application. We think that the examples presented may be too theoretical, so this makes it difficult to fully understand the key implications. In addition, it would have been useful to cover at least all the common types of capital in order to offer a better understanding of a wider range of instruments. For example, it would be useful to illustrate how the Loss Absorption Approach would apply to preference shares.
31. In addition, we note that it would be useful adding the Loss Absorption Approach to the comparison of the other three different approaches offered in the Preliminary Views published by the FASB on Financial Instruments with Characteristics of Equity showing what the classification would be like under each approach for the different instruments presented.

**Appendix 1: Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper – Distinguishing between Liabilities and Equity**

***Questions on the loss absorption approach in general***

**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?**

32. The use of “accounting losses” needs to be re-considered as it does not, for instance, reflect economic losses in case of the amount of redemption being a fixed amount and not a fair value or an approximation of a fair value. The loss absorption approach has to be further developed to be able to deal with problems as for instance the applicability within the group context. See also our responses to Questions 8 and 13.

**Question 16**

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

33. Yes, we think it should be simplified. We reiterate our comments in our response to Question 14 where we note that it would be useful comparing the Loss Absorption Approach against the other three approaches in the FASB Preliminary Views. This exercise may help to assess where simplifications should be made.

**Question 17**

**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?**

34. We agree with this analysis.

**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?**

35. As explained earlier, we do not feel that there is sufficient illustration in the DP that the proposed approach is preferable to any other approaches. It would be helpful to clarify the benefits of this approach further. In addition, it would be useful to have additional illustrative examples to better understand how it will work in practice.