Date

29 September 2008

Le Président

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Dear Sir David,

Re: IASB Discussion Paper *Financial Instruments with Characteristics of Equity*

1. FEE (Fédération des Experts Comptables Européens - Federation of European Accountants) is pleased to submit its comments on the IASB Discussion Paper *Financial Instruments with Characteristics of Equity* (the "DP").

2. As a founding organisation of EFRAG, we have considered and contributed to EFRAG's final submission to the IASB of 19 September 2008.

3. We acknowledge the DP as a step in addressing the difficulties of existing IFRS dealing with the financial reporting of financial instruments. We agree that the three approaches presented help highlighting some of the important issues that need to be fixed and we welcome the debate to open this discussion.

4. We share some of the concerns about the DP as detailed by EFRAG. In particular, we agree that the three approaches presented do not appear consistent with the definitions in the existing Framework. Moreover, the new definition of a liability proposed under the IASB Framework Project on the Elements of Financial Statements does not appear in line with any of the approaches proposed. Hence, we are unable to see how the existing inconsistencies between the Framework and the IFRS requirements on how to classify financial instruments are being addressed in the DP. 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 do not support the introduction of a remaining category. We encourage the IASB to achieve this.

5. Therefore, we believe that it would be preferable for the final resolution of the subjects of the DP to wait until the Framework Project is completed. This would enable a better foundation on which to base any future requirements for the reporting of all financial instruments. While we agree that the solution needs to be developed in a way that is in line with the Framework Project, we also feel like EFRAG that this topic is a priority and needs to stay high on the agenda.

6. We do not consider any of the three approaches presented robust enough to replace IAS 32.

7. We recognise the work carried out by EFRAG with the development of the so called Loss Absorption Approach which is presented in the PAAinE initiative on Distinguishing between Liabilities and Equity, as a means to challenge the existing financial reporting and raising relevant questions that need to be addressed. We encourage the IASB to consider further the potential benefits and drawbacks of this alternative approach in its next steps of this project and to take on board the work already done under this PAAinE initiative. However, we think that the three approaches presented in the DP and the approach developed in the PAAinE initiative require further discussion and work to address the current difficulties.

8. We support EFRAG on the importance of requiring an approach that will work for both separate financial statements and consolidated financial statements. Our preferred final solution would be in line with a principle-based approach that works in practice. This could be achieved by having clear but a limited number of criteria in place to help ensuring consistency in the application of the general principle and helping users with the preparation and understanding of the financial information. This would reduce the current degree of complexity. For instance, this would facilitate application of the requirements in separate financial statements and consolidated financial statements.

9. 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).

10. We strongly support EFRAG in its view as detailed in paragraph 38 of the EFRAG Final Comment Letter that economic compulsion is one of the most important equity/liability classification issues to resolve and that IAS 32 has been weakened mainly as a result of it reluctance to entertain this notion. We think more emphasis should be put on this statement.

11. 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,

Jacques Potdevin
President

Ref: ACC/JP/LF-SR

Appendix: Responses to the questions in the Invitation to comment - IASB Discussion Paper *Financial Instruments with Characteristics of Equity*

Some initial comments

Project approach

12. We agree with EFRAG and the IASB that there are a number of practical issues in the current equity/liability classification system under IAS 32 and that these need to be addressed. However, we do not find that the DP includes an adequate discussion on how the three approaches that are presented to distinguishing equity from liabilities would solve the existing shortcomings under IFRS. Therefore, this is one of the main reasons why we are not convinced that any of the three approaches offer a proper solution.

Relationship between this project and the ongoing Framework project

13. We support EFRAG on their perceived need to work towards having a new Framework and the requirements to classify financial instruments that are aligned. We also hope that the results of this project and the work on the IASB Framework Project on the Elements of Financial Statements will provide the IASB with an opportunity to achieve this goal.

14. Like EFRAG, we note that the three approaches presented in the DP are not consistent with the definitions in the existing Framework. Moreover, the new definition of a liability that is proposed under the IASB Framework Project on the Elements of Financial Statements does not appear in line with any of the approaches proposed. Hence, we are unable to see how the existing inconsistencies between the Framework and the IFRS requirements on how to classify financial instruments are being addressed in the DP. Preference shares are an example of how the new definition of a liability is not consistent with the proposed approaches. There are several types of instruments that could face some difficulties in the implementation of the approaches presented, as discussed below.

15. We agree with EFRAG that it would be better to address the existing inconsistencies between the Framework and the IFRS requirements when the relevant parts of the Framework Project are completed, so that the Exposure Draft can capitalise on the established Framework definitions, and inconsistencies can be avoided between future standards and the new Framework.

Defining equity

16. We agree with EFRAG on the need for further work to develop an approach that avoids equity being viewed simply as a financial instrument that is not a financial assets or a financial liability. There could be other models allowing the suggested solution (i.e. to have a requirement that equity exhibits certain distinctive criteria) to work in practice. We encourage the IASB to do more work on this suggestion.

17. We doubt whether having additional classifications in the balance sheet (such as a mezzanine class between capital and debts) will improve the transparency of the financial information. For this, additional information in the Notes will add more value to users. 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.

18. See also our response to Question B1 below.

Appendix: Responses to the questions in the Invitation to comment - IASB Discussion Paper *Financial Instruments with Characteristics of Equity*

IASB questions for respondents

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?

(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?

19. 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.

20. We feel there is no sufficient discussion in the DP to support the need for a line between the different types of claims to an entity's net assets. In addition, it is not sufficiently clear in the proposals what the criteria for drawing this distinction should be. We agree with EFRAG that it would be useful to have other approaches developed, including the approach presented in the PAAinE paper Distinguishing between Liabilities and Equity. We favour a two categories approach at this stage, but we also recognise benefits in analysing other alternatives. We wish to reiterate that the Framework project should be sufficiently advanced before issuing the new standards as set out in paragraph 14 and 15 of this appendix. The debate needs to be extended to other possible solutions and approaches and not be limited to those generated within a US context.

21. We agree with EFRAG on the key issues which need to be addressed and the importance of finding a solution which will offer a satisfactory balance between ensuring usefulness of information, simplicity whenever possible, having a principle-based approach that works in practice and focus on the substance over form of the instruments and transactions. We would also have hoped to find more detailed discussions on these issues under the three approaches presented. Overall, we do not consider that any of the three approaches presented is robust enough.

<u>The basic-ownership approach</u>

22. We agree with EFRAG that more work is required before a view can be reached on the merits of the basic-ownership approach, as detailed in the FASB Preliminary Views that it provides more decision-useful information to investors while significantly simplifying accounting requirements for issuers and their auditors.

23. We think that ownership is an element that can take a variety of forms. This could potentially make the basic-ownership approach more complex, making it difficult for issuers to understand and apply the requirements, also resulting in less useful information to investors. It is unclear how the varying forms of ownership that can exist in practice are dealt with under this approach. In addition, classification based primarily on a liquidation scenario is contrary to the going concern principle, which is used as a key part of the Framework.

24. In particular, we share the comments of EFRAG in paragraph 18 of its Final Comment Letter.

Appendix: Responses to the questions in the Invitation to comment - IASB Discussion Paper *Financial Instruments with Characteristics of Equity*

<u>The ownership-settlement approach</u>

25. We think paragraph 20 of the EFRAG Final letter offers a good summary of what we also believe to be the key weaknesses of the ownership-settlement approach. We agree with the underlying comment that this is a very rules-based solution.

<u>The reassessed expected outcome approach</u>

26. We support EFRAG on its assessment of the reassessed expected outcome approach (as detailed in paragraph 21 of the EFRAG Final Comment Letter). While we see some merit in that this approach may focus on the substance over form of the financial instruments and transactions, we do not see how this will compensate for the resulting increase in complexity. Hence, we also agree that it is complex to understand and probably therefore to apply. Therefore, we believe that this approach should not be considered further.

<u>Consolidated financial statements</u>

27. We understand the difficulties of working on a consolidated basis; separate financial statements are usually linked to the legal structures of the reporting entities. As explained earlier, we support EFRAG on the importance of requiring an approach that will work for both separate financial statements and consolidated financial statements. Our preferred final solution would be in line with a principle-based approach that works in practice. This could be achieved by having clear but a limited number of criteria in place to help ensuring consistency in the application of the general principle and helping users with the preparation and understanding of the financial information. This would reduce the current degree of complexity. For instance, this would facilitate application of the requirements in separate financial statements and consolidated financial statements. Therefore, we agree with paragraphs 22 to 24 of the EFRAG Final Comment Letter.

<u>Other possible approaches</u>

28. As mentioned earlier, we do not feel that the three approaches presented fully address the difficulties under existing IFRS. It would be useful to look at alternative approaches at this stage of the project.

29. We welcome the development of the so called Loss Absorption Approach presented in the PAAinE initiative on Distinguishing between Liabilities and Equity, as a means to challenge the existing financial reporting and raising relevant questions that need to be addressed. We encourage the IASB to consider further the potential benefits and drawbacks of this alternative approach in its next steps of this project and to take on board the work already done under this PAAinE initiative. There is a need to develop alternative approaches and we encourage the IASB to do more work.

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?

30. We agree with EFRAG that the scope of the project is too narrow. We agree that a principle-based standard would encompass all types of balance sheet items.

31. We strongly support EFRAG in that it would be essential to ensure that share-based payment awards are in the scope of this project. We would also expect that at least the same requirements for the classification of financial instruments between equity and liabilities apply for all financial instruments regardless of the scope limitations of the existing individual IFRS. We note that under existing IFRS, there is no total consistency between IFRS 2 and IAS 32.

Including share-base payment awards in the scope of this project would provide us with an opportunity to address this current limitation.

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?

32. As explained earlier, the principle of ownership is an element that can take a variety of forms, making the basic-ownership approach more complex. As an additional example, in the case of two classes of shareholders with the same rights in a going concern situation, with only one difference on liquidation, where shareholders B are subordinated to shareholders A, we think it is difficult to understand in practice why shareholders A should be presented as liabilities.

33. Insurance contracts are usually redeemable, and under the basic ownership approach this would have the following consequences for insurance contracts with participating features and for membership rights in case of mutual insurers:

    (a) Participating policyholders typically would not share the entire net assets but any surplus after providing guaranteed benefits. In case of stock companies, shareholders' rights to equity are subordinated to that guarantee. Furthermore, participation rights usually relate only to shares in parts of the business (e.g. portfolios), and/or to specified assets or to a percentage of them. However, on a bifurcated basis, policyholders' participation rights might be treated as equity, if there is no (other) equity at all or policyholders' participation rights refer to the entire surplus of the entity directly and share a fixed proportion together and with the same priorities as shareholders.

    (b) Membership rights under mutual insurers entitle policyholders to a share in any remaining net asset in case of liquidation. We note that there are situations, in which the remaining net assets are to be granted for other purposes (for example, health mutuals in the Netherlands, and state-owned non-profit insurers in Germany). A condition for a redeemable basic ownership instrument is that the policyholders have also a claim to a share in any net asset if the contract is cancelled or matures, as it would be payable in case of liquidation. However, in most cases members do not receive any share if contracts cease, since nearly all insurance contracts are valid only for a limited time (maximum time is the life time of the policyholder). Hence, in practice, although there is an owner in case of liquidation, members do not benefit if contracts cease before liquidation. Since the number of members is usually very large, in practice liquidation is not a realistic scenario. The definition of a basic ownership instrument does not consider these peculiarities of membership rights under mutual insurers. We would prefer classifying these as equity on the basis that there is no liability in case of going concern, and the rights are subordinated to any other claim and subject to any claim only in case of liquidation, which is in practice a remote possibility.

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?

34. See our response above in B3.

Appendix: Responses to the questions in the Invitation to comment - IASB Discussion Paper *Financial Instruments with Characteristics of Equity*

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

Linkage

35. As mentioned earlier, we look for a solution that will consider the substance over form of the instruments and transactions. Therefore, we agree with EFRAG that in the circumstances described in paragraphs 41-43 of the Preliminary Views by the FASB, we would expect the transactions of the two or more instruments meeting the detailed conditions (as detailed in paragraph 33 of the EFRAG Final Comment Letter) to be accounted for as if they are a single instrument.

Substance

36. See comments above in paragraph 35.

37. We strongly support EFRAG in its view detailed in paragraph 38 of the EFRAG Final Comment Letter that economic compulsion is one of the most important equity/liability classification issues to resolve and that IAS 32 has been weakened mainly as a result of it reluctance to entertain this notion.

Treatment of puttable instruments

38. We support the comments made in paragraph 39 of the EFRAG Final Comment Letter that the proposed requirements for redeemable basis ownership shares as set out in the FASB Preliminary Views document are not very clear.