Freudenberg & Co.

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13-14 Avenue des Arts
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Belgium

7/23/2008

Dear Sir or Madam,

Re: Comments on the Discussion Paper "Distinguishing between Liabilities and Equity"

We appreciate the opportunity to comment on the PAAinE´s discussion paper on distinguishing between liabilities and equity. This letter expresses the view of Freudenberg & Co. Kommanditgesellschaft, Weinheim, Germany, a family-owned company.

Equity classification under the current IAS 32 constitutes a problem for many non-publicly listed entities in Europe. The problems resulting from the equity-liabilities distinction criteria of IAS 32 have led to the classification and presentation of equity instruments of many European partnerships and cooperatives as liabilities. This is mainly due to the obligation of the issuer to repurchase or redeem the financial instruments when the instrument holder is exercising the legally guaranteed put option. Accordingly, current regulations can lead to meaningless or misleading disclosures that are not reflecting the economic substance.

Although the revision of IAS 32 should solve some of the above-mentioned problems by a rule-based approach with casuistic exceptions from the initial distinction criteria of IAS 32 integrated in the application guidance, it can only serve as a provisional solution. Furthermore, a consistent regulation should take into account that in many countries the application of IFRSs is required even for non-publicly listed entities. In our opinion, a new principle-based approach has to be established in medium term that allows an economically meaningful classification of financial instruments as equity regardless of the entity´s legal form or industry.

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For that reason, we highly appreciate the European contribution to the international discussion on equity-liability distinction. From our perspective, the Loss Absorption Approach (LAA) provides decision-useful information concerning the proprietary rights of the owners of an entity regardless of legal form or industry. Therefore, the LAA reflects the needs of investors of publicly listed companies as well as the requirements of non-publicly listed companies across different jurisdictions. We believe that the LAA represents a valid alternative to other approaches which are currently discussed by the IASB and the FASB.

However, we are aware of the fact that the LAA leaves several other problems of capital classification unsolved. While we clearly see the benefits of the proposed approach, we also realise its shortcomings. It requires further in-depth research regarding the benefits and costs of the approach as well as the coherences with other matters like the relation to profit or loss or consolidated financial statements. In addition, the IASB´s running projects, especially the "Conceptual Framework-Project", have to be considered in the evaluation of the consequences of the LAA.

Please refer to the appendix to this letter for our answers to the questions outlined in the discussion paper.

Kind regards,

Freudenberg & Co.
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Appendix:
Comments to the Questions of:
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. 1.3 ff.)? If not, why?

In our opinion, a dichotomous capital structure provides decision-useful information. Although a "list claims"-approach might have the merit of providing sophisticated information about the different claims and could take into account newly developed financial instruments, it still raises the question of where to draw the line between the claims to be classified as equity or liability for various applications. Moreover, its practicability for common financial statement analysis would be significantly restricted. Therefore, we prefer a dichotomous capital structure.

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?

As for the above mentioned reasons (see Question 1), we see some benefits in listing all claims to the entity´s assets. Nevertheless, in order to improve inter-company comparability, the ranking criteria would have to be standardised and steadily adjusted to the ongoing development of financial instruments. This would lead to impracticable and difficult to manage disclosure requirements. We believe that for the balance sheet a dichotomous capital structure should be maintained, whereas the notes could include some disclosures about specific relevant claims.

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?

From our point of view, the characteristics analysed are relevant.

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.)?

Capital distinction should be based on one core characteristic. A multi-criterion distinction has to be defined on a cumulative basis.

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?

To be able to classify financial instruments by a principle-based methodology it is important to employ a clear and concise underlying concept, which may be the entity view or the proprietary view. In this we agree with the paper. However, the discussion paper does not provide a sufficient analysis of all relevant aspects of the different views. Furthermore, the view should comply with the "Conceptual Framework-Project" and the fundamental theoretical concept underlying the IFRS. This seems to require an entity view. However, even the discussion in the discussion papers on the conceptual framework is not based on an adequate conceptual basis. Therefore, the views have to be discussed extensively before one can be chosen as the basis for a capital classification concept.

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.)?

We agree.

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?

The distinction on risk capital provides decision-useful data regardless of the legal form or industry of an entity. In fact, this distinction constitutes the fundamental basis of the equity classification concepts of various jurisdictions.

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?

Under the current definition of accounting losses the LAA might cause a circularity problem: the calculation of accounting losses implies knowledge of the liabilities of the entity, whereas the approach is used to distinguish between equity and liabilities. Furthermore, in case of deviation between accounting losses and economic losses a meaningful and substance-based classification would hardly be possible. In addition, the outcomes of the "Revenue Recognition-Project" are not foreseeable yet.

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?

We agree. It might be argued, that profit participation should be taken into account as well. However, this might lead to an additional criterion for equity classification and therefore reveal further opportunities for structuring practices.

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?

We agree. Nevertheless, it should be noted that depending on the definition of losses a substance-based classification might be difficult to apply. 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.)?

We agree.

Question 12:

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

We agree.

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?

We do not agree. We believe that currently a clear statement concerning consolidated accounting can not be made. Especially in highly branched group structures the consequences of applying the LAA are not yet foreseeable.

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?

The illustrative examples do not include preference shares which from our point of view are commonly used financial instruments.

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?

The LAA seems to be sufficiently robust. Nevertheless, we also see its shortcomings. It requires further in-depth research to prove the compliance of the approach with the benefits aimed at. Additionally, 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. Abusive structuring practices need to be addressed by appropriate enforcement measures.

Question 16:

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

From our point of view the LAA is still in a too early stage to oversee possible simplification matters.

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?

We agree with the shortcomings as stated in section 2. IAS 32 (rev. 2008) should solve some of the problems mentioned by a rule-based approach with casuistic exceptions from the initial distinction criteria. For that reason it can only serve as a temporary solution. In our opinion, a new principle-based approach has to be established in medium term that allows an economically meaningful equity classification regardless of the legal form or industry of the entity.

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?

We agree. Nevertheless, we are aware of the fact that the LAA leaves several other problems of capital classification unsolved. While we clearly see the benefits of the proposed approach, we also note its shortcomings. It requires further in-depth research concerning the benefits and costs of the approach as well as the coherences with other matters. In addition, the ongoing projects of the IASB, especially the “Conceptual Framework-Project”, have to be considered in evaluation the consequences of the LAA.