European Financial Reporting Advisory Group
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Dear Sir

Distinguishing between Liabilities and Equity

The Association of Chartered Certified Accountants (ACCA) is pleased to have this opportunity to comment on the Discussion Paper (DP) on the above subject, which was considered by ACCA's Financial Reporting Committee. I am writing to give you their views.

General comments

ACCA welcomes this timely contribution that EFRAG has made to the debate on distinguishing between liabilities and equity. We agree that this is a significant area of accounting which can impact the decision-usefulness of financial information.

We also agree that there remains some uncertainty and inconsistency in the application of IAS32 which potentially can lead to quite similar financial instruments in substance being classified differently. This we believe can add an unavoidable layer of complexity to financial reporting.

This fundamental review of the principle underlying IAS32 is also welcome given its inconsistency with the IASB's Conceptual Framework as recognised in the DP. Also with regards the current Framework, the DP rightly points out its silence regarding which perspective (entity or proprietary) should drive the presentation of financial statements. We agree this assumption is highly relevant to the classification of financial instruments as either liability or equity. However, we note that since the release of the DP, the IASB's recent exposure draft - *An Improved Conceptual Framework for Financial Reporting* - refers to the objective of financial reporting being "prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners". The conclusions from the consultations on that paper will clearly be relevant to any principles formed in distinguishing between debt and equity based on the proposals in the DP.

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We would also note that the IASB has issued a Discussion Paper for comment on *Financial Instruments with Characteristics of Equity*. This paper also tackles the issue of distinguishing between liabilities and equity, although it takes as its focus the Preliminary Views paper of the same name, issued by the FASB in November 2007. While we understand that a shorter term resolution to the issues in US GAAP may be warranted, we do not believe that there is such a pressing need in IFRS and that changes to IAS32 should await a more comprehensive review.

Despite some inherent problems in IAS32, we believe that in practice preparers are able to apply the principles of the standard. We therefore agree that the DP's proposals for a more fundamental review of the distinction between equity and liabilities at the conceptual level would be a more suitable starting point than the proposals in the FASB's Preliminary Views paper (PV).

Specific questions for comment in the Discussion Paper

Q1 Do you believe that the two different classes of capital on the credit side of the balance sheet does provides 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?

While the prevalence of hybrid financial instruments continues to grow, and puts a strain on the distinction between equity and liabilities, we believe that in principle a dichotomous structure does provide decision-useful information to users in general and investors in particular. We believe that where instruments have multi-dimensional characteristics, appropriate disclosure, which allows users to make informed decisions, gives substance to the two-tier credit side of the balance sheet.

Q2 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 mentioned in our response to question 1, we agree that additional information on the characteristics of the claims through disclosure is important in allowing users to distinguish between instruments which have multiple characteristics. However, we would reiterate that we do not believe that this would require a list approach to the credit side of the balance sheet.

Q3 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

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not, why? Do you think that any other characteristics should be considered? If yes, which?

We believe that the DP offers a comprehensive analysis of the key differentiating characteristics of equity and liabilities and forms a sound basis for their classification. We are not aware of any other specific characteristics that would be relevant.

Q4 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)?

We certainly agree that it would be more satisfactory to distinguish capital based on a limited number of criteria. The DP uses the FASB's Ownership Settlement Approach (Paragraph 1.36) to demonstrate the varying categories of financial instruments that could result from more than one criterion. We would suggest that this approach would in fact give rise to similar classifications to IAS32 as it stands, and result in a relatively high number of instruments being separated into components (hybrid instruments).

As mentioned in our responses to questions 1 and 3, we believe that appropriate disclosure could alleviate some of the problems of blending instruments over the two categories of debt and equity. However, the use of one criterion would be more supportable. A coherent principle, which defines either debt or equity, will certainly result in a simpler model to adopt.

Thus, while the Basic Ownership Approach in the PV relies on the definition of liabilities, leading to the residual claim being equity, we believe that the positive defining of equity as suggested in paragraph 1.39 provides an equally relevant criterion.

Q5 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?

We certainly agree that the view adopted in this respect would have a bearing on the classification of certain financial instruments, as set out in paragraphs 1.41 and 1.42. As noted in our general comments, the IASB's recently issued exposure draft *An Improved Conceptual Framework for Financial Reporting* points to an entity perspective being the preferred view.

The arguments set out in the DP for adopting an entity perspective do appear coherent in the context of distinguishing financial instruments. However, as suggested in the paper, we too believe that the Loss Absorption Approach could be refined to meet a proprietary perspective.

As such we believe that the more fundamental debate on whether to adopt a proprietary view or an entity view as a whole is crucial here. It is essential that there is consistency throughout financial reporting standards and between them and the Framework. We expect to use the IASB's exposure draft to conclude on this matter from a general viewpoint for financial statements, and then assess what impact it would have in the context of distinguishing financial instruments.

The interaction with legislation is also of particular significance in terms of equity and liabilities, and therefore we believe further analysis would be required with respect to applying the view across jurisdictions and entity types. It is essential that any principle should be workable in all circumstances, and while the DP does recognise this, more consideration of the actual impact would be necessary before concluding how to apply it in principle.

Q6 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 would agree that investors as providers of risk capital to the entity would have the most comprehensive information needs of all user groups, and will want to be able to determine where they rank in terms of the degree of risk and benefit sharing of their capital. We also agree that both lenders and suppliers will have similar information needs.

Q7 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?

As risk capital is the key differentiator between investors and other lenders and suppliers, we would agree that this would be an appropriate basis for distinguishing between equity and liabilities.

Q8 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?

We would intuitively support the use of accounting losses in this context, especially as we would expect most economic losses (as envisaged in the DP) would be accounted for in the financial statements in any case.

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Q9 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?

While we were not enthused by any of the proposals in the PV, we saw a benefit of the Basic Ownership Approach as offering a clear principle to determine equity. Likewise, we believe that the Loss Absorption Approach proposed in the DP also offers a clearer alternative to IAS32 and a logical explanation of equity.

We believe that much of the complexity in this area of financial reporting can be diminished by a positive definition of either equity or liability, which would leave less ambiguity and scope for financial engineering.

With regards the definition in paragraph 4.16, we consider that it is premature to use "from an entity's perspective" in the definition. As mentioned in our response to Question 5, we believe that more debate and analysis on the merits of each perspective is required. This is currently being carried out in the context of the IASB's exposure draft *An Improved Conceptual Framework for Financial Reporting*. We would need to conclude on this matter from the general perspective of financial instruments before assessing its impact in the context of distinguishing between liabilities and equity.

Q10 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 that the remaining term of an instrument should not be seen as a decisive factor in determining between an equity or debt instrument, as this could lead to instruments which have not changed in character (terms and conditions) being treated differently over time.

Clearly there would be benefit to users in knowing the settlement period of an instrument, whether it be a debt instrument or an equity instrument. This information is useful to decision makers, but should not be a driving factor in the classification of the instrument.

Q11 Do you agree with the discussion on linkage (pars. 4.33 ff.)?

We believe that linkage and separation are relevant to any approach to distinguish between an equity or a liability instrument, and therefore guidance on these areas would be vital to any considered approach. We agree with the views in the DP, which mirror those of the PV, that linkage of financial instruments which have been issued as part of the same arrangement should be applied. Without such a principle in place, instruments could be structured to contrive or avoid a particular classification in a misleading way.

Q12 Do you agree with the discussion on split accounting (pars 4.36 ff.)?

Equally, we agree that some element of split accounting would be required in order to ensure that combining other types of payment requirements to report an entire instrument as equity is avoided.

Q13 Do you agree with the discussion of the different approaches to distinguish equity from liabilities within a group context in general and with regards 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 believe that the discussion within the context of the group offers an important perspective, and one that has not been considered by the FASB or IASB papers. However, we would also note that the IASB as part of the active phase of the Conceptual Framework project is reviewing what constitutes the 'unit of account'. Underpinning this question as well as the discussions in the DP relating to the group context is whether financial reporting should be viewed from a proprietary or an entity perspective.

Mirroring our response to question 5, we therefore believe that it would be appropriate to consider the conclusions from the consultations on both the unit of account and the view taken in terms of the objectives of financial reporting, before expressing a preference for one or other of the approaches.

Q14 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?

We believe that the examples do illustrate the most common forms of financial instrument contracts, and the accompanying analysis does allow for the derivation of conclusions on other forms of instruments.

We would not disagree with any of the conclusions made in the examples. However, a comparison and explanation of any differences between the classification achieved under the Loss Absorption Approach and IAS32 would have been helpful in assessing the impact of applying the former approach.

Questions on the Loss Absorption Approach in general

The DP poses four specific questions on the Loss Absorption Approach. We have listed these below (questions 15 to 18) and will answer these together as we consider them to be inter-linked.

Q15 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?

Q16 Do you think the Loss Absorption Approach should be simplified? If yes, how?

Q17 The 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 (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?

Q18 Do you believe that the Loss Absorption Approach would represent an improvement to 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?

As mentioned in our general comments we do believe that there are issues with IAS32 which could lead to inconsistency in application. However, we also consider that in practice many entities are adequately distinguishing between quasi-equity instruments in their financial statements, using the current rules.

Hence, while we can accept the relative urgency for the FASB to consider this topic, given the varying literature in US GAAP on this area, and while we are appreciative of the IASB's need to consider convergence with FASB, we are firmly of the view that any change should result in a higher quality standard and should form part of a comprehensive rather than a piecemeal approach.

We see many benefits in the Loss Absorption Approach including the positive definition of equity, the relative simplicity of the model to apply and the sense that the classification of instruments intuitively feel correct. We acknowledge that the current IAS32 classifications of many types of preference shares and redeemable shares may not reflect appropriately the economic reality of the contracts.

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We believe that the best way to resolve those inconsistencies is a fundamental review of the Framework itself and then a thorough analysis of approaches that are consistent with that Framework, in order to provide substance to an accounting standard on this subject.

This is clearly a more long-term objective, and in this respect, we certainly consider the proposals in the DP as a very useful starting point for that fundamental review, especially in the context of defining equity.

If there are matters arising from any of the above please do contact me.

Yours sincerely

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