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Association pour la participation des entreprises françaises à l'harmonisation comptable internationale

Mouvement

A F E P

Association Francaise des Entreprises Privées

EFRAG
14 avenue des Arts
Bruxelles
Belgium

Paris, September 5, 2008

Re : Distinguishing between liability and equity

ACTEO, AFEP & MEDEF welcome the opportunity to comment on the EFRAG – PAAinE research paper on the distinction between liability and equity. ACTEO, AFEP & MEDEF and MEDEF are very complimentary about the quality of the work carried out by EFRAG under its Pro-Active Activities in Europe.

In contrast with the FASB – IASB discussion paper, the EFRAG PAAinE research paper starts with framing the issue of distinguishing liability from equity broadly and by reference to the needs of existing and potential capital providers. It also analyses the issue with respect to the perspective in which financial statements should be prepared, i.e. the entity or proprietary perspective. We believe that this is the right approach, one we believe the IASB should follow.

However we do not believe that the present conceptual basis, i.e. that equity is the residual rights on the entity's net assets, after all unconditional claims to the entity's assets have been satisfied, should be revoked. We further believe that working on a revised definition of liabilities and on a future standard fully in compliance with the conceptual framework runs more chances of reaching a desirable outcome in an efficient manner than to build on a completely different starting point. We agree with the analysis of IAS 32 weaknesses as presented in the IASB introduction to the FASB discussion paper "Preliminary views on financial instruments with characteristics of equity". Our practice of IAS 32 for the last few years let us think that, provided that the above referred anomalies are solved, there is no need for a revolutionary standard.

Furthermore we are not convinced that a distinction based on "risk capital" as defined by the authors in the paper is more decision-useful than the existing approach. It can be easily argued, we believe, that "risk capital" associated with unconditional rights to redeem runs less business risk than some form of long-term debt redeemable in fine. In particular, the authors fail to explain in what ways the proposed distinction would help users assess future cash-flows.

We provide a detailed analysis in the appendix to this letter.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

ACTEO	AFEP	**MEDEF**
Patrice MARTEAU Chairman	Alexandre TESSIER Director General	**Agnès LEPINAY** Director of economic and financial affairs

Appendix to the ACTEO & MEDEF letter of comments on the EFRAG PAAinE paper « Distinguishing liability from 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 ?

Yes, we do believe that the definition of two different classes of capital provides decision-useful information, even if the entity's capital structure is in fact multi-dimensional. We do believe that there is a significant and useful difference to make between different sources of capital provided to the entity, even though we agree with the observation that financial instruments have grown so complex and diverse that there is no obvious bright line. This is the reason why, we believe, split accounting had to be developed. Most of the complexity in split accounting is due to the complexity of the instruments, we believe, rather than of the accounting requirements.

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 ?

A general description of the "list claims – approach" looks promising at first glance ; however we wonder how a suitable hierarchy could be established without the search for relevant criteria for classification generating difficulties of definition and assessment. Ranking of instruments in practice would most probably prove to be very cumbersome to apply.

Moreover, going for the "list claims – approach" would most probably lead to re-measuring period after period all claims and hence creating further and greater accounting mismatches, unless all internally generated intangibles, including goodwill, were to be recognised. Users have more than once expressed that such an evolution would be for the worse and we, preparers, agree.

Question 3 : Do you agree with the analysis of the different characteristics of capital as the basis for distinguishing between equity and liabilities (pars.1.14ff) ? If not, why ? Do you think that any other characteristics should be considered ? If yes, which ?

Yes, we agree with the analysis provided in paragraph 1.14.

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) ?

We believe there are some shortcomings in the analysis. Indeed the authors give precedence to the definition of equity over the definition of liabilities without explaining why they make that choice. Indeed basing the definition of equity on a cumulative basis if more than one criterion is applied would result in having very dissimilar instruments classified as liabilities. We fail to see why such a direction would be more useful to the present and future capital providers than to have hybrid instruments being part of equity.

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 ?

We would agree that the view adopted in financial reporting has an influence. However we disagree with part of the analysis :

- much of the present debate is not between the entity view and the "proprietary view" per se, but rather between the entity view and the "parent company view" ; under that view, the focus in on the interests, ie the instruments, not the holders ; the proprietary view would call for a different set of assets and liabilities to be considered ; as a result, we believe that IFRS clearly exclude such an approach ;

- the exception created recently for puttable instruments at fair value cannot be called an inconsistency since it has clearly been decided as an exception.

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 with the analysis of users' needs and believe that the authors have identified the relevant starting point. However we observe that users are most interested in financial information which helps to forecast cash-flows, in order to assess the level of risk they would bear and/or the return they may expect from their present/ a potential investment. We regret that there is no analysis of how the loss absorption approach helps forecast cash-flows. We note that in the end of Section 4 the authors indicate that information helping to assess liquidity would be provided in the notes. We regret to see no discussion of why the notion of risk capital has more relevance to users than liquidity or solvency notions.

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 ?

No, we do not. See our answer to question 6 above.

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. 4.1ff) ? If not, why ? Would you agree that the loss absorption approach should focus on accounting losses ?

We support the statement made in the document that accounting should aim at providing a fair representation of the entity's economics. Accounting standards have however their own shortcomings and limitations which make us doubt that accounting losses can be used as a proxy for economic losses.

Furthermore we disagree with the continuum concept in loss absorption that the authors have developed in their approach. We believe that capping or flooring the risk capital element in an instrument should disqualify that instrument from being classified as equity.

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 4.16 ? If not, why ? How could this definition be improved ?

We believe that overall the general concept on which the authors elaborate is clearly explained. However in contrast with the first sections of the paper section 4 "Refining the approach" fails to explain satisfactorily the purpose served by the refinements brought to the approach. We also believe that this concept is far away from being ready for application.

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 ?

Yes, we do, as we understand that terms and conditions of the instrument allow the analysis in substance of the instrument..

Question 11 : Do you agree with the discussion on linkage (pars 4.31 ff) ?

Yes, we do, also for an analysis in substance of instruments..

Question 12 : Do you agree with the discussion on split accounting (pars 4.36) ?

We agree with the basics (economic substance and the growing complexity of financial instruments call for split accounting), but favour an approach where the liability component is determined first. This is consistent with our view that our accounting framework should keep a positive definition of liabilities.

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 ?

No, we disagree with that analysis. From an entity's perspective, equity holders (whatever the distinction between equity and liability may be) have to be considered in sole relation to the net assets to a share of which they are entitled. In the context of a group liquidation, the controlling interest in a subsidiary can be sold as such, and the parent be liquidated while the former subsidiary is still operating. Therefore we believe that regarding equity holders in a subsidiary as less subordinated than the parent's equity holders as is done in par. 5.8 is not substantiated.

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 ?

Section 6 is a welcome illustration of the loss-absorption principle. However the conclusions reached for the most complex cases remain unclear to us. Moreover, we would have wished to see the examples provided in the FASB –IASB paper to be analysed using the loss-absorption approach and how outcomes different from the other approaches would provide users with more decision-useful information. Furthermore full field tests would be necessary to ensure that the approach is workable and provides useful information.

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 ?

Please refer to our answer to question 9.

Question 16 : Do you think the loss absorption approach should be simplified ? If yes, how could it be simplified ?

As indicated in our answer to question 14, we believe full field tests would need to be conducted. Question 16 is in our view much too premature.

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 2.17ff) ? If not, why ? Do you see any other shortcomings ? Do you see advantages of the current approach ?

We believe that the existing weaknesses in IAS 32 have been well analysed in the IASB introduction to the FASB discussion paper discussion financial instruments with characteristics of equity.

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 doubt it would. The existing approach has now been widely set in practice and its shortcomings and weaknesses are easy to identify. We believe that financial reporting would be better served by amending the existing approach rather than by building on completely and untested grounds.