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PAAINE DISCUSSION PAPER DISTINGUISHING BETWEEN LIABILITIES AND EQUITY

General comments

EFRAG and the Accounting Standards Committee of Germany (ASCG) have prepared a very useful Discussion Paper (DP), bringing together important conceptual arguments with respect to the distinction between equity and liabilities and have demonstrated original thinking in the development of the so-called Loss Absorption Approach (LAA). BUSINESSEUROPE appreciates the high quality of the conceptual exposition in the DP and although a number of our comments are critical that should not deter the authors from developing the concepts further.

While EFRAG/ASCG viewed the matter from a conceptual angle, we have viewed it also from other angles and naturally reviewed the outcome to determine whether it makes practical sense, is able to be implemented in practice and provides more meaningful information to users. We also asked ourselves whether there is an urgent need for change and whether the subjects that are addressed should result in short term amendments to existing standards.

BUSINESSEUROPE agrees that current IFRS has shortcomings in the distinction between liabilities and equity. However, we feel that the Discussion Paper is predominantly written to resolve the "puttable instruments problem", leaving the classification of other instruments unchanged. To solve this important, but also rather peripheral, problem a fundamentally different approach to distinguish liabilities and equity is proposed that has far-reaching consequences in all areas of equity/liability classification. Due to the vast range of different types of capital in practice, we cannot see all ramifications of this new approach and we note that the Working Group has not been able to fully deliberate a number of essential elements (e.g. consolidation; interaction between balance sheet classification, the income statement and the concept of profit/loss, which is so vital for performance reporting). The new approach can have merit but it requires further in-depth study and a careful comparison with alternative approaches. We note that the focus on loss absorption appears to be conflicting with the going concern notion of the Framework and wonder whether the departure from this principle has been sufficiently elaborated.

BUSINESSEUROPE has a number of detailed remarks with respect to the LAA that will follow later. Overall we are of the opinion that a fundamental change should only be made when the benefits clearly outweigh the costs. The Discussion Paper does not convince that this is the case for the new approach, which is at least as complex as current IAS 32. Furthermore, we are concerned about the suggestion in the DP to

define liabilities as the residual when equity is defined on the basis of the LAA. There are many unresolved questions with respect to the consequences of such a reversal. Based on our current understanding of the LAA we can not support such a change. Equity should remain the residual within a Framework that clearly defines liabilities (as the current Framework does).

Taking the above arguments into consideration we conclude that the shortcomings in exiting IFRS may be better addressed by specific amendments (or interpretations) and that the LAA requires more in-depth investigation and consideration, including comparison with alternative approaches that have been developed by others, to enable a future decision to introduce a completely new approach to distinguishing between equity and liabilities.

Our detailed comments on the questions raised in the DP are presented below.

Detailed comments and questions

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?

Yes, BUSINESSEUROPE finds the distinction useful because it provides meaningful information to users of financial statements. Furthermore, it is aligned with general economic and financial market theory that analyses the different economic interests of equity and debt holders. There may be some appeal in the introduction of a third – mezzanine – category but we would prefer a two-tier structure with appropriate rules for linked and split accounting.

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?

BUSINESSEUROPE is of the opinion that a listing of all claims provides useful disclosure as it can allow an insightful presentation of the multifaceted nature of different claims. However, to be comparable across companies listing criteria or classes would have to be defined and we wonder whether that enhances transparency. It may be best to maintain the two different classes for the balance sheet in combination with disclosures about individual claims 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?

BUSINESSEUROPE thinks that the characteristics that have been analyzed are relevant. We do question whether implied or explicit return promises to the holder of the instrument should not also be taken into account.

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.)?

BUSINESSEUROPE agrees with the analysis. In case more than one criterion is used a cumulative definition needs to be applied. We wonder what the benefit would be of having various dissimilar items being grouped into liabilities when a singular and narrowly defined criterion is used to distinguish 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?

BUSINESSEUROPE agrees that a view needs to be selected. We would expect a more thorough discussion of the arguments in favor and against each view to be the basis for such a decision. A preference for the entity perspective appears to be expressed because that is consistent with the current treatment of rights to put in IAS 32. (par. 2.41). We also note that IASB Discussion Paper on "The Reporting Entity" starts from the premise that the entity perspective needs to be applied (eg. S8 on page 10). However, neither this DP nor the Conceptual Framework project provides very convincing conceptual arguments for such a choice. A more general debate is required to come to a decision on the choice between the entity view and the proprietary view and alignment between IFRS and US GAAP on this point should be ensured. Should an entity view be explicitly applied, clear measures of effects related to the proprietary view should be inserted, such as currently is the case for e.g. basic and diluted EPS, which serves to warn shareholders that the entity-based report has elements that impact them.

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.)?

BUSINESSEUROPE agrees with the analysis in as far as it addresses the needs of investors and shows how it helps them to assess future cash flows. However, we point out that the distinction between debt and equity has significant legal and regulatory

importance. Legal aspects that should be addressed to come to complete analysis relate to contracting (e.g. debt covenants, preferred instruments), capital maintenance rules and limitations on distributions to shareholders. Regulators in a number of industries and debt rating agencies also use the distinction between debt and equity and we question whether their needs have been properly addressed.

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?

BUSINESSEUROPE agrees that the distinction is useful and we point out that the distinction is still a cornerstone of modern finance theory. We question the notion in the DP that the individual classification should be maintained in consolidation (in such a case legal form appears to overrule substance).

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?

It is difficult to answer this question without any clarity on performance reporting. As is already mentioned in the DP there is a risk of circularity in reasoning and it remains unresolved how the servicing costs of equity and debt instruments will be handled. The relevance of the difference between economic and accounting losses for the classification is not very clear to us and suggests that measurement considerations are relevant for distinguishing between liabilities and equity which would appear anomalous.

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?

No, BUSINESSEUROPE does not think so. The paper does not clearly explain why participation in profit should not be part of the definition. The focus on the buffer function of equity serves primarily the information needs of creditors, but does not present a complete insight in claims on (future) profit. This may be a primary concern for investors, but may also be relevant for other users. The one-sided approach creates an unexplained bias towards conservatism (liquidation values). Due to the fact that we fail to understand why participation in profit is not taken into account in the determination of loss-absorbing capital we can not confirm that the proposed definition is correct.

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, BUSINESSEUROPE agrees. In making that comment we assume that "terms and conditions inherent in the instrument" refers to the substance of the instrument. The passage of time in itself should not result in a reclassification of an instrument.

Question 11

Do you agree with the discussion on linkage (pars. 4.13 ff.)?

Yes, BUSINESSEUROPE agrees that linkage will be needed to be able to report in accordance with the substance of certain transaction but we caution that it may be difficult to draw a bright-line for transactions that are not linked by contract.

Question 12

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

Yes, BUSINESSEUROPE agrees.

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, BUSINESSEUROPE does not agree. The purpose of consolidated financial statements is to present financial information about the group as if the group *were* a single entity. However, in practice this assumption is violated by limiting claims by creditors on assets of specific subsidiaries. In such cases, equity of the parent is not absorbing *all* losses. Neither is the equity of the separate subsidiaries. This creates a significant flaw in the approach. Although in simple group structures, this flaw may be overcome, it cannot be used unambiguously for complex financial instruments used in complex group structures.

The discussion in section 5 is not very clear and fails to provide convincing arguments. More work needs to be done to come to a clear exposition of the consequences of the LAA in a group context.

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?

BUSINESSEUROPE has doubts. Some illustrative examples are rather complex, and the outcome is not always obvious. This observation illustrates that the Loss Absorption Approach is not simple to apply. We miss in the illustrative examples preference shares, as a common type of capital. Furthermore, we note that the FASB paper on "Financial Instruments with Characteristics of Equity" contains a comparison of the classification of various instruments under the three approaches that FASB defines in that paper. It would be worthwhile to add the LAA to that overview and indicate how the instruments would be classified under the LAA.

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 Loss Absorption Approach can be a robust basis for the distinction between equity and liabilities. However, a truly robust distinction also requires a similarly clear definition of liabilities and we would like to see further analysis in this area. It is too early to conclude that we can depart from the principle that equity is the residual in a framework where assets and liabilities are objectively defined. We disagree with the suggestion that accounting standards should be developed to limit structuring opportunities. Accounting standards should not limit or avoid any transaction that may have economic validity. They should faithfully represent such transactions. The objective of the IASB is to develop a single set of high quality, understandable and enforceable global accounting standards. It is up to preparers, auditors and enforcement agencies to avoid undesirable structuring activities. This should not be a design criterion for the standards.

Question 16

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

Is too early to decide whether the LAA can be simplified because full visibility of the consequences of the LAA is not available presently.

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?

BUSINESSEUROPE agrees with the shortcomings that have been identified.

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?

BUSINESSEUROPE agrees that the Loss Absorption Approach solves the "puttable instruments problem". For other common types of financial instruments, the outcome is often the same as within IFRS. We doubt whether this limited difference in outcome warrants a totally different approach to be implemented in IFRS. We foresee that the Loss Absorption Approach may cause interpretation problems in complex financial instruments/structures. Adapting existing instruments and loan covenants to this different approach may cause high costs and market uncertainties. Solving specific shortcomings with an entirely new approach may cause those costs to exceed the benefits. We therefore conclude that the LAA should not be implemented presently but studied further as a possible long-term solution for distinguishing liabilities and equity.