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Comments on the IASB discussion paper: “Financial Instruments with Characteristics of Equity”

Dear Sir David,

We warmly welcome the plan to revise the current rules on distinguishing between equity and non-equity instruments and thank the IASB for the opportunity to comment on its discussion paper of 28 February 2008 “Financial Instruments with the Characteristics of Equity”.

A. General comments

In our view, the objective of revising the rules on classifying financial instruments as equity or non-equity should be to define equity in a way which is based on the principle of substance over form and which is independent of legal or sector-specific factors. We believe it is important for accounting standards to enable all preparers to issue financial statements which adequately reflect the economic situation of their company.

Under company law in Germany (as in most EU member states), there are a number of special rules for partnerships and cooperatives. Many of these entities do not hold any financial instru-

ments which could be classified as equity under the three proposed approaches. Application of the rules envisaged in the discussion paper would consequently place these entities at a considerable disadvantage. We take the view that an appropriate definition of equity should also be able to accommodate the situation at entities of this kind and should not be influenced by any specific type of legal form. There is a particular problem in this regard with the basic ownership approach, which would classify only very few financial instruments as equity.

We also have serious reservations about the suitability of the reassessed expected outcome approach since it is highly complex and would be extremely onerous to apply. Of the three approaches proposed, the ownership-settlement approach appears the most likely to ensure broad and appropriate classification of financial instruments as equity. But this approach does not bring any material changes to the existing IAS 32 rules.

If any real improvement on the current distinction between equity and non-equity is to be achieved, therefore, further approaches need to be considered. We are thinking, for example, of the “loss absorption approach” proposed by the European Financial Reporting Advisory Group (EFRAG) as part of its Pro-Active Accounting Activities in Europe (PAAinE) initiative. This approach classifies financial instruments as equity on the basis of their ability to absorb losses, irrespective of their subordinated status (meaning that, in the event of liquidation, there is only a claim to the issuer’s net assets after all other obligations have been met). We believe that this method offers the advantage of enabling financial instruments to be classified as equity or non-equity solely on the basis of their economic characteristics (principles-based accounting). This would ensure consistency with the IFRS Framework. Furthermore, the approach would be much better at meeting the needs of users as set out in the Framework and would have no bias towards any specific legal form. Against this backdrop, we would urge the IASB to give careful consideration to the PAAinE initiative’s loss absorption approach.

In addition, we believe that a new definition of equity will require the current IAS 32 definition of financial liability to be revised as well. Otherwise, implementation of the rules as envisaged in the discussion paper will give rise to inconsistencies. A preferred share, for example, cannot be classified as equity under the basic ownership approach because it is not the most subordinated class of capital. But it is not possible to classify it as a financial liability either as things stand because a preferred share does not constitute an obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity on potentially unfavourable conditions. So without revising the definition of financial liability, it would not be possible to classify preferred shares at all under the basic ownership approach.

Our comments on the questions raised in the discussion paper are as follows:

B1 Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve or simplify IAS 32? If not, why?

In our opinion, none of the three approaches outlined in the FASB Preliminary Views document are a suitable basis for distinguishing between equity and non-equity. We therefore do not believe they represent any significant improvement on the present situation. Our reservations about the approaches proposed by the FASB can be summarised as follows:

Basic ownership approach: The objectives of this approach are to significantly simplify the criteria for distinguishing between equity and non-equity compared to the existing US GAAP rules and cut the potential for accounting arbitrage. The attempt to reduce the level of complexity is to be welcomed. Nevertheless, we take the view that the basic ownership approach would not help to improve financial reporting and fails to meet the basic IFRS principles of relevance and reliability. We are particularly critical of the following points:

- We do not consider it appropriate to classify only financial instruments in the most subordinated category of capital as equity. Under the basic ownership approach, the classification of a financial instrument as equity or non-equity would depend on whether or not the preparing entity had issued more deeply subordinated instruments. The classification is consequently not based on the economic substance of the financial instrument in question. As a result, identical instruments could be classified differently by different entities. Preferred shares, for example, are identical to common shares from an economic perspective since both instruments represent a residual claim to net assets and payments in both cases are at the discretion of the issuer. The situation with non-cumulative preference shares, holdings by dormant partners and shares in cooperatives is similar because these financial instruments also absorb losses and thus represent a residual claim. Yet under the basic ownership approach, preferred shares, holdings by dormant partners and non-cumulative preference shares would have to be classified as non-equity since they are not the most subordinated category of capital.
- The basic ownership approach would severely impair the comparability of financial statements. This can be illustrated by the following example. Two entities (A and B) currently hold the same amount of equity (100) under IAS 32. The equity of A is composed solely of common shares while that of B is made up of both common (50) and preferred (50) shares. Under the

basic ownership approach, the equity of entity B would be halved (since only common shares can be classified as equity) in spite of the fact that the two financial instruments are essentially the same from an economic point of view.

- Perpetual instruments would not be considered equity under the basic ownership approach on the grounds that they reduce the amount of capital allocated to the basic ownership instruments in the event of liquidation and thus represent a liability. We do not support a blanket classification of perpetual instruments as non-equity. In our view, the key criterion for classifying a financial instrument as equity should be its ability to absorb losses. If it is able to do so, we believe that it should be classified as equity irrespective of its degree of subordination.
- The following aspect is also an argument against distinguishing between equity and non-equity on the basis of “most subordination”. Unless an entity is liquidated, senior shares carry the same risks and rewards as more subordinated equity instruments. All classes of equity therefore display the same economic characteristics and are subject to the same risks as are subordinated instruments. For this reason, it is at odds with the principle of substance over form to accord them different accounting treatments in our view. As mentioned above, common and preferred shares, for example, are identical from an economic perspective if they represent a residual claim on net assets and there is no entitlement to regular payments by the issuer. It is therefore difficult to understand why their accounting treatment should differ.
- IAS 32.11 defines an equity instrument as a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. This is a negative definition. If a financial instrument on the liabilities side of the balance sheet is not a financial liability within the meaning of IAS 32, it must be deemed an equity instrument. The basic ownership approach (like the other approaches in the discussion paper) diverges from this principle. It does so, however, without amending the definition of financial liability under IAS 32. This could give rise to situations in which all or certain components of a financial instrument cannot be classified either as equity within the meaning of the basic ownership approach or as a liability. IAS 32.AG 37, for example, currently specifies that, for redeemable non-cumulative preference shares whose dividends are payable at the discretion of the issuer, the difference between the issuing amount and the present value of the redemption amount should be reported as equity since the dividends do not represent a financial liability. Under the basic ownership approach, the entire instrument would have to be classified as a liability. But this would not be possible under IAS 32 as thing stand because voluntary dividends do not represent a financial

obligation. Without adjusting the IAS 32's definition of financial liability, therefore, there would be a contraction within the IFRS regime.

- This approach would also be at odds with IFRS 2. Obligations arising from certain share-based payment arrangements which are booked to equity under IFRS 2 would not meet the definition of equity under the basic ownership approach. We take the view that new or revised accounting standards should integrate with the existing accounting regime without creating inconsistencies with the present rules.
- Paragraphs 67 to 69 of the FASB document envisage that no derivatives on the issuer's equity instruments will be classified as equity. This is justified on the grounds that these derivatives dilute the net assets available to existing shares (basic ownership instruments) because, for example, an option has resulted in further shares being issued at a price below fair value. It is concluded that they consequently represent a liability. We do not share this view and believe that the current accounting treatment (recognition as equity of a component corresponding to the amount of the option premium) should be retained. We would merely suggest clarifying certain aspects of the present rules such as the fixed-for-fixed principle.

Ownership-settlement approach: In principle, we consider the ownership-settlement approach preferable to the basic ownership approach because it also allows perpetual and indirect ownership instruments (derivatives on the entity's own equity) to be classified as equity. This makes the approach less discriminatory, particularly against entities which are not incorporated companies. We nevertheless take the view that the ownership-settlement approach is not a significant improvement on the existing IAS 32 rules. Our main reservations are as follows:

- As the IASB discussion paper points out, the ownership-settlement approach is the most similar to IAS 32. This means that many of the criticisms of the existing rules are not tackled. The approach does nothing to clarify the fixed-for-fixed principle, for example, and offers no solution to the problems of handling de facto obligations. Nor are inconsistencies eliminated between IAS 37, which determines the existence of a liability on the basis of the probability of an outflow of economic resources, and IAS 32, which does not address this aspect.
- Like IAS 32, the ownership-settlement approach focuses on the manner in which derivatives are settled and not on their economic characteristics. As a result, two derivative instruments which are identical from an economic point of view receive different treatment depending on whether or not they are settled with a fixed number of shares. If, for instance, it is possible to settle a

derivative on an issuer's own equity instrument with the issuer's own shares at the discretion of the issuer, we believe that an equity classification better reflects the economic substance of the transaction. Take, for example, a convertible bond which can be settled either with a fixed number of shares or with their cash equivalent. In our view, this financial instrument is identical in economic terms to a traditional convertible bond, which is settled with a fixed number shares only, and should receive the same accounting treatment. But this is not possible under IAS 32 and remains impossible under the ownership-settlement approach.

- The ownership-settlement approach merely adds two further classes of equity (perpetual and derivatives on the entity's own financial instrument) to that recognised under the basic ownership approach. Our above comments on basic ownership instruments therefore apply here too.
- The ownership-settlement approach would, as the IASB correctly points out, result in more instruments having to be separated into components than is the case under IAS 32. We are not convinced that the additional time and effort this would involve would be matched by a corresponding increase in the quality of financial information.

Reassessed expected outcomes (REO) approach: The REO approach would lead to unnecessary complexity, in our view, because it would be very difficult to apply in practice. We are particularly concerned about the following points:

- The probability of each outcome has to be assessed at each balance sheet date. These assessments are potentially highly subjective and would severely impair the reliability of the information in the accounts.
- This approach would lead to a high degree of volatility in profit and loss and in equity.

BI (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?

See above.

B1 (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?

We would recommend that the IASB give greater consideration to EFRAG's proposed loss absorption approach and to how it would affect the distinction between equity and non-equity. This approach classifies financial instruments as equity on the basis of their ability to absorb losses, irrespective of their subordinated status (meaning that, in the event of liquidation, there is only a residual claim). We believe that this method offers the advantage of enabling financial instruments to be classified as equity or non-equity solely on the basis of their economic characteristics. The distinction would thus be based solely on principles-based accounting and consistency with the IFRS Framework would be ensured.

We would like to highlight the following aspects of the loss absorption approach:

- The distinction between equity and non-equity is made solely on the basis of a financial instrument's ability (or inability) to absorb losses.
- As a result, the financial instrument is classified solely on the basis of the terms of the contract, that is to say irrespective of how other financial instruments are classified. All financial instruments belonging to the same class of capital therefore receive the same accounting treatment across all entities.
- This approach enables the economic character of equity, i.e. its ability to absorb losses, to be correctly defined. This is a broad definition, under which retained earnings, capital reserves and revaluation reserves, for example, would be clearly classified as equity since they are all able to absorb losses.
- Limiting the definition to a single, economically explicit criterion ensures that instruments can be classified as equity or non-equity simply and unequivocally.
- Of all users of financial statements, risk capital providers have the most extensive need for information. The type and scale of financial information provided under the loss absorption approach is geared towards the needs of these investors.

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?

The scope of the project is too narrow, in our view. Only three types of financial instrument are described (basic ownership, perpetual and indirect ownership instruments) and the document analyses whether these could be classified as equity under each of its three approaches. As we see it, this is a departure from principles-based accounting because there is no attempt to explain the rationale behind the equity classification in each approach.

At present, the criteria for equity classification are to be found in IAS 32 (for financial instruments) and in the Framework (from which the equity nature of retained earnings and capital reserves may be inferred). We believe it would have been helpful for a project dealing with an accounting definition of equity to have set out general principles which are not limited to certain selected financial instruments and to have looked at the conceptual characteristics of equity. This is the only way, in our view, to arrive at definitions of equity and non-equity which are both sufficiently broad and clear-cut.

As mentioned in our comments on the basic ownership approach, we do not believe it is possible or useful to revise the rules on distinguishing between equity and non-equity without also reviewing the definition of financial liabilities in IAS 32. If the definition of equity is adjusted in isolation, situations may arise in which an instrument cannot be classified as either equity within the meaning of one of the three approaches or a financial liability within the meaning of IAS 32.

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?

The definition of basic ownership instruments envisages that redeemable financial instruments can be classified as equity if they are settled at fair value (or at an approximate value for a percentage of the net assets). Owing to legal restrictions which apply to cooperatives and the vast majority of partnerships, it might be very difficult to apply this rule in Germany.

As a result, redeemable instruments could only be classified as equity in Germany in very rare circumstances.

B4 *Are there 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?*

Substance over form is one of the basic principles of accounting. We therefore take the view that this principle should also be considered by the three approaches outlined in the FASB document. As mentioned above, however, we believe that these approaches interpret substance over form with the needs of incorporated companies in mind. This means that the classification criteria do not adequately reflect the economic substance of financial instruments held by entities with a legal form other than that of an incorporated company.

We are also critical of the fact that the interpretation of substance over form does not address all the criticisms levelled at the current IAS 32. The document does not, for example, clarify whether economic compulsion to make payments should result in a financial instrument being classified as a liability. This is normally the case if a financial instrument provides for an agreed interest add-on if payments are in arrears.

The principles of linkage and separation are absolutely essential to a meaningful distinction between equity and non-equity in our opinion. However, more detailed implementation guidance needs to be provided if they are to be applied in practice.

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

We have no further comments.

Yours sincerely,
for the Zentraler Kreditausschuss
Bundesverband deutscher Banken


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