THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: 08-647

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Comments regarding IASB's Discussion Paper on Financial Instruments with Characteristics of Equity

Dear Mr. Enevoldsen,

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), considered EFRAG's draft comment letter on IASB Discussion Paper Financial Instruments with the Characteristics of Equity.

We thank you for this opportunity to comment on your draft letter and we are therefore pleased to provide you with the following comments:

- In general, CESR is supportive of the comment letter prepared by EFRAG on this issue. In particular, we agree with EFRAG's comments that there are problems with the equity/liability distinction. We also agree with EFRAG that this situation should be acknowledged in the discussion paper, and should lead to a discussion on the purpose of distinguishing between equity and liability. We feel, like EFRAG, that this step is an important step in understanding the criteria for distinguishing between equity and liability that are useful to the users of the financial statements.

- However, we believe that the weaknesses identified with IAS 32 could be fixed through a short-term project, which would give the IASB time to work on the criteria referred above.

- We also support other important aspects of EFRAG's comment letter such as the criticism regarding the project's approach (the modified joint approach referred to in par. 2 in the draft EFRAG comment letter) and the lack of assessment of the project's consequences on the Framework at a time when a project is underway to renew this Framework. Regarding the joint approach, CESR believes that while the Ownership Settlement (O-S) approach may result in an improvement to the complex U.S. GAAP guidance in this area, it is less clear that it would result in a significant improvement to IAS 32, as it results in similar results to IAS 32 in most cases.

- CESR is supportive of EFRAG's comments underlining that there are also other possible approaches to the distinction between equity and liability. CESR thinks the work done in Europe through EFRAG's Pro-Active Accounting Activities in Europe (PAAinE) developing concepts, could be useful in the further development of the current project. CESR would like any future ED to provide a more thorough discussion of the conceptual basis for the conclusions on the defining characteristics of an equity instrument than is provided in either the IASB Discussion Paper or the FASB Preliminary Views document. There are other characteristics of equity besides being the most residual interest, such as voting rights and current rights to share in returns, which are not addressed in the FASB Preliminary Views. The FASB Preliminary Views seems to imply that there is no economic concept that the definition of equity is trying to capture. The FASB Preliminary Views seems to suggest that where the line is drawn between liabilities and equity is entirely arbitrary. We believe that the Boards should adopt a distinction between equity and liability that has a sound conceptual basis that is well articulated either in the standard itself or in the Framework.

- CESR also agrees with EFRAG that there might be gaps or overlaps if both equities and liabilities exhibit some characteristics. However, we believe this is not the way the Boards have intended the distinction between both categories. Our understanding is that only equity will in the Boards current view exhibit specific characteristics. CESR feel that this raises important issues in terms of concept since merely defining a liability as the residual after any basic ownership instrument will diminish the conceptual notion of an obligation which is the key to a certain number of current standards.

- In addition to the above, CESR would like to point out the following concerns:

- In terms of approaches proposed by the Boards, we do not think that the reassessed expected outcome (REO approach) provides a practical solution to the distinction between liability and equity. CESR thinks that both the basic ownership approach and the ownership settlement approach could serve as a basis for a solution to this issue. The basic ownership approach has merits, the main one being its simplicity. However, as developed below, it also has significant drawbacks. CESR members believe that a balanced solution would probably be somewhere in-between those two approaches. Therefore, CESR encourages that further research is performed to find additional criteria that would complement the basic ownership approach

- EFRAG's comment letter proposes a 3-category approach as an alternative presentation of financing sources (par. 7(b) and 26). CESR is of the opinion that a clear distinction between equity and liability is an important qualitative characteristic of financial statements because it fosters comparability among issuers. CESR is concerned that possible 3-category approach could reduce both the understandability of information on capital and the reliability of some key financial ratios used by investors.

- On Basic Ownership Instruments we are of the opinion that it is not clear whether most of the instruments that would qualify for equity treatment under IFRIC No. 2, "Members' Shares in Co-Operative Entities And Similar Instruments" (IFRIC 2) or the amendments to IAS 32 and IAS 1, "Puttable Financial Instruments And Obligations Arising On Liquidation", would qualify for equity treatment under the Basic Ownership approach. CESR finds it surprising that the IASB, which recently adopted amendments to IAS 32 and IAS 1 to remedy what the Board characterized as the "lack of relevance and understandability of the current accounting treatment" of the equity interests of many entities would consider an alternative approach that may negate such changes. Perhaps the Basic Ownership approach does not in fact disqualify as many co-operative entity instruments from equity treatment as one might think. However, because neither the FASB's Preliminary Views nor the IASB's Discussion Paper directly address how the typical features of such entities' shares would be treated under the Basic Ownership approach, it is difficult to determine what the effect will be. For example,
    - It is not clear whether the guidance in the FASB Preliminary Views document on shares puttable at a formula based on book value is intended to be similar to the guidance in IAS 32 amendment for puttable shares.
    - IFRIC 2 indicates that an instrument is not redeemable if the entity management under law, regulation or corporate charter has an unconditional right to refuse redemption. This guidance has not been explicitly incorporated in the Basic Ownership approach.
    - IFRIC 2 would allow an amount of paid-in-capital to remain classified as equity even if all equity instruments are redeemable, if a law, regulation, or the corporate charter unconditionally prohibits redemptions of equity below a specified level. This guidance may not be relevant under the Basic Ownership approach.

- We suggest that at a minimum any exposure draft provide an in-depth discussion of the reconciliation of the Boards' current views with respect to redeemable ownership instruments with IFRIC 2 and the recent amendments to IAS 32 for puttable shares. Alternatively, the Boards could adopt the guidance in IAS 32 with respect to puttable shares (and IFRIC 2 to the extent it can be reconciled to the B-O approach) rather than developing entirely new criteria as in the FASB Preliminary Views paper.

- Regarding the scope of the project CESR is of the view that while the Basic Ownership model would result in most share-based payment awards being treated as liabilities, we are concerned that in the FASB Preliminary Views, the FASB indicates that it would have to consider at a future date whether the Basic Ownership model would apply to such awards. We believe that much of the simplicity of the model would be lost if exceptions were made allowing certain indirect ownership instruments to be classified as equity

- CESR also suggests that EFRAG establishes a combined list of examples collected throughout Europe by National Standard Setters of instruments involving equity and/or liability, and which are not listed in the Appendix A of the IASB Discussion Paper. We think that such a list would provide a very useful basis for the consideration by the Boards of the widest possible range of situations involving either equity or liability or both.

- Regarding comparability over time the Basic Ownership approach implies that the classification of the financial instrument is re-assessed at each reporting date. If new financial instruments were issued during the latest reporting period that present the characteristics of the most subordinate instruments, then the previously most subordinate instrument is reclassified, and so is also the remuneration attached to this instrument (reclassification from dividend to interest expense). CESR believes that comparability over time is an important qualitative characteristic of financial statements, and therefore we would suggest that alternative solutions be sought out to provide users of the financial statements with appropriate comparative information, either on the face of the financial statements, or in the notes.

I should be happy to discuss all these issues further with you.

Yours sincerely,

Fernando Restoy
Chair of CESR-Fin