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

A F E P

Association Francaise des Entreprises Privées

IASB
30 Cannon Street
London EC4M 6XH
UK

Paris, September 5, 2008

Re : <u>Financial instruments with characteristics of equity</u>

ACTEO, AFEP & MEDEF welcome the opportunity to comment on the IASB discussion paper presenting preliminary views on Financial Instruments with the Characteristics of Equity.

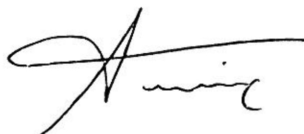
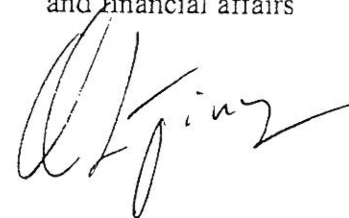
We seriously question the starting point for this project – the FASB discussion paper - which seems to run in parallel with the conceptual framework project instead of interacting with it. We believe the IASB cannot ensure any high quality outcome of the liability/equity project unless the two projects very strongly interact. In particular, we note that progress on the definition of elements in the conceptual framework project is based on a positive definition of liabilities, not on one of equity.

We agree with the analysis of IAS 32 weaknesses as presented in the IASB introduction to the FASB discussion paper. We believe however that these weaknesses can be addressed without revoking the present conceptual basis, i.e. that equity includes all claims to the entity's assets, after all liabilities have been settled. 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. 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.

In addition we believe that setting firm on a few principles and leaving aside all anti-abuse rules are the appropriate bases for a simplified and fully understandable standard. Furthermore we observe that many financial instruments which are set up today are very complex. Such complexity requires a robust analysis in substance and well stated principles to be adequately reflected in an entity's financial position.

We provide the 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 ACTEO & MEDEF's letter of comments on the discussion paper presenting accounting for financial instruments with characteristics of equity

Questions raised by the IASB in addition to the questions included in the FASB discussion paper

Question B1

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

We do not recommend the IASB to consider the FASB Preliminary Views as a starting point for the improvement of IAS 32. We do not believe that a positive definition of equity is the right direction to take. The FASB basis for conclusions remains unhelpful on this issue as it fails to assess and weigh the advantages of a positive definition of equity.

Furthermore, we disagree with the focus on simplification and would prefer choices being made with the objective of presenting useful information to investors and other creditors.

(a) *Do you believe that the three approaches would be feasible to implement ? If not, what aspects do you believe would be difficult to apply, and why ?*

We comment the various approaches in our answers to the questions raised in the FASB discussion paper. Please refer to those answers.

(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 believe that the IASB has well identified present IAS 32 weaknesses (par 15 to 34) and that such an analysis is the best starting point for the IASB project. We believe that an easier direction is certainly to look for the appropriate amendment of the liability definition rather than for a positive definition of equity. And from there on to make the appropriate decisions in order to eliminate the existing shortcomings and inconsistencies.

Question 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 ?

No, we do not believe that the scope of the project as set out in paragraph 15 of the FASB Preliminary views document is appropriate. In our view, such a scope is too narrow, as it starts with a pre-conceived idea. It indeed describes a class of financial instruments which is supposed to include all equity instruments, without any rationale explaining the choice made. We do not believe that such a project can escape being addressed from a conceptual standpoint, before determining appropriate principles to be applied. Once the conceptual basis is decided, the IASB will have to decide, at the standard level, what the standard should encompass in its scope.

Question B3

Are the principles behind the basic ownership instrument approach 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 ?

Redeemable shares at nominal price of some cooperatives and mutuals in France would not meet the definition of basic ownership instruments in par.18-21 of the FASB paper. Those instruments have been captured in the IAS 32 amendments recently issued on puttable shares, as instruments which share in the performance of the entity from issuance until redemption have been scoped in the exception by the IASB. We believe that the IASB analysis has been thorough and that no step back should be taken. Nor should any step back from IFRIC 2 be taken.

Question B4

Are the 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 ?

We are not aware that other principles would be inappropriate in France. However we do not have necessarily the ability to identify any potential difficulty.

Questions on the basic ownership approach (BOA)

Question BOA 1

Do you believe that the basic ownership approach would represent an improvement in financial reporting ? Are the underlying principles clear and appropriate ? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of these preliminary views and provide minimal structuring opportunities ?

FASB's rationale to promote the basic ownership approach seems to be primarily anti-abuse driven. As a result FASB fails in our view to analyze how the distinction between equity and liabilities could be the most useful to financial statements' primary users, those users being all capital providers to the entity, investors, lenders and other creditors.

FASB's basis for conclusions seems to imply that any distinction between equity and liabilities could do, provided that it avoids structuring opportunities as much as possible. We disagree with this approach. We observe that gains in clarity and simplicity would be made at the expense of relevance. As a result we do not believe that such an approach would lead to an improvement in financial reporting.

We also note that FASB basis for conclusions fails to be convincing as most arguments could verify for other instruments than basic ownership instruments as defined in the document. For example, there are lots of instruments, whether the most subordinated or not, of which return is a distribution rather than a determinant of comprehensive income.

Question BOA 2 & 3 : Perpetual instruments

Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present ?

The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present ?

We support present practice in the basic distinction on which it has been built, i.e. whether cash invested in the entity and the return on it are left to the discretion of the entity or covered by some contractual rights which create symmetric obligations to the entity. Some creditors face only credit and liquidity risks in the entity ; others share in the business risks and performance of the entity, either for the nominal amount they have invested or for the return on it, or both. We believe this distinction is useful for the users of financial statements and supports an appropriate definition of comprehensive income.

As a result, a distinction between equity and liabilities based on settlement is in our view the most relevant. Users of financial statements are interested in being able to assess future cash-flows. Being able to distinguish between amounts the entity is committed to deliver in cash or other financial assets and amounts which are available for its business endeavours is in our view extremely useful in assessing the financial position of an entity. We therefore believe that perpetual instruments should remain classified as equity.

We however believe that assessing the settlement of an instrument should take into account economic compulsion. We consider rational economic behaviour as an obligation of the entity. If economic compulsion is not dealt with as such, the equity/liability split fails to meet the usefulness described above.

Supporting a distinction between equity and liabilities based on settlement makes the second question raised by the FASB (i.e. measurement) a non-issue.

Question BOA 4 : Redeemable Basic Ownership Instruments

Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational ? For example, can compliance with criterion (a) be determined ?

We agree with the FASB and IASB view that basic ownership instruments with redemption requirements should be classified as equity, when those instruments meet all characteristics of basic ownership instruments but for their redemption feature. Indeed we agree that no entity can exist without basic ownership instruments, i.e. without investors who share the ultimate risks and rewards of the entity. We observe that those redemption features primarily exist when the instruments are not tradable and the entity organises – or ensures - the liquidity of its basic ownership instruments.

We believe conditions set in paragraph 21 make criteria in paragraph 20 operational. In our view indeed it is not possible to verify that criterion (a) in paragraph 20 is met. We believe criterion (b) is necessary to ensure that the instrument truly meets the definition of a basic ownership instrument. Meeting criterion (b) though might rely on general legal requirements safeguarding lenders and other creditors of an entity, rather than on detailed contractual features specific to the instrument.

Reporting redeemable basic ownership instruments as part of equity requires, we believe, a revision of the definition of a liability. Such classification should stem from the application of the definitions of the elements in the framework, rather than being set as an exception as in IAS 32 revised at present.

Furthermore we believe that the definition of a basic ownership instrument should be worked at the level of each legal entity in a group. Subordination should be assessed in relation to the group of assets to which the holder of the instrument is entitled, not at the level of the group, unless conditions of the instrument at the group level vary. We therefore entirely support paragraph 29 provisions (although we note that they are in contradiction with features described in par. 18 of the FASB paper).

Question BOA 5 : Separation

A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts ? Especially, is the dividend an obligation that the entity has little or no discretion to avoid ? Does separating the instrument provide useful information ?

We believe that separation is the necessary outcome of an analysis of substance of an instrument. We agree that separation should occur whenever the equity instrument remains outstanding independently from the obligation to deliver cash or other financial assets. Provided that the distinction between equity and liability is relevant, we believe that separation provides useful information.

Question BOA6 : Substance

Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in appendix A ? However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach ? Are there factors or circumstances other than the stated terms of the basic ownership approach ? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument ?

We believe that assessing economic substance of any instrument or transaction is a pillar of relevant and reliable financial reporting. This is the reason why we support economic compulsion playing a key role in applying a distinction between liability and equity.

This is also the reason why we do not support the basic ownership approach. We do not believe that the economic difference between the most subordinated financial instrument and another instrument which would have exactly the same characteristics but for its rank in liquidation brings a meaningful economic differentiation from the perspective of an entity assessed on a going concern assumption.

Question BOA7 : Linkage

Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction ?

We believe that linkage provisions are necessary to ensure that substance over form can be fully applied in practice. We support provisions such as those presented in paragraphs 41-43 to be part of a future standard requiring classification of financial instruments between equity and liabilities.

Question BOA 8 : Measurement

Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result ? ? If not, why should the change in value of certain derivatives be excluded from current-period income ?

In our view, derivatives of which settlement is a delivery of an entity's equity instruments by the entity should be classified as equity. This is because those instruments either will lapse or will lead –at a future date- the holder to share business risks and performance of the entity. For example, when an employee accepts as part of its compensation package to receive contingent rights on stock options, we do believe that he/she fully becomes an equity participant as of grant date. Depending on the ultimate outcome, that employee may – or may not – participate in the business risks and performance of the entity. There is no settlement alternative in which the entity would be committed to deliver cash or other financial assets.

Question BOA 9 &10 : Presentation issues

Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are the additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements ? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash ?

We agree that basic ownership instruments with redemption features are reported separately from other instruments classified as equity. This separate presentation should be accompanied by a disclosure note describing and measuring the redemption rights.

Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed ? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

We do not agree that basic ownership instruments with redemption features are measured at fair value. As a result, there is no presentation issue, from our point of view, in the income statement.

However if it was decided that basic ownership instruments with redemption features be measured at fair value, we believe that the change in value should be reported solely in equity. The change in value does have its economic counterpart in unrecognised changes in net assets of the entity. There is no economic gain or loss.

Question BOA 11 : Earnings per share (EPS)

The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail ; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes ? What EPS implications related to this approach, if any, should the Board be aware of or consider ?

We have not analysed this issue thoroughly yet.

Questions on the ownership-settlement approach (OSA)

Question OSA 1

Do you believe the ownership-settlement approach would represent an improvement in financial reporting ? Do you prefer this approach over the basic ownership approach ? If so, explain why you believe the benefits of the approach justify its complexity.

In our view, IAS 32 is presently mainly based on a settlement approach, although it includes some inconsistencies in the manner in which that approach is being implemented. We support retaining that approach, for the reasons described in our answers above, provided that the present inconsistencies and shortcomings are eliminated.

Question OSA 2

Are there ways to simplify the approach ? Please explain

As we have already stated, the appropriate criterion to select a classification between equity and liabilities lies in the search for relevance rather than for simplification solely. We therefore respond to this question on those grounds.

Provisions related to indirect ownership instruments are in our view overly complicated. Moreover we fail to see the rationale for the adoption of some criteria.

Whenever the settlement of an instrument is the delivery by the entity of cash or other financial assets, the instrument should not be described as "ownership" instrument, even if, from the perspective of the holder, the pay-off is the same. We indeed believe that the classification should be made from the entity's perspective and not from the holder's. In other words we believe that "indirect ownership instruments" should include only instruments of which the only potential settlement in relation to the entity is – directly or via a chain of instruments – the delivery of an entity's basic ownership or other perpetual instrument.

Moreover we believe that the approach has been overly complicated by some measurement provisions. We disagree that upon exercise an indirect ownership instrument would result in an increase in equity equal to the fair value of the instrument. In our view an equity contribution can be measured at the fair value of the contribution only when that contribution is in the form of an asset, a group of assets or net assets. An indirect ownership instrument (in our revised definition) is not an asset of an entity. The delivery of an ownership instrument upon settlement is not an economic event from the perspective of the entity. The only contribution that the entity will ever receive from the holder (or the chain of holders) is the contribution received at inception of the instrument in its indirect ownership form. (Nota : The above comments are relevant not only in relation to the ownership settlement approach but also to paragraphs 47-49 of the basic ownership approach.)

We believe that the analysis of outcomes as described in the model is relevant and would be welcome assistance to preparers in the identification of components (par A25 – A29). We believe that the IAS 32 provisions related to the separation of components are working well and should be maintained. Subsequent measurement of asset and liability components should not be developed in the model. In our view they belong to the standard relevant for assets and liabilities having the same features. Finally we do not see why provisions related to settlement, conversion, exercise and extinguishment detailed in the basic ownership approach are not sufficient to be applied in the model. In our view (provided they are modified to take into account our comment above

Question OSA 3

Paragraph A 40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational ?

We believe that the substance principle applied to indirect ownership instruments as described in paragraph A40 is sufficiently clear to be operational. However in our view it is not sound enough. We believe it fails to take into account whether the entity has discretion to avoid cash settlement. We believe that discretion to avoid cash settlement is not left to the entity in circumstances when the entity is under economic compulsion.

Question OSA 4

Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements ? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash ?

See our response to question BO9. We object to the classification as liabilities of any instrument of which settlement is the delivery of an entity's equity instruments. We therefore do not have to consider how to segregate liabilities.

Question OSA 5

Are the proposed requirements for separation and measurement of separated instruments operational ? Does the separation result in decision-useful information ?

As indicated in our answer BOA 5, we believe that separation is necessary to provide meaningful and consistent information to users of financial statements. We also believe that par. A13 – A24 provide adequate analysis of the different potential outcomes leading to appropriate separation.

We agree with the initial and subsequent measurement requirements as proposed in par A30 – A34. In our view these requirements are consistent with the view that equity is a residual.

Question OSA 6

The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes ? What EPS implications related to this approach, if any, should the Board be aware of or consider ?

Question OSA7

Are the requirements described in paragraphs A35 – A38 operational ? Do they provide meaningful results for users of financial statements ?

We agree with those proposals.

Questions related to the Reassessed Outcome Approach

We have decided not to respond in detail to the questions raised in relation to the REO approach. We indeed do not think that this approach is in any way workable.

ØØØ

Ø