

European Financial Reporting
Advisory Group
13-14 Avenue des Arts
1210 Brussels
Belgium

By Email to Commentletter@efrag.org

July 28, 2008

Joint Comments of German Associations and Public Corporations on the discussion paper „Distinguishing Between Liabilities and Equity“ published by Pro-Active Accounting Activities in Europe

Dear Sir or Madam,

The Association of German Public Sector Banks (VÖB), the German Cooperative and Raiffeisen Confederation (DGRV), the Federation of German Industries (BDI), the German Federal Chamber of Tax Advisers (BStBK), the Federal Association of German Cooperative Banks (BVR), the Association of German Chambers of Industry and Commerce (DIHK) and the German Savings Bank Association (DSGV) are pleased to submit their joint comments regarding the discussion paper „Distinguishing Between Liabilities and Equity“ published by Pro-Active Accounting Activities (PAAinE) in Europe in January 2008.

A. General Remarks

We extremely welcome the proposal for a further model to distinguish equity and liabilities submitted by the PAAinE as a result of an European joint project. In our opinion the underlying concept of the „Loss Absorption Approach“ can far better, than all other currently discussed proposals, account for the interests of the investors as well as the issues of non-listed companies having a different legal form

than stock corporations. In particular, we estimate exceedingly positive the general focus on the ability of equity to absorb losses.

However, the present paper is so far only of a theoretical nature; therefore, a differentiation of many instruments can hitherto merely be carried out on a hypothetical basis. At the same time, we have observed that also the present paper is in its basic structure orientated on the legal form of a stock corporation rather than from on a neutral view concerning legal forms.

B. Answers to the questions

We would like to comment to the questions as follows:

Q 1 – Do you believe that defining two different classes of capital on the credit side on 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. 13 ff.) If not, why?

We consider a distinction into two classes of capital on the credit side as appropriate and decision-useful, as the information about the financial situation corresponds to the circumstances of the entity and allows for an overview of the liquidity situation and the liquidity requirements already arising out of the balance sheet. Even if the characteristics and form of the equity instruments are complex and therefore represent its multidimensional criteria, we consider an explanation or distinction of equity exclusively in the Notes for insufficient, if not even misleading.

Q2 – 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?

As already explicated in Question 1, we share the view, that a dichotomy in equity and liabilities in the balance sheet offers decision-useful information.

From our point of view, the structure of the credit side of the balance sheet should be developed so adequately, that at least a first overview of the situation of the

equity and liabilities in the balance sheet is possible. Details regarding the form of the several items and instruments should be presented in the Notes.

Q 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?

We agree in principle with the analysis and the individual explanation of the characteristics of equity and liabilities. In particular, we consider loss absorbing as the relevant criterion for distinguishing between liabilities and equity instruments.

We would like to note at this point that the section is largely formulated neutrally, which we welcome at first. However, in several passages a clear orientation on ordinary stock as the basic form of equity instruments can be recognized. Herewith, however, we do not agree, as we fear that an orientation on the basic form of one single instrument of equity will regularly lead to problems in interpretation and implementation. We argue insofar for a revision of the paper developing analysis and criteria in a way that neither conclusions on individual legal forms nor on certain instruments can be drawn.

Q 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.)?

As explained, we consider loss absorbing as the decisive criterion for the classification of equity instruments. From our point of view, this criterion is sufficient for distinguishing between liabilities and equity instruments.

Q 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?

The discussion paper basically depends on the loss absorbing function of capital as the relevant criterion to distinguish between liabilities and equity. The possibility of different interpretations of the loss absorbing-criterion subject to an entity view

or a proprietary view and hence a different classification of the same instrument should, however, be further discussed. With respect to the definition of the loss absorbing-criterion, in our view, one of the following perspectives should mandatory be decisive. The entity view, the proprietary view or the creditor view could be considered. Accordingly, we consider further explanation regarding the topic 'Entity versus Proprietary View' desirable.

Furthermore, we share the view that for a final evaluation of the loss absorbing-criterion, it needs to be defined mandatory at first, from which perspective a participation in losses has to be assessed.

Q 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 consider that the users of financial information are a multidimensional group. Therefore information provided by the entity is interpreted and assessed differently, respectively, according to the interests of the various stakeholders. According to the IFRS framework, investors in their capacity as providers of risk capital will usually have the most comprehensive information need of all users.

Q 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?

We agree that a distinction between equity and liability based on the definition of risk capital provides decision-useful information for users of financial statements. In this case, we understand risk capital as capital, which participates in losses (Section 3.14), hence takes over a loss absorbing function. However, we consider a definition of risk capital and accordingly of the loss absorbing function, which is neutral regarding entities in different legal forms as essential.

Q 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?

In the context of classifying capital as equity or liability, the loss absorbing-criterion provides decision-relevant information (Question 7), whereas the question concerning the definition of losses as economic losses or accounting losses is posed. Economic losses are defined as any decrease in the value of an entity in sections 4.2 and 4.3 due to changes in future cash flows. Accounting losses, however, are defined as losses of the current period listed in the profit and loss account pre-tax and pre-distribution of dividends or rather proportions of profit (Sections 4.4 up to 4.15).

Focusing the definition of accounting losses purely on the current reporting periods and on the figures of the profit and loss account seems to be problematic. On the one hand, there is the possibility not to include losses in the profit and loss account but to recognize them directly in equity. On the other hand, the restriction on loss absorbing in the current reporting period suppresses the participation in losses in case of liquidation. As an example, profit transfer agreements should be mentioned, within which minority participators do not participate in the losses of the current period, as the majority participators bear these. In the point of time of liquidation, however, also minority participators bear the losses pro rata. Such a profit and loss transfer agreement is necessary due to tax reasons and is no structuring opportunity. Furthermore, the payments of dividend and compensation of minority shareholders are subject to legal protection provisions, triggering unavoidable obligations for the entity.

Q 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?

Overall the Loss Absorption Approach depending on the liability function of capital and the criterion of loss absorption is a proper approach. It should, however, be explained elaborately and defined in more detail.

The definition of loss absorbing capital, mentioned in section 4.16, refers to the definitions of risk capital and loss absorption and contains an explicit reference to

the entity view. Thus, the same questions are posed as described in the remarks to questions 7 and 8. For example, it is not fully clear if ordinary shares of minority shareholder would be classified as equity because in profit and loss transfer agreements, legal dividend- or pay off-arrangements loss absorbing in the current period is not provided, although ordinary shares are identified as the purest form of equity.

A further question concerning the definition of loss absorbing capital results from the existence of factual or actual loss-absorption. Here, the example of a capital contributed within a silent partnership agreement should be mentioned, who participates in losses to the full extent of his paid in capital and who does not have a right of cancellation of his own. The capital, however, can be called in on the part of the entity, as far as the dormant partner retrieves at least his deposit made. De facto, the capital serves as a buffer of losses for the entity and is available for them unconditionally. A repayment of the capital on the part of the entity through cancellation, however, can only take place, if no losses are accumulated, which would reduce the amount of the capital. Therefore, the capital is available for the entity as loss-absorbing capital, merely a cancellation and the hence following redemption of the capital in the event of loss cannot take place.

Q 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?

In principle, we agree to the statement that the decision for a classification of an instrument is based on the terms and conditions inherent in the instrument. This classification should also endure in variation in time. Therefore, we consider a re-assessment in certain intervals dispensable also with the background of the principle of consistency. For a final evaluation of the circumstance, however, we consider a concretion of the Loss Absorption Approach necessary.

Q 11 – Do you agree with the discussion on linkage (pars. 4.13 ff.)?

No comment.

Q 12 – Do you agree with the discussion on split accounting (pars. 4.36 ff.)?

According to the current state of the discussion, in our view, the question cannot be finally answered, as without concrete criteria of differentiation you can only hardly assess, under which circumstances certain instruments should be split off.

Q 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?

An explicit procedure for the identification on the level of (subsidiary) entity cannot clearly be concluded out of the discussion paper. Accordingly, from these criteria hardly any conclusions for the presentation, if done in a group context, can be drawn. For an analysis of the consequences which would result from the chosen procedure further explanation on this topic and the preceding questions (minority interests, profit transfer agreement) would be necessary.

Q 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?

The described examples of section 6 illustrate well the principles of the Loss Absorption Approach. We would like to note though that this is only an explanatory description so that we thereof assume that in practise cases exist, which cannot be subsumed under the examples described. Consequently, an answer to the question, which includes all alternatives is not possible, as for this purpose firstly the questions and notes, which were contained in the preceding comments are to be clarified.

Q 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?

As already explicated in our answer relating Q 9, we consider loss absorbing as the basic principle appropriate for a differentiation between equity and liability. However, we consider the current implementation as too theoretical to make a statement regarding the suitability for a future accounting standard and concerning structuring opportunities.

Q 16 – Do you think the Loss Absorption Approach should be simplified? If yes, how could the Loss Absorption Approach be simplified?

As the present paper hitherto basically contains theoretical explanations of the Loss Absorption Approach, concrete criteria concerning the final distinction of equity, however, to a large extent are missed, we currently see hardly any possibilities for a significant simplification.

Q 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?

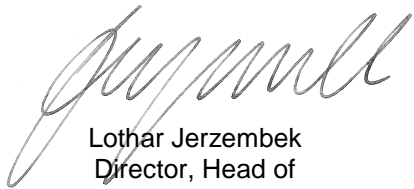
No comments.

Q 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?

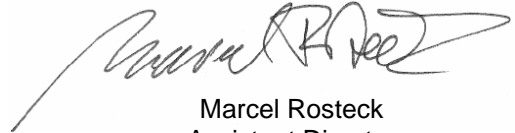
No comments.

Please feel free to contact representatives of DGRV (Eckhard Ott, ott@dgrv.de, Ulf Jessen, jessen@dgrv.de), if you have any further questions or desire any further exchange of information.

Best regards,



Lothar Jerzembek
Director, Head of
Accounting and Financial Reporting Department



Marcel Rosteck
Assistant Director
Accounting and Financial Reporting Department

Association of German Public Sector Banks (VÖB)



Dr. Eckhard Ott
Chairman of the Board

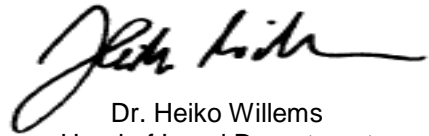


Ulf Jessen
Technical Director
Accounting and Auditing

German Cooperative and Raiffeisen Confederation (DGRV)



Berthold Welling
Managing Director



Dr. Heiko Willems
Head of Legal Department

Federation of German Industries (BDI)

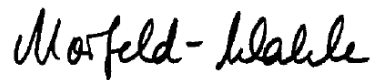


Nora Schmidt-Keßeler
Chief Executive Officer

German Federal Chamber of Tax Advisers (BStBK)

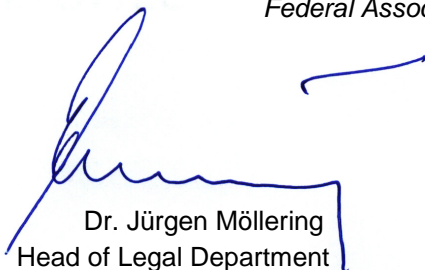


Gerhard Hofmann
Member of the Board



Stefanie Morfeld-Wahle
Chartered Accountant

Federal Association of German Cooperative Banks (BVR)



Dr. Jürgen Möllering
Head of Legal Department



Annika Böhm
Company and Accounting Law

Association of German Chambers of Industry and Commerce (DIHK)



Pia Jankowski
Head of Market Services



Diana Wieske
Consultant

German Savings Bank Association (DSGV)