DUTCH ACCOUNTING STANDARDS BOARD (DASB)

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Our ref : CvC
Date : 28 July 2008
Re : Comment on PAAinE Discussion Paper Distinguishing between Liabilities and Equity

Dear members of the EFRAG Technical Expert Group,

The Dutch Accounting Standard Board (DASB) appreciates the opportunity to respond to your PAAinE Discussion Paper Distinguishing between Liabilities and Equity.

Our general remark is that although current IFRS has shortcomings on the distinction between liabilities and equity, we observe that most companies have no problems with current IAS 32. Although classifications may have changed on the transition to IFRS, most companies are now familiar with the fundamentals of IAS 32, and are able to predict how new instruments would affect their balance sheet.

Since the capital structure is one of the most important objects in financial analysis, fundamental changes in standards are only warranted if it solves severe and widespread problems. As we understand, the Discussion Paper focuses on problems found only in a limited number of cases.
A fundamentally different approach as proposed has far-reaching consequences. Due to the vast range of different types of capital in practice, and the complex and sometimes unclear description of the approach, we cannot see all ramifications of this different approach.

We think that any fundamental change should only be made when the benefits clearly outweigh the costs. The Discussion Paper does not convince that the new approach, which is at least as complex as current IAS 32, solves problems found in practice on a large scale.

Therefore, we conclude that the shortcomings with respect to puttable instruments may be better addressed by specific amendments to the current approach than introducing an entirely new approach.

Our detail comments are set out in the appendix to this letter.

Of course we would be happy to discuss our reaction with you.

Yours sincerely,

Hans de Munnik
Chairman Dutch Accounting Standards Board

Appendix

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, we agree with your arguments. However, we disagree with your decision to scope out any valuation and income statement classification. Balance sheet and income statement are closely interrelated and cannot meaningfully be studied separately.

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?

Yes, we believe that this would have merits, but in the current practice, a distinction between equity and liabilities is still necessary. For the long term, practice may evolve to this approach.

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?

Yes, we agree.

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.)?

Yes, we agree.

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?

Yes, we agree.

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.)?

Yes, we agree.

Question 7a
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?

Yes, we agree.

Question 7b
Is there any other basis for the distinction that you would consider providing more useful information? If yes, which and why?

No. We acknowledge that defining equity involves multiple attributes. None of them always overrides the others.

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?

Yes, we agree. Since financial reporting is accounting-based, the classification should be accounting-based, too.

Question 9
Do you think that the Loss Absorption Approach is explained sufficiently clear in this paper (Section 4)?

No, we do not agree. The paper does not clearly explain why participation in profit should not be part of the classification. The focus on 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.

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, we agree with both statements.

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

Yes, we agree.

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

Yes, we agree.

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, we do 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 fundamental 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.
Therefore, we think this flaw undermines the entire approach. The paper is unclear how this problem should be resolved.

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?

No. 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.

Question 15a
Do you believe that the Loss Absorption Approach is sufficiently robust to be prescribed in an accounting standard? If not, why?

No. The paper does not convince that the Loss Absorption Approach provides less opportunities for structuring than current IFRS. The illustrative examples reveal that this approach is not more easy or more objective to apply than current IFRS.

Question 15b
If you are concerned about structuring opportunities what would be your suggestion to limit the structuring opportunities?

We believe that accounting standards should not aim at prohibiting structuring. As long as the financial statements present the economic reality, firm should be free to change or rearrange financial instruments. A change in classification in the balance sheet normally coincides with changes in economic features.

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

Not applicable. We believe that the Loss Absorption Approach should not be pursued. Therefore, any simplification cannot alter any fundamental merits.

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?

No, we do not agree. We observe that most companies have no problems with current IAS 32. Although classifications may have changed on the transition to IFRS, most companies are now familiar with the fundamentals of IAS 32, and are able to predict how new instruments would affect their balance sheet.

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?

No, although we agree that the Loss Absorption Approach solves the 'puttable instruments problem', we see little improvement in general. 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 'haute finance' financial instruments. Adapting existing instruments and loan covenants to this different approach may cause high costs and market uncertainties. Solving 'local' shortcomings with an entirely new approach may cause those costs to exceed the benefits.