EFRAG

European Financial Reporting Advisory Group

XX XXXX 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org or uploaded via our website www.efrag.org by 5 September 2008

Dear Sir/Madam,

Discussion Paper *Financial Instruments with Characteristics of Equity*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB Discussion Paper *Financial Instruments with Characteristics of Equity* This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

The Discussion Paper is the first stage of a possible IASB project to improve the equity versus liability classification requirements in IAS 32 *Financial Instruments: Presentation*. This is a subject of fundamental importance to accounting. It has become increasingly clear over the last few years that there are significant problems with the existing IFRS literature on the equity/liability distinction and on the classification of financial instruments between assets, liabilities and equity. As a result, a fundamental review—and perhaps some fairly significant changes to the existing requirements—has been urgently needed. We are therefore grateful to the IASB for issuing this Discussion Paper. We would encourage the IASB to put the project on its active agenda as soon as possible, and to give the work a high priority.

The Discussion Paper discusses three possible approaches to distinguishing equity from liabilities. In contrast to current IAS 32— which defines an equity instrument as a financial instrument that is not a financial asset or a financial liability— all three approaches propose a standalone definition of equity.

We have some significant reservations about the paper. In particular:

(a) although we agree that the three approaches described help to highlight some of the issues that need to be carefully considered in developing an equity/liability classification system, the paper lacks a discussion as to the purpose of distinguishing between equity and liability. Without that discussion it is difficult to identify criteria that can be used to assess whether one classification approach is better than another. The paper talks a lot about the classification approach needing to be simple and we agree that simplicity is a desirable characteristic. However, it is not an end itself.

(b) we think it is essential that there are very strong links between this project and the work being carried out in the Framework project on the definitions of the elements of the financial statements, which does not seem to be the case at the moment. Indeed, we think a good case could be made for resolving most of the issues at the conceptual level before progressing further with this project.

(c) We think it is essential that whichever approach is eventually chosen works for both separate financial statements and consolidated financial statements without the need for additional, arbitrary rules. That is not the case with either the basic ownership approach or the ownership-settlement approach as currently written up.

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

If you would like further clarification of the points raised in this letter, please do not hesitate to contact Svetlana Boysen or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
EFRAG's detailed comments on the IASB Discussion Paper *Financial Instruments with Characteristics of Equity*

Some initial comments

1 Before responding to the questions asked by the IASB in its Invitation to Comment, we wish to make a few general comments on the paper and on the subject discussed.

Project approach

2 The project on finding the solution to distinguishing equity from liabilities has been carried out following a so-called modified joint approach. This has meant that the FASB took the lead on the project and issued a FASB Preliminary Views document, and the IASB subsequently issued that document as an IASB Discussion Paper without discussing it in any detail. While we agree that this approach can sometimes be very efficient, we are not convinced that in this case it has brought significant benefits. IFRS has a different starting point on the classification of instruments as equity or liabilities (arguably a more advanced one) than US GAAP. Because the approaches proposed in the FASB Preliminary Views are driven by a need to solve issues in the US GAAP they lack a link to the issues that IFRS constituents face in applying IFRS requirements in this area. As a result the paper feels like it starts from the wrong place to improve and simplify IFRS requirements. We found aspects of the last Discussion Paper of this type that the IASB issued (the Discussion on Fair Value Measurements that contained FAS 157) similarly incomplete because of this difference in perspective. We would encourage the IASB to take this into account in future projects.

3 We have seen the following comment in a recent agenda paper discussed at a joint meeting of the IASB and FASB: "This project is a priority for some in the US because US GAAP is complex, difficult to apply, and needs almost constant maintenance. It may be less of an issue internationally." We would like to point out that, even though the starting point is different under IFRS compared to US GAAP, this project is a priority for Europe too. The IASB invitation to comment points out a number of deficiencies in the current equity/liability classification system in IAS 32 and we believe that these deficiencies require resolution.

Relationship between this project and the ongoing Framework project

4 We believe that, when one is discussing a fundamental issue like which financial instruments (or maybe which components of financial instruments) are to be classified as equity and which as liabilities, one needs to start at the conceptual level. Currently under IFRS we apply the requirements in IAS 32 to classify financial instruments, and we use the Framework definitions of 'assets' and 'liabilities' to classify non-financial instruments (such as shareholders' reserves and a life insurer's discretionary participation feature). One result is that some financial instruments (or components thereof) that meet the Framework definitions of assets and of liabilities are classified as 'equity' or the other way around. We are hoping that as a result of this project—and the Framework project on the Elements of Financial Statements—classification of financial instruments will be in line with the Framework.

5 None of the approaches proposed in the DP are consistent with the existing Framework. We further note that the proposals in the DP are not compatible with the current working draft of a proposed new definition of a liability that has been

developed in the Framework project. ("A liability of an entity is a present economic obligation that is enforceable against the entity. (a) Present means that the economic obligation exists on the date of the financial statements. (b) An economic obligation is something that is capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic obligations. (c) Obligations link the entity with what it has to do because obligations are enforceable against the entity by legal or equivalent means.") For example, although redeemable common stock would seem to meet this liability definition, the proposed approaches would classify it as equity if certain criteria are met.

6 Therefore, we think it is very important that there are very strong links between this project and the work being carried out in the Framework project on the definitions of the elements of the financial statements. Indeed, we think most of the work should be done within the context of the Framework project. The new standard on the classification of financial instruments as financial liabilities and equity could be then almost an application guidance of those generally applicable definitions.

Defining equity

7 All three approaches discussed in the paper define 'equity'; existing approaches tend to define 'assets' and 'liabilities' and treat equity as the residual interest in the assets of the entity after deducting all its liabilities. In effect, the paper is implying that equity should not be viewed simply as a financial instrument that is not a financial asset or a financial liability; rather, equity should exhibit certain distinctive characteristics. We are quite comfortable with this suggestion, although we think:

(a) it is difficult to require both equities and liabilities to exhibit certain characteristics without there being either overlaps or gaps between the two. For that reason, it is probably necessary for either 'equity' or 'liabilities' to be the 'default category' (in other words, either equity should be defined as credits that are not liabilities or liabilities should be defined as credits that are not equity).

(b) If all credits that are not equity are to be treated henceforth as 'liabilities', we think it might be necessary to consider the need to use an alternative label to 'liabilities' because some of the items that would not be equity are not what people would normally think of as liabilities. This in turn suggests to us the possible need to differentiate in some way in the presentation between things that "people would normally think of as liabilities" and other credits that are not equity. And that sounds like a classification system that involves three categories: equity, liabilities and things that are not equity but also not liabilities. The possibility of adopting a 3-category approach is discussed further in paragraph 26 of this letter.

IASB questions for respondents

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?

(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?

(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?

Does the paper start by asking the right questions?

8 It seems to us that, when one approaches the equity/liabilities split issue, it is first necessary to ask why we are distinguishing between equity and liability. What is the purpose of the distinction?

(a) Under existing standards, the distinction seems to play a fundamental role in determining the perspective from which the entity's activities and financial position are viewed. Every source of finance that is not equity is a claim on that equity; every reduction in net assets that is not a distribution to equity holders is a reduction in the profit attributable to those equity holders.

(b) Another function of the distinction currently is to enable accountants to distinguish between amounts that should be deducted in arriving at net income and amounts that are distributions of that net income.

(c) Another function currently relates to measurement; liabilities are remeasured, equity is not.

There may of course be other reasons to distinguish between equities and liabilities and other implications of making that distinction. The point remains though: what is the question that the equity-liability split is trying to answer?

9 For that reason, we had expected the paper to start by considering questions such as:

(a) Who are the primary users of the classification system?

(b) What are important attributes that distinguish liabilities from equity for these users?

(c) Can one classification system (perhaps combined with additional disclosures) satisfy other users requiring different types of information?

10 Establishing answers to these questions would help to devise a principle according to which equity would be distinguished from liability instruments, as well as the criteria against which various approaches to distinguishing equity from liabilities could be evaluated. We find the absence of such criteria to be a real problem because it makes it difficult to know whether the approaches described in the paper (and other approaches that we can think of) are improvements on the existing IAS 32 approach.

11 We also think the paper would have been better had it discussed classification systems other than ones that involve two categories. We think it is too simplistic to argue that a two-category approach is needed because things are either in net income or not and things are either re-measured or not. In our view it is not 'a given' that these issues are related. For example, if all financings are treated as claims on the company:

(a) rather than try to distinguish between equity and liabilities for balance sheet purposes, it should be possible to devise a balance sheet presentation system that lists all financings in an order that is of most use to users. This might be based on what is considered to be the key attribute (perhaps priority on liquidation, entity's discretion to make payments or loss-absorbing properties of instruments) or perhaps some sort of hierarchy. Indeed, one could also explore further whether, if users have substantial knowledge of the features of instruments, they will rely less on how preparers classify those instruments into liabilities and equity.

(b) if it is considered still necessary to distinguish between financing costs that are deducted in arriving at net income (ie interest) and financing costs that are distributions of net income (ie dividends), that distinction could focus exclusively on what would result in the most useful net income number without having to consider the implications for the balance sheet.

(c) it would still be necessary to determine which claims would need to be remeasured; however, it ought to be possible to consider this question even if the classification system is not based on the dichotomous split.

12 Instead, the FASB PV document starts by characterising the equity/liability distinction issue as being about drawing a line between the different types of claims to an entity's net assets. Then it observes that there is no natural line and that "equity has been historically identified as a residual interest in an entity, and this Preliminary Views retains that general idea", and concludes that the debate is really about "the search for the appropriate level of residual". It then states (in paragraph 54) that the basic ownership approach is designed to draw the necessary line in the simplest and most informative way that the Board could devise. We agree that simplicity can be a good thing. However, something can be simple but wrong, so we are much more interested in the suggestion that the approach draws the line in the "most informative way that the Board could devise".

13 The FASB PV document does state (in paragraph 61) that supporters of the basic ownership approach believe that classifying only basic ownership interests as equity actually better serves all classes of stakeholders. However, there is no discussion in the document as to why this is the case, which is a pity because that is exactly the sort of discussion we believe is needed to determine how best to proceed.

The PVs document might not have started by asking the right questions, but are the approaches it describes a good starting point for the IASB's work?

14 We think the three approaches described in the PVs document are useful in that they highlight certain aspects about the debate that need to be carefully considered. Perhaps chief amongst those are the need to find a satisfactory balance between usefulness, simplicity, the need for a principle-based approach, and reliance on economic substance of an instrument rather than its form. They also highlight the need to identify the attribute of the instruments that makes a difference in substance when making the equity/liability distinction.

15 However, in the absence of the type of discussion we described above, it is difficult to judge if a particular approach strikes the right balance between these various characteristics. For that reason, we have had to limit ourselves to some fairly general comments about each of the approaches.

<u>The basic-ownership approach</u>

16 The FASB document states that the FASB has reached a preliminary view that the basic ownership approach provides more decision-useful information to investors while significantly simplifying accounting requirements for issuers and their auditors. We agree that, if the approach is capable of providing decision-useful information in a simple way, it should be considered as a possible successor to the existing IAS

32 approach. However, we think that more work needs to be done before one can reach any conclusions about the merits of the basic-ownership approach.

17 Capital instruments have many different attributes and, if they are to be categorised into 'equity' and 'liabilities', it is necessary to identify the relevant attribute (or attributes) that achieves that categorisation in the most informative way. In the basic ownership settlement approach the FASB selects the most residual claim on liquidation as the most relevant attribute for distinguishing financial liabilities from equity. Paragraphs 55 and 58 of the FASB PV document justify this by explaining that other claimants to the entity's assets bear risks and are entitled to rewards but they are at least partially protected from risk by basic ownership instruments and their share of the rewards is limited. It further states that any claim that is senior to the most subordinate ownership interests is potentially dilutive of the residual that would otherwise be attributable to basic ownership interests. Finally, the FASB PV document states that the basic ownership instruments are considered the one class of claimants without which the entity could not exist or operate; holders of basic ownership instruments are viewed as the owners of the entity.

18 We agree that instruments that possess the above characteristics feel like equity of the entity. However, the question remains whether reliance on the criterion of being the most residual claim on liquidation helps to identify instruments that possess those characteristics in all circumstances. Taking the example of two classes of common stock issued by the entity where one class is more subordinate on liquidation than the other, we wonder whether it is appropriate to state that only the holders of instruments with the most subordinate claim on liquidation are the ones that bear the ultimate risk and are entitled to the ultimate rewards inherent in an entity and its activities. We are not convinced that they are the one class of claimants without which the entity could not exist or operate, especially if liquidation is remote.

19 Furthermore, we think it is probably unhelpful for the FASB PV document to refer to the holders of basic ownership as the owners of the enterprise, even though it goes on to warn readers against confusing the owners in the context of basic ownership approach and legal owners. We think this only confuses things. The concept of ownership is usually understood in a broader sense than that determined under the basic ownership approach—for example, some view the notion of owners as involving voting rights—and we think the issues involved are complex enough without introducing a new meaning of 'owner'.

<u>The ownership-settlement approach</u>

20 The ownership-settlement approach, like the basic ownership approach, treats basic ownership instruments as equity but expands on the basic ownership approach's notion of equity by including perpetual instruments and instruments that are linked directly to value of the basic ownership instruments. We see a number of weaknesses in attempting to define equity in this way:

(a) The approach feels outcome-driven (in particular to accommodate the view of some that derivatives on own equity are nascent equity and that perpetual instruments should be treated as equity) rather than being a principle-based approach derived from concepts.

(b) The approach seems to be based on a mix of different principles. Basic ownership instruments are equity because they represent the most subordinated interest in the entity's net assets. Perpetual instruments are equity because they lack settlement requirements. And certain derivatives are equity because they are settled by issuing basic ownership instruments and their value is positively correlated to the price of those basic ownership interests. In other words, instead of trying to identify a principle to place at the core of the equity/liability classification system, it defines equity by adding together several alternative criteria. As a result, the approach blends varied instruments in one category without trying to determine whether these instruments have a common characteristic and whether that characteristic would make a difference of substance in relation to other instruments which stay outside this category. This makes the approach inconsistent with the objective of the project to define equity in such a way that it exhibits distinctive characteristics.

(c) The approach as described appears to be very rules-based. We think IFRS should be principles-based. Standards that are little more than a set of rules tend to be difficult to apply and open to financial engineering.

(d) According to the comparison made by the IASB in its Invitation to Comment between the IAS 32 principles and the approaches proposed in the FASB PV document, the ownership-settlement approach is the one that is most similar to IAS 32 with regard to both the number and type of financial instruments classified as equity instruments. However, for the above mentioned reasons we do not think the approach would solve the main weaknesses with the existing IAS 32 approach in a coherent way, although we accept that it might address some of the weaknesses, albeit in a fairly ad hoc way.

<u>The reassessed expected outcome approach</u>

21 The reassessed expected outcome approach is designed with the objective of making the structure of the instrument and the form of settlement irrelevant. However, although we understand that this methodology is based on pricing methodology, we still find it difficult to envisage how it can be applied for financial reporting purposes, because it is so complex to understand and probably therefore to apply.

<u>Consolidated financial statements</u>

22 Another concern we have about the PVs document's the discussion of the equity-liabilities distinction is how it deals with consolidated financial statements. This seems to be a particular problem when classifying basic ownership instruments, and is therefore a problem for both the basic ownership approach and the owner-settlement approach.

23 We think what is needed is a set of principles that would apply equally to separate financial statements and consolidated financial statements. For example, consider the description of a basic ownership instrument set out in paragraph 18 of the paper. That description is based on legal notions of subordination (paragraph 18(a)) and residual interest (paragraph 18(b)) which work well when the reporting entity is a legal entity. However, we think those notions work less well when the reporting entity is, for example, a group of companies rather than a legal entity.

(a) If the reporting entity, when consolidated financial statements are prepared, is the parent entity, then the description works reasonably well, except that it would not have the effect described in paragraph 29 ("Basic ownership interests of a subsidiary ... would retain their basic ownership nature in the consolidated financial statements...") because a holder of the subsidiary's basic ownership interests would not be entitled to a percentage of the assets of the parent that remain after all higher priority claims have been satisfied (so paragraph 18(b) would not be met).

(b) However, if the reporting entity, when consolidated financial statements are prepared, is the group, then we do not think the description works. Firstly, we are not sure how to apply the paragraph 18(a)'s notion of liquidation to a group. Should we assume the whole group is liquidated? In what order? We think the residual interest test in paragraph 18(b) could also be a problem because, when viewed from the group perspective, no instrument holder has a residual interest.

24 Therefore, if we are to develop a high-quality, principle-based global approach to the classification of financial instruments between equity and liabilities, the consolidated financial statements issue needs to be explored thoroughly and resolved. An arbitrary rule of the kind set out in paragraph 29 of the PVs document is not a satisfactory solution.

<u>Other possible approaches</u>

25 We mentioned earlier that the three approaches described in the PVs document are not the only approaches worth exploring. For example, we believe that it would be beneficial for the IASB in its future work on the project to take into account the work done by the German standard setter as part of Pro-active Accounting Activities in Europe (PAAinE) initiative which resulted in the discussion paper "Distinguishing between Liabilities and Equity".

(a) One of the advantages we think this paper has over the PVs document is that it does start by attempting to answer the questions mentioned in paragraphs 8 and 9 above.

(b) The PAAinE paper analyses claims to assets and their characteristics and proposes that the loss absorbing feature of instruments could be used as the distinguishing attribute between equity and liabilities. We understand that a similar notion is currently used by users whose primary interest is the assessment of the reporting entity's solvency. For example, we understand that Fitch Ratings, one of the global rating agencies, relies in its assessment of capital structure and leverage of enterprises on identifying the loss-absorbing properties of instruments in order to rank instruments on a debt-to equity-continuum into such categories as instruments with superior equity content, highly equity content, moderate equity content, low equity content and no equity content. The loss absorbing feature is similar, but subtly different from, the most subordinate feature underpinning the basic ownership approach, and we think it is instructive to think about the implications of some of the differences.

26 As we have already mentioned, we think a claims approach (ie an approach that treats all balance sheet credits as financing) is also worth considering further. We also think it could be useful to explore further an approach that in effect involves three categories: equity, liabilities and things that are not equity but also not liabilities. With such an approach, it would still be necessary to decide how to treat the things that are neither equity nor liabilities in the balance sheet and, if the treatment in terms of net income is determined separately from the balance sheet, in the income statement. Nevertheless the 3-categories approach is seen by some users to be useful because it enables 'pure equity' and 'pure liabilities' to be separated from instruments and other balances that have elements of both equity and liabilities.

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?

27 If we wish to have principle-based standards, we should have an equity/liability classification system that can be applied to all types of balance sheet item, regardless of whether they are financial instruments and also regardless of whether they are financial instruments with characteristics of equity. For that reason, we think the scope of the project is too narrow. We believe that most of the work should be done at the conceptual level within the context of the Framework project and we would prefer it to include all balance sheet items.

28 If a narrower scope is essential, we think it should be all financial instruments, not just those financial instruments that fall within the scope of paragraph 15 of the PVS document.

29 We note that paragraph 28 of the FASB PV documents states that the FASB needs to consider "at a future date whether or not share-based payment awards should be in the scope of any standard resulting from this Preliminary Views." We think it is absolutely essential that, in any a high-quality, principle-based global approach to the classification of financial instruments between equity and liabilities, the classification elements at the very least apply to share-payment awards, and indeed all other financial instruments.

B3 Are the principles behind the basic ownership 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?

30 As we have already explained, we are not convinced that the basic ownership approach is the solution to the issue of distinguishing equity from liabilities. Therefore, we answer this question generally, and not in relation to this particular approach only.

31 Ideally, the principle used to distinguish equity from liabilities should be applicable across all types of entities and jurisdictions. Nevertheless, we acknowledge there are certain types of entities as well as legal traditions in some jurisdictions which may pose challenges to a classification system that would prove acceptable in most other cases. In view of this, we would encourage the IASB to test solutions that it would be considering in this project to understand their effect in those particular situations. These situations include:

(a) legal requirements governing redeemable instruments;

(b) legal requirements to distribute profits for certain types of entities;

(c) capital structures of co-operative type of enterprises; and

(d) partnerships involving general and limited partners.

Question to constituents: Do you have any specific examples of situations that require special consideration in resolving the issue of equity versus liability classification in addition to those mentioned above?

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?

32 Please see our response to question B3 above.

Question to constituents: EFRAG's draft comment to question B4 refers to its response to question B3. Do you have any additional comments that you think should be included here about specific types of entity or instrument or jurisdictional requirements that ought to be taken into account?

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

Linkage

33 Paragraphs 41-43 of the PVs document explain in effect that two or more instruments should be accounted for as if they are a single instrument if they are contractually linked, were entered into at or near the same time with the same or a related counter-party, together achieve an overall economic outcome that could have been achieved with a single instrument and reporting them separately would achieve a different result.

34 We are in two minds about this proposal.

(a) On the one hand, we agree that, in the circumstances described, we would want the transactions to be accounted for together. There is no difference in substance between the one instrument and the two instruments, so there should be no difference in the accounting either. (Incidentally, we think this is a principle that should apply much more widely than just the equity/liability classification of certain types of financial instruments.)

(b) On the other hand, we are not in favour of including anti-abuse clauses in accounting standards. (We are not sure why an entity, faced with a choice between issuing two instruments that would together achieve exactly the same result as one instrument nearly at the same time to virtually the same counterparty, would issue the two instruments rather than the one unless it is seeking to gain some sort of accounting advantage.)

Perhaps another way of looking at the linkage notion is to say it is not an anti-abuse clause; rather, it is a clause that corrects a weakness in the basic approach. (Were it not for the linkage principle, the approach being proposed might result in a difference in the accounting between the one instrument and the two, even though in substance the position is the same.) However, that does not give us any comfort either because it suggests to us that the basic approach is based on the wrong principles. Proposals based on good principles should not lead to different accounting in circumstances that are different in form but not in substance.

35 We have two other comments:

(a) We do not understand why 'linkage' is addressed separately from 'substance'. In our view, linkage is just one aspect of the wider substance notion.

(b) We talked about the anti-abuse nature of the proposal earlier. If anti-abuse *is* the concern , one might wish to consider whether phrases like 'comparable single instrument', 'similar outcome(s)', 'near the same time', 'simply' are sufficiently robust.

Substance

36 We strongly support the view that transactions and other events should be accounted for in accordance with their economic substance, and not merely their legal form. We do not believe that a faithful representation—on any accounting matter, not just the equity/liability classification of certain types of financial instruments—can be achieved unless the accounting reflects that economic substance.

37 However, we suspect that the term 'economic substance' means different things to different people. For example, although our notion of substance would incorporate what is said in paragraphs 44(a) and (b), it would also go much further. We think the notion described in paragraph 44 might actually be about what is and is not substantive, rather than economic substance.

38 For that reason, it would be interesting to explore the implications of paragraph 44 further than it currently is in the paper. For example, what would be its implications for the various types of economic compulsion examples that are commonly discussed? The PVs document explains (in paragraph 66) that the FASB has been unable to reach a satisfactory conclusion about economic compulsion, but in our view this is one of the most important equity/liability classification issues to resolve and IAS 32's reluctance to entertain the notion has been one of the main reasons why the standard has been weakened.

Treatment of puttable instruments

39 We think the proposed requirements for redeemable basic ownership shares set out in paragraphs 20 and 21 of the FASB PV documents are not very clear. The FASB PV states that basic ownership instruments meeting the criteria in paragraph 18 are equity. It then goes on to state that the paragraph 18 criteria would be met for redeemable instruments if they meet the criteria in paragraph 20 and 21. However:

(a) it seems to us that the criteria in paragraphs 20 and 21 are not the same as in paragraph 18. For example, paragraph 18's focus on the priority of an interest in liquidation is not reflected in the criteria in paragraphs 20 and 21.

(b) the requirement in paragraph 20(b) (that, to possess the paragraph 18 characteristics, the terms of a redeemable instrument need to prohibit redemption if redemption would impair claims of any instruments with higher priority) is difficult to understand. Taken to the extreme one could argue that all redeemable instruments impair in some way the claims of any instruments with higher priority because their redemption reduces the entity's gearing and, therefore, exposes creditor to higher risk.

(c) paragraph 21 states that the amount described in paragraph 20 (a) is the fair value of the instruments. However, it goes on to explain that, if the redemption amount is designed to approximate the fair value of the instrument or the share of the assets to which the holder would be entitled to and there is no active market for the instrument, a redemption amount based on book value would be acceptable. This reference to "book value" is not clear: book value of what? In addition, we would not have thought that in most cases book value would approximate fair value of the instrument or the share of the assets to which the holder would be entitled.