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Sir David Tweedie
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity* (February 2008). Principal authors of this comment letter were Peter Bitzyk, Rudolf Diewald, Heiner Klein, Michael Laminger, Aslan Milla und Roland Nessmann.

We believe that the revised standard IAS 32 should have the following goals:

- The criteria for the distinction between equity and liability should be clear and comprehensive.
- Any legal entity (including cooperatives and partnerships) should be entitled to account for capital as equity provided it has been contributed as capital at risk.

The starting point for our comments, as requested in paragraph 8 of the DP, are the questions in the FASB Document *Preliminary Views: Financial Instruments with the Characteristics of Equity* of November 2007. In addition we have answered the questions in Appendix B of the IASB DP.

Part 1: Questions in the FASB document *Preliminary Views: Financial Instruments with the Characteristics of Equity*

Questions on the Basic Ownership Approach (BOA)

Q1. *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 this Preliminary Views and provide minimal structuring opportunities?*

Yes, the improvement leads to reduced complexity and results in a clear and easy distinction between equity and liability, which facilitates comparison between companies. The underlying principles are clear and appropriate and the approach would significantly simplify accounting for financial instruments within the scope of the Preliminary Views.

As the BOA can cause problems for cooperatives and partnerships, we recommend several amendments, which are described in more detail in our answer to Q4.

Q2. *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 concerns, if any, does this classification present?*

If the principles of the BOA are used on a worldwide basis, we do not see a big issue. Perpetual instruments are only part of equity if they do not reduce the distributable net assets for the holder of the most subordinate class of claims against the entity, i.e., the equity holders. However, from a practical point of view there will be a problem if the effect of perpetual instruments becoming liabilities when this new standard comes into force is a shortage of equity, resulting in a credit or liquidity crunch. This rule will need to be accompanied by appropriate transitional rules or other accompanying measures.

Q3. *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? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.*

As long as the entity does not see an obligation to repay the perpetual instrument, in our view it should not be remeasured at all, and only the dividends should be shown as an expense when declared, or at regular intervals. The reasoning is that, with the underlying going concern assumption and the instrument being perpetual, the accounting should provide the user with information about expected future cash flows.

Q4. *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?*

The classification of redeemable BOA instruments as equity complies with reporting requirements. Nevertheless, the requirements in paragraph 20 ***et seq.*** will be difficult to apply in practice.

- The liquidation proceeds, which are used to determine whether the redemption feature does not prevent the classification of the financial instrument as equity, are hard to calculate if the BOI is not traded on an active market, as explained in paragraph 21: "the redemption formula is designed to approximate fair value of the instrument or the share of assets to which the holder would be entitled; and if there exists no active market for the instrument or the financial instrument can be exchanged only to the reporting entity". From our point of view, there are several problems within this definition:
  - The reference to liquidation proceeds is not consistent with the going concern assumption, which is the basis for the fair value; most assets and liabilities would need to be revalued in order to calculate this amount
  - Which redemption formula is designed to approximate the fair value of the financial instrument?
  - What is the absence of an active market?

In our view, these requirements should be reduced to either

- the use of fair values, when the financial instruments are traded on a regulated public market, or
- the use of a proportionate share of the net assets of the company, based on book values.

For some entities, such as cooperatives or partnerships, whose instruments may not be traded on an active market, we see the need for an additional rule, to the effect that

- where the holder has a redeemable instrument, and
- the associates have agreed contractually that the redeemable amount is less than or equal to the proportionate share of the fair value / net assets, and
- this value is used for reporting purposes, and the contractual agreement is disclosed in the notes, such redeemable instruments must also be classified as equity.

The reason is that these agreements cannot reduce the claims of other creditors, and how partners in such non-traded entities agree on their respective entitlements on leaving the entity should be left to their discretion.

Q5. *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 nor discretion to avoid. Second, the dividend right does not transfer with the stock after a specific 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?*

If the dividend payment requirement is similar to the interest payment requirement on a bond, then it is an obligation of the entity and should be shown as liability.

Q6. *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? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?*

Only stated factors should influence the classification, in order to avoid unclear solutions and the arbitrary exercise of management discretion.

Q7. *Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?*

We see no circumstances where the linkage principle would result in classification that does not reflect the economics of the transaction.

Q8. *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 this result? If not, why would the change in value of certain derivatives be excluded from current-period income?*

We agree to the use of “at fair value through profit & loss” for derivatives on own BOA instruments.

Q9. 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 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 with the separate reporting of BOA instruments with redemption requirements in a separate line from other BOA instruments within equity. The cash requirements for these instruments should be disclosed in the notes.

Q10. 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.*

The change in the fair value of a redeemable BOA instrument should be shown as a single line item without disaggregation.

Q11. *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?*

As long as BOA instruments are equity, they should be included in the calculation of EPS; in our view, there should be different calculations for EPS based on redeemable BOA instruments and for EPS including all other BOA instruments.

Questions on the Ownership Settlement Approach (OSA)

Q1. *Do you believe the OSA would represent an improvement in financial reporting? Do you prefer this approach over the BOA? If so, please explain why you believe the benefits of the approach justify its complexity.*

Because of the increasing complexity in comparison with the basic ownership approach and the greater scope for management discretion in structuring financial transactions to achieve the reporting results desired, we do not believe that the ownership-settlement approach represents an improvement in financial reporting.

Q2. *Are there any ways to simplify the approach? Please explain.*

We see no possibilities for reducing complexity without changing the whole approach.

Q3. *Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the BOA, 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?*

Taking circumstances not stated in the contract into account, as in the example in paragraph A40, opens the door to non-comparable financial reporting, because judgment not based on precise instructions must be exercised.

Q4. Statement of financial position*. 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 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?*

The necessary information could equally well be disclosed in the notes. However, we see the requirements – and the whole approach – as too complex to be compatible with rules that are reasonably easy to understand and apply. For this reason, we have not explored this topic in detail.

Q5. *Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?*

Answer as in Q4, above.

Q6. *The Board has not discussed the implications of OSA 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 or consider?*

Answer as in Q4, above.

Q7. *Are the requirements described in paragraphs A35–A38 operational? Do they provide meaningful results for users of financial statements?*

Answer as in Q4, above.

Questions on the Reassessed Expected Outcomes Approach (REO)

Q1. *Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the cost incurred to implement this approach exceed the benefits? Please explain.*

We are not of the opinion that the REO approach would represent an improvement in financial reporting, because the constant revision of the probabilities of possible outcomes would result in reclassifications and changes in measurement.

Q2. *Do the separation and measurement requirements provide meaningful results for the users of financial statements?*

The REO approach is so complex and requires the exercise of so much discretionary judgment that in our view its use would not represent an improvement in financial reporting.

Q3. *The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. 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 or consider?*

The REO approach is so complex and requires the exercise of so much discretionary judgment that in our view its use would not represent an improvement in financial reporting. Even though we have not considered the implications for EPS in detail, we see a lot of problems in reassessing the equity on which the EPS calculation is based, which would result in meaningless and non-comparable EPS figures.

Part 2: Appendix B of the DP: Additional questions for respondents

B1. *Are the three approaches expressed in the FASB Preliminary Views documents a suitable starting point for a project to improve and simplify IAS 32? If not, why not?*

In general we would like to point out that none of the 3 approaches would meet all of the above described goals. The Basic Ownership Approach (BOA) is a suitable starting point for simplifying IAS 32; especially if our suggestion in the answer to Q4 of the BOA section is taken into account, the problems faced by many not capital market oriented entities can be solved. This would then be an easy to implement, understandable and cost effective way to improve IAS 32.

B1.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?*

Answer as in B1, above.

B1.b *Are there alternative approaches to improve and simplify IAS 32 that could be recommended? What are those approaches and what would be the benefit of those alternatives to users of financial statements?*

EFRAG and some other standard-setters recently published an alternative Discussion Paper *Distinguishing between Liabilities and Equity* based on the so-called loss absorption approach. In addition to some theoretical shortcomings to the approach, we are not convinced that the option of "short-time equity" with an additional need for an equity maturity sheet would increase the understandability of financial reporting, in particular the equity / net assets reported. We see the same problems for the EPS calculation as with the REO approach. The problems can more easily be solved – at least in our view – by an amendment of IAS 32 in the way suggested in our answer to Q4 in the BOA section.

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?*

The scope is appropriate.

B3. *Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to what types of entities or in which jurisdictions are they inappropriate, and why?*

The BOA can only cause problems with privately owned entities (e.g., partnerships), where the personal contribution in terms of work, relationships and/or knowledge of one partner is more important and requires special agreements which do not fit with an equity model developed for capital market oriented corporations. We are nevertheless of the opinion that IAS 32, if amended as suggested in the answer to Q4 in the BOA section, can solve almost all of these problems and thus provide a principle-based solution for all entities.

B4. *Are there 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?*

Answer as in B3, above.

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

In general we would like to point out that none of the 3 approaches would meet all of the above described goals. Although we believe that a revised Basic Ownership Approach (BOA) could meet those criterias. As explained in the answer to B1, above, we think an amendment of IAS 32 the simplest and quickest way to eliminate most of the current problems of distinguishing between equity and liability. However, if the Boards decide to undertake a complete revision of the framework, the definition of assets, liabilities, equity and some other open issues, e.g. performance reporting, the basic ideas of the PAAinE/EFRAG DP *Distinguishing between liabilities and equity* could be a very fruitful starting point.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman