VMEBF
Bilanzierung in Familienunternehmen

Mr. Hans Hoogervorst
International Accounting Standards Board – IASB
30 Cannon Street

London EC4M 6XH
United Kingdom

Weinheim, 05/01/19

Dear Mr. Hoogervorst,

RE: DISCUSSION PAPER DP/2018/1

We appreciate the opportunity to comment on the IASB´s latest discussion paper DP/2018/1 "Financial Instruments with Characteristics of Equity". With this letter we would like to contribute to the Board´s due process and take part in the discussion on the proposals in the discussion paper.

The Association for Participation in the Development of Accounting Regulations for Family-owned Entities (VMEBF) was founded in 2006 and consists of German companies with a strong family shareholder background. Beyond its members, the association represents a huge number of family-owned large and medium-sized entities in Germany, often legally organised in the form of partnerships. The objective of the VMEBF association is to make the role of German family businesses as stakeholders in the development of international financial reporting more visible and to act as a constructive partner for the standard setters. We work closely together with the German standard setter ASCG (Accounting Standards Committee of Germany) and the German Institute of Chartered Auditors (IDW – Institut der Wirtschaftsprüfer in Deutschland e.V.) as well as other political institutions.

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Distinguishing equity from liabilities is an important practical issue for a large part of our member companies. In the past, many partnerships had to classify their interests as liabilities when applying IAS 32. The amendments to IAS 32 (rev. 2008) helped to solve some of the problems of partnerships applying the standard. However, some partnerships still have to show parts of their in-substance equity components as liabilities according to IAS 32. We therefore highly welcome the efforts of the IASB developing an approach leading to a consequent and direct classification of partnership interests as equity and having a standard that is in line with the IFRS Conceptual Framework for Financial Reporting.

From our point of view, capital distinction should best be addressed by implementing a principles-based definition of equity (e.g. as already developed by EFRAG when discussing the so called loss absorption approach in the context of the PAAinE-initiative in 2008). A consistent definition of equity should therefore focus on the economic substance of equity instruments instead of prioritising the prevention of structuring opportunities and thereby creating a much too narrow approach with a variety of casuistic exceptions from the principles initially adopted. Moreover, any kind of rule distinguishing between equity and liabilities should be applicable across different legal forms and jurisdictions. With the new proposals as pointed out in DP/2018/1 in mind, we regret that the approach proposed in the discussion paper – again – leads to a conceptual classification of all puttable instruments as liabilities. Only the application of the exceptions in IAS 32.16A-D leads to a classification of some puttable instruments as equity.

However, looking at the latest proposals the IASB seems to adhere to equity being defined as the residual interest in the assets of an entity after deducting all its liabilities. As a consequence, we would like to propose some adjustments to the classification criteria proposed in the discussion paper in order to enable partnerships to show their interests as equity without having to recourse to the exceptions for puttable instruments in IAS 32.16A-D.

According to the Board´s preferred approach, an entity would classify a financial instrument as a financial liability if it contains:

a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or
b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

Applying those criteria to interests in a partnership (i.e. some specific puttable instruments) would – still – lead to those puttable instruments meeting the definition of financial liabilities (see DP/2018/1, par. 3.20). We understand that this is because the instrument contains an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation. However, from an economic point of view we believe that especially the timing feature leads to a capital

distinction approach that is too narrow. Although we recognise the charm of a narrow approach to capital distinction, we believe that the IASB could achieve a more consistent capital distinction regime (meaning a regime considering the economic substance of the financial instruments) with some small amendments to the proposed criteria for capital distinction.

First, we would propose to amend the timing feature by adding the requirement that the "specified [point in] time" to transfer cash or another financial asset has to be "predefined on contract inception". As especially puttable partnership interests only lead to a transfer of cash or another financial asset to the holder on termination of the instrument, the criterion would not be met by such in-substance equity instruments of a partnership. This would also be in line with the requirement to inform the investor when a specific financial instrument (here: the puttable instrument) falls due as pointed out in par. 2.17 of DP/2018/1. However, to inform an investor about the economic resources required to meet such obligations when an in-substance equity instrument falls due (meaning: is terminated) the IASB could think about some reasonable notes disclosures requiring an entity to describe its puttable instruments including the economic resources required to meet its corresponding obligations.

Moreover, we believe that the requirement of an "unavoidable contractual obligation for an amount independent of the entity's available economic resources" is far too vague and thus rather hard to understand and apply. We would therefore propose to amend the criterion by referring to the "residual momentum of an equity instrument". For example, the IASB could add a requirement that the entities obligation does not characterize "an interest in the economic success or development of the entity" but instead reflects the interest of the holder in a predetermined or determinable (in-substance fixed) amount of cash or other financial assets to be transferred. This approach considering the substantial economical intention of the instrument holder could lead to a capital distinction criterion that would on the one hand be easier to apply, and on the other hand would take into consideration a fundamental feature of most positively framed equity definitions.

Finally, we are not yet able to foresee whether the Boards preferred approach might lead to problems within the consolidation routines as applied within our member companies.

With regard to the overall capital distinction concept, we are surprised that the proposals for an allegedly "better" and more useful or consistent capital distinction regime (as assumed) require such an amount of additional notes disclosures explaining the results of the new concept. It appears to us that the significant extent of additional explanation is rather resulting from the complexity of the approach outlined in DP/2018/1 and as such contributing substantially to a negative cost/benefit relation.

With regard to the embedding of the capital distinction project we believe, that a consistent and comprehensive capital distinction approach should be integrated into the conceptual framework for financial reporting.

If the IASB should decide to carry forward the discussions on the capital distinction approach proposed in DP/2018/1, we would welcome the Board keeping up the puttable exception in IAS 32.16A-D.

If you have any further questions or like to talk about our answers and suggestions in a personal meeting, please do not hesitate to contact us.

Kind regards,

Association for Participation in the Development of
Accounting Regulations for Family-owned Entities (VMEBF)

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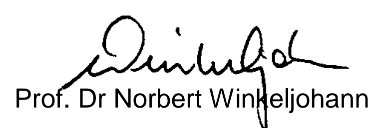
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