

International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Weinheim, 21/03/24

Dear Professor Barckow,

RE: ED/2023/5 – FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

We appreciate the opportunity to comment on the IASB’s exposure draft ED/2003/5 “Financial Instruments with Characteristics of Equity – Proposed amendments to IAS 32, IFRS 7 and IAS 1”. With this letter we would like to contribute to the Board’s due process and take part in the discussion on some of the proposals in the exposure draft.

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) as well as other political institutions.

**Vereinigung zur Mitwirkung an der Entwicklung des Bilanzrechts für Familiengesellschaften e.V.
VMEBF e.V., c/o Freudenberg & Co. Kommanditgesellschaft, 69465 Weinheim**

Board: Santokh Advani (Chair) · Tel.: (040) 3347 500 60 · E-Mail: santokh.advani@mbholding.com
Prof. Dr Dieter Truxius (Deputy Chair) · Tel.: (06182) 898 2809 · E-Mail: dieter.truxius@accobis.com
Dr Hans-Jörg Harth · Tel.: (06452) 70 2211 · E-Mail: drhtj@viessmann.com
Dr Michael Reuter · Tel.: (0211) 3679 0646 · E-Mail: mail@michaelreuter.com
Dr Thomas Ull · Tel.: (0421) 8980 4282 · E-Mail: thomas.ull@de.pwc.com

Bank account: Deutsche Bank AG, Mannheim · BIC: DEUTDESMXXX · IBAN: DE74 6707 0010 0040 1588 00

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 (even though the recognition of a financial instrument as equity that conceptually classifies as debt capital only serves as an imperfect solution). However, some partnerships still have to show parts of their in-substance equity components as liabilities according to IAS 32. We therefore hoped that the IASB would develop an approach leading to a consequent and direct classification of partnership interests as equity. Following the evaluation of the comments on DP/2018/1 we have noticed with regret, that the IASB has decided to abandon its conceptual work on the distinction between equity and liabilities and only continues to pursue amendments and clarifications as related to the previous capital distinction regime in accordance with IAS 32 (rev. 2008).

Although the IASB has taken this path, we would like to reiterate our view on the issue of capital distinction. 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.

Since the IASB does not intend to make fundamental changes to the concept of capital distinction in IAS 32 (although this would be economically desirable), puttable instruments such as shares in partnerships are still to be regarded as liabilities, but may be shown as equity in the financial statements if the exceptions as per IAS 32.16A-D apply. As a consequence, we are now commenting on some of the IASB's proposed amendments in ED/2023/5.

With regard to IAS 32.15, we understand that when applying the classification criteria for financial instruments the issuer of a financial instrument shall do so in accordance with the substance of the contractual arrangements and the definitions of a financial liability, a financial asset and an equity instrument. In this context, proposed IAS 32.15A now states that an entity:

- a) shall consider only contractual rights and obligations that are enforceable by laws [...] or regulations and are in addition to those created by relevant laws or regulations (such as statutory or regulatory requirements applicable to the instrument); and
- b) shall not consider any right or obligation created by relevant laws or regulations that would arise regardless of whether the right or obligation is included in the contractual arrangement.

According to our assessment, especially with regard to partnership interests, application practice has come to terms quite well with the requirements of IAS 32.15 in recent years and has created meaningful and appropriate interpretations in the context of national company law. We are therefore of the opinion that further clarification of these requirements will neither help preparers of financial statements nor improve the meaningfulness of financial statements. Instead, we believe that potential diversity in practice mainly results from the (justified) application of judgement to differing economic circumstances or regulation. For example, extensive legal requirements in German company law determine a large part of the rights and obligations of financial instruments, in particular of partnership shares (e.g. profit distribution, termination rights, compensation claims). If these legal provisions are indispensable, they do not need to be included and repeated in an individual contract. Individual contractual or statutory agreements are only necessary, if a legal provision is optional or if there is no legal provision at all. Nevertheless, legal requirements always have an impact on contractual agreements. As a consequence, the economic substance of a financial instrument is determined by the sum of all rights and obligations, regardless of whether they result from legal requirements, partnership agreements or individual contractual agreements.

Having said that, we do not think that the classification of a financial instrument should depend on the legal system of the country in which the company is based. Such a classification mechanism would on the one hand impair the comparability of financial statements and on the other hand provide huge structuring opportunities, especially for international groups. Moreover, the proposed amendments would lead to an unequal treatment of companies with differing legal forms. For example, in Germany the termination rights of partnerships are based on company law whereas termination rights in limited liability companies have to be agreed on in the company agreement, because company law does not provide for a termination right for limited liability companies. If we understand the proposals in the ED correctly, only such a contractual agreement would have to be taken into account in the classification of a financial

instrument. With all this in mind, we are concerned that the above-mentioned amendments could conflict with IAS 32.16A-D and therefore endanger the applicability of the exceptions granted there. Consequently, we suggest the IASB not to proceed with this proposal.

Another aspect, that might be relevant for our member companies, is the proposal on shareholder discretion. When applying IAS 32.19 to classify a financial instrument as a financial liability or an equity instrument, an entity considers whether it has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. In some cases, the settlement is at the discretion of the entity's shareholders. In such cases, practice issues arise about whether to treat a shareholder decision as an entity decision and how shareholder decision-making rights affect whether the entity has an unconditional right to avoid delivering cash or another financial asset (or to settle the instrument in such a way that it would be a financial liability).

The now proposed amendment is intended to help distinguish whether shareholders or partners decide as holders of a financial instrument or in their capacity as shareholders/partners – with effects on the classification of the financial instrument. In detail, the IASB proposes to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions. In that context, the IASB requires entities to describe the factors it is required to consider in making that assessment and lists a number of factors to be included when doing so.

For German companies this distinction is of huge practical relevance, as in all legal forms it is the shareholders who decide on the appropriation of earnings etc. Although we understand the intention of the IASB when proposing the amendments in IAS 32.AG28A-C, we believe that some of the proposals in those paragraphs might be impractical when applied in practice. This especially applies when it comes to an overall assessment of the various factors that have to be weighed up against each other in order to reach a general conclusion on the classification of a financial instrument – particularly if those factors would lead to diverging evaluations when assessed individually. As a consequence, we suggest the Board to remove the indicators proposed in IAS 32.AG28A and allow preparers of financial statements for judgement to enable an assessment taking into account all relevant facts and circumstances.


In conclusion, we would again like to emphasize that especially the topic of capital distinction under IAS 32 has proven to be a major obstacle to the further (voluntary) application of IFRSs among non-listed family businesses in Germany over the past years. With regard to ED/2023/5, we are afraid that the current proposals will not influence the decision in favour of an expansion of voluntary application of IFRSs amongst non-listed German family businesses but will rather lead to an even stronger refusal of IFRSs as their leading financial reporting regime.

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.

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



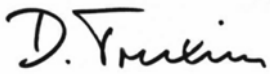
Santokh Advani



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Prof. Dr. Dieter Truxius



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