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Contact Mark Vaessen

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Dear Sirs

**PAAinE Discussion Paper – *Distinguishing between liabilities and equity***

*Introduction*

We appreciate the opportunity to comment on the PAAinE Discussion Paper, *Distinguishing between liabilities and equity* (“the DP”). The views expressed in this letter are those of KPMG Europe LLP, which comprises the KPMG member firms of Germany and the United Kingdom.

As an international network KPMG has a global process in place to respond to international standard setters on behalf of its member firms worldwide. The KPMG International Financial Reporting Group will respond separately to the IASB’s Discussion Paper, *Financial Instruments with the Characteristics of Equity* for which comments are due by 5 September 2008.

In this respect, whilst the response to the IASB has not yet been submitted, we expect it to question whether it is the right time for the IASB to take on such a major project. The IASB’s current work programme includes a number of very major topics, not least the conceptual framework. We expect the international network of KPMG member firms to express the view that the current debt equity model based on IAS 32 is not fundamentally flawed so as to require immediate attention and we are not convinced that the IASB should prioritise developing a new conceptual approach. However, if the IASB decides to take on such a project then KPMG believes that the loss absorption model as set out in the DP is worthy of consideration by the IASB.

In responding to the DP we have not answered the detailed questions and our comments are of a more general nature, although they do indeed touch upon a number of the subjects raised by the questions. This partly reflects the fact that the DP is at a conceptual stage; it outlines the key ideas and concepts to the loss absorption approach but, as discussed below, we believe there are a number of areas that require further consideration before the approach set out in the DP can be taken to its next stage.

### *General comments*

We agree that a debt/equity split is useful information for decision making. Consequently, we would not support an approach which is just focused on a list of claims by the various capital providers, for the reasons set out in the DP. However, we think the analysis in the DP of claims on assets and their characteristics is a helpful contribution in trying to arrive at those attributes that might distinguish equity from liabilities. In our view, the loss absorption approach is an approach that may be helpful in identifying a model to distinguishing between equity and liabilities.

We very much support a principles-based solution to this issue and accordingly agree that the distinction between debt and equity financial instruments should be based on one criterion or as few criteria as possible. The merits of such an approach are that it should be easier to adopt and avoids ‘criteria arbitrage’. Clarity in the distinction is of paramount importance and we think the DP clearly sets out its conceptual basis for the distinction (loss absorbing capital). One of the issues with the current IAS 32 is the apparent inconsistency between the definition of equity as a residual interest and the wide ranging types of instruments caught by the definition of a liability, some of which might be regarded as in substance equity because they contain elements that would generally be regarded as a residual type interests. The merit of the approach set out in the DP is that it achieves internal consistency and at a principle level makes the distinction clear.

The paper notes there is more work to do in clarifying how the principle would work in a group context. This is a very important issue as investors and users focus on the consolidated accounts. Therefore, in our view, key parts of any next steps in developing the loss absorption approach would be to further explore its application to a group and consideration of the effects of the two conceptual methods of applying the approach set out in Section 5 of the DP. In doing so, it needs to be kept in mind that the group is not a legal entity but a reporting entity and that the capital at a group level cannot, at least from a legal perspective, be loss absorbing. On the other hand it seems to us that any solution to this problem would need to cater for a situation whereby at an individual subsidiary level an instrument may be equity, but at the ‘group’ level is classified as debt because of some form of guarantee or linked obligation at parent level. These two potentially conflicting approaches need to be examined in more detail.

We acknowledge the merits of the approach taken in the DP to define equity. The current approach taken in IFRS of defining both equity and liability results in some very marginal decisions for ‘mezzanine’ types of instruments. A definition of equity is consistent with the approaches set out in the IASB’s discussion paper and has the merit of acknowledging that an equity instrument exhibits certain distinctive characteristics rather than just being viewed as a residual.

We also agree that basing the distinction between equity and liabilities on risk capital can provide decision useful information to a wide range of users on financial statements for entities in different legal forms and is a model worthy of further consideration by the IASB.

We support the concepts of linkage and split accounting in the DP, although as we note above, further consideration needs to be given to the concept of linkage in a group situation.

It is helpful that the DP includes some examples to illustrate the loss absorption principle. However, we also believe it would be helpful to extend this analysis to include comparison of the various types of capital instruments under the PAAinE approach with their treatment under the current IFRS approach and those possible new approaches proposed in the IASB's Discussion Paper

*Areas where greater clarification is required*

For the reasons set out in the paper we agree with the use of 'accounting' losses rather than any concept of 'economic value' losses. However, exactly how this approach applies in practice in our view requires a little more clarification. The definition in paragraph 4.7 refers to 'net negative comprehensive income for a given reporting period before conditional servicing costs...'. In the glossary on page 94 accounting loss is defined as 'the net negative total recognised income and expenses before conditional servicing costs...'. We are unsure as to whether the different wording is intentional but more particularly it leaves us unclear as to the relevance of any possible distinction between losses occurring on an ongoing basis from period to period and those arising on liquidation. We believe that the paper should discuss both aspects and clarify how it affects the loss absorption criteria.

The DP sets out its arguments clearly and the simplicity of the approach is inherently appealing. As is the case with any principle exceptions should be avoided wherever possible and we are not advocating such an approach. However, we feel that the concept behind the approach needs to be 'tested' in a number of situations to see if the simplicity of the principle is able to provide a consistent principles based solution to some of the more complex instruments and situations which are quite common in today's business environment. In particular:

- a) We believe that the paper would classify perpetual debt with a discretionary coupon as a liability on the basis that at some indeterminate point in time the claim of the holder would still be par value. Whilst this might be true on a liquidation there is no claim to be made during the life of the entity and never will be unless one assumes liquidation/non-going concern. We question whether the approach in the paper has fully thought through the implications of such issues.
- b) We believe it would be helpful to consider the treatment of those instruments that absorb losses for only a defined period, for example an instrument of ten years maturity which is loss absorbing in period one until five but not loss absorbing from period six to ten. We are unclear as to whether reclassification of this instrument would be allowed given that the terms and conditions are unchanged over the life of the instrument (4.22-4.24) and we note that split accounting would not solve this particular problem.

- c) Example IE 11 states that an instrument issued on 25 December and repayable on January 4 the following year which is loss absorbing will be classified as equity. Given the conceptual approach taken in the DP we can understand the rationale for this conclusion. However, this would seem to provide the opportunity for the deliberate structuring of transactions and potential window dressing; we question whether this information is really decision useful for the investor. This is particularly the case when compared to the perpetual loan referred to above. We believe that further consideration should be given to this issue.
- d) In a case where a company has a profit and loss transfer agreement we might assume no capital would be treated as loss absorbing because there is no possibility of a loss arising in the company. However, in the case of a collateralised debt obligation SPE we assume that most, if not all, the instruments issued by the SPE would be classified as equity because under the usual 'cash waterfall' arrangements in such a vehicle all instruments are under their terms and conditions capable of absorbing losses – there is a continuum of loss absorption. It does seem questionable as to whether these results are appropriate and decision useful from an investor's point of view.
- e) In terms of derivatives on own equity (warrants, options) the DP concludes that the contract itself is neither equity nor liability but that if a premium is received then this is equity as it would be loss absorbing and is non refundable. Accordingly, in the case of a forward contract which obliges the investor to buy a fixed number of shares on a fixed day at a fixed price, we understand that the DP would not consider such an instrument to be equity. However, given the fixed price nature and the absolute commitment in the contract from the perspective of the entity this capital will be available to absorb future losses. Again we would welcome greater clarification as to how this fits into the loss absorption model and the rationale for it not being treated as equity.

Please contact Mark Vaessen at +44 207 694 8589 or Andrew Vials at +44 207 694 8473 if you wish to discuss any of the issues raised.

Yours faithfully

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