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RÉPUBLIQUE FRANÇAISE

Conseil National de la Comptabilité

3, Boulevard Diderot
75572 PARIS CEDEX 12

Téléphone **01 53 44 52 01**

Télécopie **01 53 18 99 43/01 53 44 52 33**

Internet http://www.cnc.minefi.gouv.fr

Mel jean-francois.lepetit@cnc.finances.gouv.fr

Le Président
JFL/MPC

n°393

PARIS,

Mr. Stig Enevoldsen
EFRAG
13-14 Avenue des Arts
1210 BRUSSELS
Belgium

Re : Discussion Paper – Distinguishing between Liabilities and Equity

Dear Stig,

The Conseil National de la Comptabilité (CNC) is pleased to provide its comments on the Pro-Active Accounting Activities in Europe (PAAinE) Discussion Paper on Distinguishing between Liabilities and Equity.

The CNC welcomes the PAAinE's initiative to elaborate an alternative proposal as a contribution to the international debate and considers this contribution as of great value. The CNC considers that the approach proposed in the Discussion Paper is worth taking into consideration given the current international reflexions by FASB and IASB on the distinction between liabilities and equity.

The Discussion Paper asks all the right questions on this difficult matter. Interesting arguments are developed on the nature of equity, on participation in ongoing profits, losses and liquidation excess, on "subordination", on fixed term / maturity, on participation rights and on voting rights.

We also note with satisfaction that the Discussion Paper has entered into thoughts about entity view and proprietary view. Since the IASB published a Discussion Paper on the Reporting Entity, it would be interesting to follow through and compare with any new reflexions on the IASB Framework.

The distinction between liabilities and equity, as proposed in the Discussion Paper, is based on one sole criterion. If we are convinced that the fewer criteria the more simple is the approach, we have nevertheless some concerns with the practical implementation of the proposed approach, and we encourage the PAAinE to perform further work on the particular points discussed hereafter in the Appendix.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Jean-François Lepetit

APPENDIX

1. Relationship with the IASB Framework

The CNC encourages the PAAinE to develop arguments that could support the approach chosen in favour of a positive definition of equity, since it is a fundamental change compared to the positive one for financial liabilities as it exists in the current IFRS (equity being seen as a residual component).

In this context, further work on the consistency between the liabilities resulting from the proposed positive definition of equity in the Discussion Paper on one hand and the definition of liabilities as it appears in the current Framework on the other hand should be performed.

2. Loss absorption criteria

While we believe the loss absorption criteria is a feature which has to be taken into consideration to define equity instruments, the practical implementation of the loss absorption approach as it is described in the Discussion Paper needs further work. For this purpose, it would be interesting to follow through on the four following questions raised by the document itself.

1. The CNC remarks that classifying a financial instrument into liability or equity would essentially depends on the manner in which contracts will be drawn up. We understand the loss absorption criteria as to be met through a legal reduction of the holder’s claim when losses occurs, rather than a simple risk exposure. Consequently we wonder why two instruments which have similar negative consequences for their respective holders should be classified differently by each issuer due to their only legal terms. This case is illustrated in example IE2.

2. Mainly based on example IE11, we also question about the practical consequences of the mechanism which has to be established for determining the accounting losses attributable to the instrument before it matures, and for allocating all the losses to the instrument.

3. Because this does not come out clearly in the Discussion Paper, we wonder if the loss absorption criteria on liquidation date or at the repayment date has also to be met on a continuous way during all the life of the instrument.

4. Additionally, where the only remuneration of an instrument is loss absorbing, a split accounting issue is also raised : the question is then whether a distinction should be made between the “loss absorbing interests” component and the “principal” component.

3. Continuum of loss absorbing capital and comparability between entities

We consider that the continuum of loss absorbing capital can disadvantage comparability between companies since the same instrument could be designated as equity or liability depending of the net result of the issuer.

Furthermore the systematic reassessment of the effectiveness of this continuum can lead to frequent reclassifications which will impair comparability between successive periods for the same issuing entity.

4. Case studies

We regret that the commentaries read on the illustrative examples in the Section 6 do not allow for a comprehensive analysis and a clear understanding of the approach proposed in the Discussion Paper. The examples provided in the Discussion Paper are very theoretical and don't seem to relate to current instruments. Moreover, the range of instruments included in these examples does not seem to be wide enough to enable the reader to have a clear vision of the real consequences of this approach.

The CNC therefore suggests that the 25 examples proposed in the FASB Preliminary Views and reformulated in the IASB Discussion Paper be the subject of an additional analysis under the approach developed by the PAAinE.

Additionally, we would like to have seen some European specific instruments studied apart, as European cooperative shares for instance.

5. Classification in the consolidated accounts

The CNC wonders what the provisions relative to classifying the instruments issued by a subsidiary in consolidated accounts will be. In particular, the case of equity instruments issued by special purpose entities (or ad hoc entities) should be analysed.
We suggest that further work be performed to determine if the equity instruments issued by these SPE should be classified as such in the group's consolidated financial statements.

6. Scope

Regarding the scope, which is not precisely defined in the Discussion Paper, the CNC has based its comments on the only financial instruments that are currently under the scope of IAS 32.