

February 17, 2014

Mr. Hans Hoogervorst
Chair
International Accounting Standards Board
30 Cannon Street
London
United Kingdom

**Re: Comment Letter on Conceptual Framework Discussion Paper:
Distinction Between Equity and Liabilities Instruments**

Dear Mr. Hoogervorst,

The CFA Institute¹, in consultation with its Corporate Disclosure Policy Council (“CDPC”)², appreciates the opportunity to comment on the International Accounting Standards Board’s (“IASB” or the “Board”) Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* (“Conceptual Framework DP”). As we note in our overview letter regarding the Conceptual Framework DP, we are responding to those aspects of the discussion paper where we think investor input may be most needed and where we believe improvements in the Conceptual Framework may have the most direct and immediate impact on financial reporting from an investor perspective. To increase the accessibility of our response to our membership, we have provided separate comment letters on the four topic areas of focus, which are as follows:

- Definition of Equity & Distinctions Between Liability & Equity
- Measurement
- Presentation & Disclosure
- Other Comprehensive Income

We have also provided comments related to Other Issues in Section 9 of the Conceptual Framework DP in our overview comment letter.

¹ With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 116,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 137 countries, of whom nearly 108,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is trying to help ensure that corporate financial reporting and disclosures provided to investors and other end users is of high quality.

SUMMARY OF VIEWS

We welcome the efforts undertaken by the IASB to revisit the conceptual foundations that underlie the reporting of liabilities and equity. There are adverse behavioural consequences (e.g. structuring to meet accounting outcomes) arising from the absence of a robust conceptual platform for the definition of liabilities and equity. These are exacerbated by the pace of innovation in financial instruments and various structured finance products. These innovations have led to new ways of shaping the distributions of risk and cash flows and new ways of circumventing existing accounting principles for claims. These innovations not only have challenged traditional liability and equity concepts, but have led to increasing efforts to obscure the nature of the claims against the assets, and the risks and return distributions inherent in those claims.

We acknowledge that the development of a robust conceptual basis for recognition, measurement and presentation of claims against the assets of companies has been a longstanding and challenging problem for standard-setters. The consultative and deliberative efforts of both the IASB and Financial Accounting Standard Board (FASB) over the years have demonstrated the difficulty of developing a definition of liabilities and equity that does not have cases where there will be inconsistent accounting treatment towards a subset of financial instruments which have similar economic outcomes. This problem arises from either a strict definition of equity or strict definition of liabilities for accounting purposes. The challenges with an all-encompassing liability versus equity definition also arise due to the wide variety of organizational forms that have variation in the underlying economic rights of ownership claimants (e.g. co-operatives, limited partnerships with puttable shares).

In the evaluation of existing literature and prospective classification models there are various factors or indicators applied to differentiate liability from equity including:

- Present versus future ownership claims;
- Entitlement to residual claims on assets at liquidation of the reporting entity;
- Relative subordination of claims (e.g. who are bearers of residual claims);
- Form of settlement of obligations (e.g. cash, asset transfer settlement versus equity instrument settlement);
- Variability in the value of obligations that are settled through equity instruments;
- Timing of obligations (e.g. obligations that only arise at liquidation are considered to be different from other obligations).

It is inevitable that gray areas in practical classification across the broad spectrum of financial instruments arise due to these multiple ways of considering equity versus debt. Another problem is that the functional classification can change over time. For example, instruments with convertible, put, or call features may be liabilities at some times and equity at others. This problem is exacerbated by the use of measurements based on management intent and/or business

models. For these reasons, any classification system must be accompanied by enough disclosure so that investors can reclassify when economic circumstances change.

Barriers to Eliciting Meaningful Investor Feedback:

Practical Comparisons to Existing Standards & Previous Proposals

Notwithstanding the inherent conceptual difficulties and importance of resolving the distinction between liabilities and equity, the articulation of this topic within the Conceptual Framework DP is one that is likely to be hard for investors to meaningfully opine on due to the limited discussion of the economic consequences (e.g. structuring) and interpretation difficulties arising under current classification requirements. Another source of difficulty in eliciting investor views is the limited conceptual evaluation of the information needs of different types of users (i.e. equity versus fixed income investors) and thereafter an analysis of how the proposed classification prioritizes the needs of one type of user over the other. In other words, the development of liability and equity definition at a conceptual level needs to be more user-centric than is the case within the Conceptual Framework DP.

There is some discussion of the distinction between liabilities and equity under IAS 32 (i.e. Table 5.1) and through Paragraphs 5.53 to 5.59. Furthermore, the examples in Appendix C and D are helpful towards understanding the differences within existing literature and describing the application of the strict debt obligation approach. However, it is not clear whether or how the proposed conceptual framework update will actually affect individual accounting standards (i.e. IAS 32, IFRS 2 and IFRIC 2). These individual standards establish such classifications in the financial statements utilized by investors and other creditors and it is important for investors to understand how these individual standards and actual financial reporting will change or whether this is purely a conceptual update. In our opinion, investors need to see how changes in the conceptual framework will change the financial statements that they utilize in the investment decision-making process. An understanding of the impact of changes is also required by other types of users, regulators, and preparers.

Users could also benefit from understanding in more detail how the IASB progressed its thinking from the models considered during the 2007-2010 consultative deliberations. Paragraphs 5.45 to 5.52 only cite high level reasons (i.e., complexity, lack of understandability and inconsistency with the definition of a liability) for not considering previous models. The Conceptual Framework DP should have provided more detail of the debate and evolution of the liability/equity distinction criteria from previous standard-setting consultative and deliberation efforts, to allow stakeholders to judge the merits of the preliminary views expressed by the IASB.

The last public consultation on the liabilities and equity topic in 2007/2008 proposed three approaches that aimed to define equity namely:

- ***Basic Ownership (BO) Approach:*** Allowed only basic ownership instruments and some puttable instruments to be classified as equity.
- ***Ownership Settlement (OS) Approach:*** The ownership settlement approach included basic ownership instruments perpetual instruments and indirect ownership instruments (e.g. derivatives) as equity instruments.

- **Reassessed Expected Outcomes (REO) Approach:** The objective of reassessed expected outcomes was to ensure consistent accounting treatments for instruments with similar outcomes regardless of how these were structured or issued. The REO was highly complex with its probability weighted anticipation of equity-like versus debt-like outcomes and the application of contingent claims modeling techniques.

The board deliberations at that time addressed additional approaches including the loss absorption, claims participation and mezzanine approaches. That said, these other approaches were not subject to stakeholder outreach and public comment. The project was then shelved in 2010.

In our comment letter to the IASB and FASB, we supported the basic ownership approach due to its relative simplicity, and the limited opportunities for structuring that it would provide. The BO approach resonated with the proposed definition of equity articulated in CFA Institute’s own Comprehensive Business Reporting Model (CBRM). The Conceptual Framework DP evaluates the BO option but only does so in the context of justifying its preferred ‘strict obligation’ approach.

With the inclusion of this topic in the Conceptual Framework DP, it would have been helpful for stakeholders to have seen the linkage of updated definitions with previous standard-setter development efforts so as to better evaluate whether the updated definition of equity claims overcome the practical application problems.

Needs of Equity Investors Should Shape the Liability versus Equity Classification: Strict Equity Approach Would Be More Useful Than Strict Obligation Approach

One challenge with the proposed strict liability definition is captured by the insightful classification considerations put forward by several academics³. These academics assert that the development of a decision-useful classification system for liabilities and equity should address several key questions, including:

- Who are the primary users of the classification system?
- What important attributes distinguish liabilities and equities for these users?
- Can one classification system, combined with additional disclosure, satisfy users requiring different types of information?

The aforementioned academic authors further assert the following:

Applying a strict definition for liabilities and allowing the equity classification to absorb instruments not meeting this definition may be decision-useful for creditors concerned with solvency risk, but such an approach may not meet the need of claimants concerned with valuation, such as investors in common stock.

Because any liability-equity classification system is unlikely to encompass the attributes of central importance to all subgroups, trade-offs are inevitable, and some subgroups’ demands for information may not be met by the classification ultimately designed. Identifying subgroups unmet demands may assist in designing disclosures to help satisfy those information needs.

As expressed in CFA Institute’s CBRM, we hold the view that equity shareholders should be seen as the primary users of financial statements and their analytical needs should be prioritized when designing financial reporting requirements. Thus if a least imperfect choice had to be made between a restrictive equity definition versus a restrictive liability definition, we would prefer the restrictive equity classification.

³ Botosan, C.A., Koonce, L., Ryan, S.G., Stone, M.S., and Wahlen, J.M (2005), *Accounting for Liabilities: Conceptual Issues, Standard Setting, and Evidence from Academic Research*, Accounting Horizons, Vol.19, No.3, pp 159-186.

Statement of Equity Re-measurements:

Will They Provide Additional Decision-Useful Information As Intended by the Board?

The IASB preliminary views are to treat equity as a residual and to thereafter resolve liability/equity distinction problems through requiring re-measurements of different equity claims through the statement of equity.

We would agree that there can be additional informational content for investors through the proposed re-measurements of equity claims in the statement of equity. However, the Conceptual Framework DP indicates that these will be based on mixed-measurement attributes (i.e. mixture of fair value and cost/amortized cost). We would note that unlike fair value amortized cost re-measurements of transfers amongst equity claims is unlikely to provide useful information. In this respect, the proposed updates to changes to the statement of equity will have limited information content. Hence, we recommend that in the absence of fair value measurement, there should be a requirement of disclosures of cash flows and risks that would help understand the consequences of re-measurements.

We are also concerned that because the additional re-measurement information requirements on the statement of equity are largely motivated as a compromise for the definitional difficulties of liabilities versus equity, it may result in companies having little incentive to provide decision-useful, sufficiently disaggregated and reliable information through the statement of equity.

Our Proposed Solution:

A Narrow Definition of Debt & Equity and

Supplemental Disclosures and Re-measurements for All Other Instruments

Our alternative conceptual solution would be to employ a narrow definition of equity, a narrow definition of liabilities and then segregate instruments with elements of debt and equity into a separate balance sheet caption which includes expanded disclosures of the nature of the instruments and their features, their priority of payment, their fair values and a sensitivity analysis of such instruments to changes in market conditions or features which impact their valuations or cash characteristics.

Further, a disclosure of re-measurements of all liability, equity and liability/equity captions based upon fair values would be highly decision-useful to investors. We disagree with the notion expressed in Paragraph 5.56 which indicates that fair valuing debt potentially results in counterintuitive results. We think a re-measurement disclosure which is based on the fair value measurement of the liability, equity and liability/equity and shows the transfer of value between the capital providers and the entity holders, would simply report real economic effects and would be highly decision-useful to investors and very instructive to those who see the fair valuing of debt as counterintuitive.

We recognize that such an approach may result in some arguing that traditional relative valuation metrics (e.g. debt-to-equity, ROE, etc.) will be less decision-useful as they will only include instruments with very strict interpretations of liability and equity. We would, however, highlight that they might become more decision-useful as they are likely to be more consistently applied across entities – comparability being a key aspect of relative valuation analysis – and that

investors and other users of financial statements could make their own assessment of the classification/characterization of the other instruments. Investors performing fundamental analysis would find such disclosures more decision-useful as they seek to identify the cash flows which are most important to their analysis (i.e. the nature of the instrument they own or seek to own and its priority in the capital structure).

The debate regarding debt versus equity seeks to use a single-dimension (i.e. line) to characterize and classify instruments which are multi-dimensional. Rather than continue to debate the classification and measurement of such instruments, we think it is important to move forward with solutions which improve the usefulness of the available information for investors.

Thank you again for the opportunity to comment on the Conceptual Framework DP. If you or your staff have questions or seek further elaboration of our views, please contact either Vincent Papa, PhD, CFA, by phone at +44.207.330.9521, or by e-mail at vincent.papa@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,
/s/ Sandra J. Peters

Sandra J. Peters, CPA, CFA
Head, Financial Reporting Policy
Standards & Financial Markets Integrity Division
CFA Institute

/s/ Ashwinpaul C. Sondhi

Ashwinpaul C. Sondhi
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council