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Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London
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5 September 2008

Dear Sir

**Discussion paper: Financial instruments with characteristics of equity**

We are responding to your invitation to comment on the *Discussion Paper: Financial instruments with characteristics of equity* (the 'Discussion Paper') on behalf of PricewaterhouseCoopers. Since this is a modified joint project of the FASB and IASB (the 'Boards'), we consulted with members of the PricewaterhouseCoopers network of firms to develop our responses simultaneously to both the FASB's *Preliminary views on financial instruments with characteristics of equity* (the 'preliminary views document') and the additional questions in the Discussion Paper. Accordingly both our FASB response on the preliminary views document dated 30 May 2008 (our 'FASB response'), which we have attached as Appendix B, and this response on the Discussion Paper summarise the views of the member firms. 'PricewaterhouseCoopers' refers to the network of member forms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the opportunity to comment on the IASB's Discussion Paper on this important topic and support the Boards' participation in a joint project as a means to converge accounting standards. The determination of whether a financial instrument is a liability or equity instrument is an important decision that will not only affect balance sheet classification, but also the selection of its measurement attribute and whether any resulting measurement changes or related cash flows are recognised through the income statement.

We agree with the IASB's criticism of International Accounting Standard 32, *Financial Instrument: Presentation* (IAS 32) set out in the Discussion Paper. Although IAS 32 often results in a classification that reflects the economic substance of a financial instrument, we agree that there are a number of situations where applying the principles of the standard in practice does not result in a faithful representation of the economic characteristics of the instrument. Furthermore IAS 32 contains a number of exceptions that have resulted in internal inconsistency. For example the amendment to IAS 32 *Puttable Financial Instruments and Obligations Arising on Liquidation*, whilst resolving an anomaly, allows certain puttable and finite life instruments to be classified as equity despite meeting the definition of a financial liability.

In view of these difficulties with IAS 32 we support a move to a new accounting model for debt and equity under IFRS, provided that it resolves the difficulties associated with IAS 32 without either creating new ones or requiring fundamentally different accounting for those instruments that are already appropriately classified as debt or equity. With some modifications, we believe the ownership-settlement model achieves these objectives: for many financial instruments it results in the same classification as IAS 32. However, at the same time it addresses many of the known application issues and inconsistencies of the standard. For more detail on the modifications we are proposing to the ownership-settlement model, please refer to our FASB response.

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We recommend that the Boards address the scope of the project early in the process since this is fundamental to ensuring that there is real consistency between the two standards. Paragraph 15 of the FASB preliminary views document limits the scope of the proposals to basic ownership instruments, instruments settled in basic ownership instruments or whose fair value is determined by prices of basic ownership instruments, and other instruments that are ownership interests in legal form. IAS 32, on the other hand, applies to all financial instruments other than those specifically excluded from its scope. This difference in scope reflects a difference in the approach to defining scope under US GAAP and IFRS and is therefore not easily resolved in the context of a single project.

We have a specific concern with the limited scope proposed in the preliminary views document and would not wish to see this imported into IFRS literature. The inclusive approach to defining scope in paragraph 15 may lead to economically similar instruments being classified differently as a result of legal form. For example, a common instrument in many IFRS jurisdictions is a perpetual subordinated debt instrument. This instrument is similar to a perpetual preferred share. Both instruments are undated and provide the holder with a steam of fixed coupon payments. The subordinated debt instrument does not appear to be in the scope of paragraph 15 as it is not an ownership interest in legal form, whereas the preferred share is legally an ownership interest and therefore would be within the scope. We believe the same accounting treatment should be applied to economically similar instruments regardless of legal form.

The difference in scope also gives rise to a problem with the proposed measurement provisions in the preliminary views document. While we support the Boards' participation in a joint project as a means to converge accounting standards, we only support convergence of an instrument's classification not convergence of measurement. As explained in our FASB response the accounting for financial instruments under US GAAP has generally been established on an instrument-by-instrument basis, and therefore the preliminary views document proposes recognition and measurement models for those financial instruments that will be classified as liabilities (or assets) as a result of the new guidance. However, a measurement model for financial instruments not classified as equity already exists in IFRS in the form of International Accounting Standard IAS 39 *Financial Instruments: Measurement* (IAS 39). Therefore no additional measurement guidance is required under IFRS for an instrument that is classified as a liability (or asset) as a result of this project. Introducing new measurement models to those that already exist in IAS 39 only for those instruments within the scope of this project would introduce further complexity and could result in economically similar transactions being measured differently. Attempts to converge measurement for only this subset of financial instruments contradicts the Boards' ongoing efforts to reduce complexity in this area of accounting as discussed in the IASB Discussion Paper and the FASB's Invitation to Comment on *Reducing Complexity in Reporting Financial Instruments*.

Appendix A to this letter sets out our specific responses to each of the additional questions in the IASB's Discussion Paper. As noted above, we have also attached, as Appendix B, a copy of our response letter to the FASB. The FASB response reflects our views under both US GAAP and IFRS and should therefore be referred to for further detail.

If you have any questions on the content of this letter, please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7212 4555), or Pauline Wallace (+44 20 7804 1283).

Yours faithfully

PricewaterhouseCoopers LLP

**Appendix A**

**B1 Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?**

**(a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?**

**(b) Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?**

As explained in the cover letter to this response, we agree with the Board's criticism of IAS 32 and acknowledge there are both application issues and inconsistencies within the standard. We advocate developing a new approach for debt and equity provided that addresses some of these known issues in IAS 32 whilst not creating new ones. For this reason we recommend that the Boards consider adopting a modified version of the ownership-settlement approach.

We do not support either the ownership or REO approaches as outlined in the preliminary views document for the reasons outlined in our FASB response letter.

**B2 Is the scope of the project as set in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?**

We do not believe that the scope of the project as set out in paragraph 15 is appropriate for the reasons set out in our covering letter.

**B3 Are the principles behind the basic ownership instrument inappropriate to any type of entities or in any jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?**

We believe the principles behind the basic ownership approach do not result in an appropriate definition of equity, irrespective of type of entity or jurisdiction. While we are a proponent of the simplification of the accounting standards, we do not believe that the basic ownership approach strikes an appropriate balance between accounting simplification and the need to reflect economic reality. Please refer to the FASB response attached as Appendix B to this letter for more detail.

We encourage the Board to address those financial instruments in the scope of IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments* and the amendment to IAS 32, *Puttable financial instruments and obligations arising on liquidation.* This interpretation and amendment were designed to address specific ownership structures that are common in certain jurisdictions where IFRS is currently applied and any change to the debt/equity model should reflect the conclusions that were reached in these cases following considerable debate.

**B4 Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance). If so, to which types of entities or in which jurisdictions are they inappropriate, and why?**

We believe the principles of separation, linkage and substance are broadly appropriate. Please refer to our FASB response for further detail.

**B5 Please provide comments on any other matters raised by the discussion paper.**

The FASB has identified and analysed a significant number of different instruments that are typical in the US as part of the preliminary views document. We believe that the Boards should also consider a variety of instruments in other jurisdictions in order to validate the proposed models, ensure that there are no unforeseen consequences from applying the models, and determine whether any outcomes cannot be justified or appropriately explained.