European Financial Reporting Advisory Group ■

20 October 2006

IAS 32 and IAS 1 Amendments
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir/Madam

Re: ED of Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements*: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft of Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements*: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

It is our understanding that these amendments are being proposed now because the IASB has concluded that the presentation requirements of IAS 32 are in need of urgent repair if entities preparing their financial statements in accordance with IFRS are to produce financial statements that make sense. We agree that the anomalies created by the current classification of certain types of puttable financial instruments require the urgent consideration of the IASB. In our view, a solution that addresses *all* (not just some) the circumstances which result in such anomalies should be developed as soon as possible.

Although some will argue that quick repairs should not be made when the issue involved is also the subject of a long-term project, we in principle support the IASB's decision: if a standard is so broken that the resulting financial statements do not make sense, it is not acceptable to expect entities to continue to apply that broken standard for years whilst awaiting the completion of the long-term project. In our view the IASB should apply this approach consistently across all its standards.

Having said that, we have significant reservations about the amendments being proposed in this particular case. Our detailed comments are set out in the appendix to this letter, but to summarise:

- The amendments proposed are not consistent with the Framework. While we can accept minor changes resulting in deviations from the current Framework, we believe that, if these are to be made to the concepts set out there, those proposed changes should be discussed in the context of the Framework as a whole. The reasons and consequences of these conscious decisions to deviate as well as the plan to address the resulting inconsistencies should be considered and explicitly articulated.

- Although the Basis for Conclusions argues that the proposed amendments will make financial statements more relevant and more comparable, we are not persuaded that will in fact be the case. For example, one effect of the proposed amendments is that two entities that have issued exactly the same type of capital instrument could be required to classify them differently (in one case as equity and in the other as liabilities) depending on whether the entity has issued any other classes of capital instruments. We do not see how the introduction of such a requirement enhances comparability.

- The proposed amendments seem very rule-based. We are not in favour of rule-based requirements because their lack of principle makes them susceptible to financial engineering. For that reason we fear that the proposals will create more problems than they solve.

- We are also concerned that there are no obvious signs in the Basis for Conclusions section that much consideration has been given to possibility that the proposals will have unintended consequences.

In our view these weaknesses are so fundamental that they cannot be ignored and therefore we believe the IASB should not proceed with the proposals. Our views are therefore much closer to those expressed in the Alternative View section than in the rest of the Exposure. If, however, it is decided to implement the proposed amendments nevertheless, we would ask the Board to consider some changes to the current draft to address the detailed concerns listed in our reply to Question 1.

If you would like further clarification of the points raised in this letter, please do not hesitate to contact either Svetlana Pereverzeva or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Question 1: Financial instruments puttable at fair value—*The Exposure Draft proposes that financial instruments puttable at fair value should be classified as equity, provided that specified criteria are met. Do you agree that it is appropriate to classify as equity financial instruments puttable at fair value? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification of financial instruments puttable at fair value, why?*

We do not support the proposals in this exposure draft, for the reasons set out below.

The Framework defines 'liability' and 'equity' and, in proposing these amendments, the IASB is suggesting that IAS 32 should adopt definitions of those terms that are not consistent with the Framework's. As we have stated in several previous responses, we believe that it is essential that changes of any significance to the concepts set out in the Framework should be discussed first in the context of the Framework as a whole. We believe that such changes should not be introduced via standards. Ideally the Framework should be changed first although we would usually accept minor changes resulting in deviation from the current Framework, if reasons and consequences of these conscious decisions to deviate as well as the plan to address the resulting inconsistencies are considered, well grounded, justified and explicitly articulated. If, however changes to concepts are debated only in the context of individual standards and are implemented through standards, the validity—and therefore the usefulness—of the Framework is damaged.

Furthermore, the proposed amendments seem very rule-based. We are not in favour of rule-based requirements because their lack of principle makes them susceptible to financial engineering.

We also have several concerns about those rules:

- Although there are several references in the ED to instruments being puttable at the fair value of the *net assets*, the term 'net assets' is not defined. Yet the text implies in places that the term is intended to be a reference to the fair value of the *recognised* net assets; in some other places it seems to be a reference to the fair value of the recognised *and unrecognised* net assets, in other places a reference to the market value of the entity as a whole; and in other places it seems to be a reference to the fair value of the instruments themselves. We think this needs clarifying.

- Furthermore, the ED does not appear to provide any guidance on determining the fair values. For example, some argue that the illiquidity of a large number of the instruments in question should be taken into account in determining the fair value. Some high level guidance that clarifies issues such as this would therefore be useful.

- Paragraph (a) of the proposed definition of puttable instrument stipulates that the instrument should have been issued at fair value. The Basis for Conclusions unfortunately does not explain the reasoning behind this rule. It has been suggested to us that the IASB is trying to limit its amendment to shares that give their holder an exposure purely to changes in fair value. However, although the Basis for Conclusions emphasises how similar the instruments puttable at fair value are to ordinary shares, there is no requirement that ordinary shares need to be issued at fair value if they are to be presented as equity.

- The proposals introduce into IFRS literature a totally new notion of the 'most subordinated class'. The notion is not explored in the Basis for Conclusions, so it is difficult to judge how thoroughly it has been tested to ensure that it is a sound, robust and operational notion.

- Assume an entity has one class of shares and they meet the definition of 'financial instruments puttable at fair value'. Those shares will be presented as equity under these proposals. Assume that the entity now makes a rights issue (in other words, it issues more of those same instruments to existing holders at a small discount). Those instruments will presumably not be financial instruments puttable at fair value because they have not been issued at fair value. Does that mean the entity will have to classify some of that single class of shares in issue as equity and some as liabilities? And, if some of those instruments are subsequently put back, how will the entity know whether it is a liability or equity that has been put back? We are concerned about the complexity that such rules are going to create.

- We note that, although the proposal is that certain instruments that are currently presented as liabilities will henceforth be presented as equity, it is also proposed that warrants and other derivatives to be settled by the issue of such instruments will continue to be presented as liabilities even though the principle in IAS 32 is that warrants and other derivatives to be settled by the issue of an instrument should be classified in the same way as that instrument. This exception to an exception adds yet more complexity and creates yet more financial engineering opportunities.

- Lastly, we believe that the way in which the proposed amendment is structured and drafted is much more complex than it needs to be. The proposed criteria are spread throughout the standard. For example some of the criteria affect the definition of liability in paragraph 11 of the revised IAS 32. We believe that as a result the amendments as currently drafted will make the revised standard very difficult to apply, even and especially by entities that will not be affected by the proposed amendments.

The Basis for Conclusions argues that the existing requirements are affecting the relevance and understandability of the financial statements and that the proposed amendments will make financial statements more relevant and more comparable. We agree that, if the existing requirements are flawed and the proposals eliminate (or reduce) those flaws, the relevance and understandability—and quite possibly also the comparability—of the financial statements will be improved. However, this does not necessarily appear to be a case. For example, if two entities issue exactly the same type of capital instrument ('Class A shares') but one has also issued a second class of instrument that is more subordinated ('Class B shares'), one entity will classify the Class A shares as equity whilst the other will classify them as liabilities. We had always understood the 'comparability' notion to require like items to be treated alike, so we do not see how these proposed amendments enhance comparability.

Although we are not convinced these changes are needed, we wanted also to consider whether they do any harm. We have identified above some of the harm they could in theory do, but we wanted to understand whether the IASB had considered the harm they might do in practice. For example, although we recognise that the proposed rules are designed to address a very narrow issue, we are concerned that they could have wider unintended consequences that are difficult to foresee. We therefore wanted to be understand the extent to which the IASB had considered that possibility. Unfortunately, there seem to be no obvious signs in the Basis for Conclusions section that consideration has been given to the issue.

Question 2: Obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation—*The Exposure Draft proposes that an instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation should be classified as equity, provided that specified criteria are met (eg ordinary shares issued by a limited life entity). Do you agree that it is appropriate to classify as equity these types of instruments? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification for these types of instruments, why?*

Although we can see more clearly what the concern is in this case, most of the comments in our reply to question 1 apply equally to this question.

Question 3: Disclosures—*The Exposure Draft proposes disclosures about financial instruments puttable at fair value classified as equity, including the fair values of these instruments, and the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity.*

(a) Do you agree that it is appropriate to require additional information about financial instruments puttable at fair value classified as equity, including the fair values of these instruments? If so, do you agree that the fair value disclosures should be required at every reporting date? If not, why? What changes do you propose, and why?

(b) Do you agree that it is appropriate to require disclosure of information about the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity? If not, why? What changes do you propose, and why?

Alternative View paragraph AV3 argues that the disclosures referred to in (a) are inappropriate because—as they mirror disclosures required for financial liabilities but not, to date, for equity—the disclosure requirement reveals the Board's "implicit view that these instruments are, in fact, liabilities. Yet the *Framework* is clear that disclosure is not a substitute for recognition." We agree with this Alternative View.

We do not support the proposed changes. However, if the IASB nevertheless proceeds with the proposals and reclassifications of the kind referred to in (b) occur, we believe that the disclosures referred to in (b) should be provided.

Question 4: Effective date and transition—*The proposed changes would be required to be applied retrospectively, from a date to be determined by the Board after exposure (with one exception permitted relating to compound instruments). Earlier application would be encouraged. Are the transition provisions appropriate? If not, what do you propose, and why?*

As we have already made clear, we do not support the proposed changes. However, if the IASB nevertheless proceeds with them, we agree that they should be applied retrospectively.

We also believe that retrospective application will always be possible. Paragraph BC27 suggests that it may occasionally be necessary to apply the relief available in IAS 8 when it is impracticable to determine the original issue price of the affected instruments. However, if it is impracticable to determine the original issue price of an instrument, it will not be possible to show that the instrument has been issued at fair value so it will not be a 'financial instrument puttable at fair value'.