THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Technical Director—File Reference 1550-100
Financial Accounting Standards Board
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Dear Sir

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the Preliminary Views *Financial Instruments With Characteristics Of Equity***,** published in November 2007.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours faithfully

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 68/08

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Memorandum of comment submitted in May 2008 by The Institute of Chartered Accountants in England and Wales, in response to Financial Accounting Standards Board Preliminary Views *Financial Instruments With Characteristics Of Equity*, published in November 2007.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on Financial Accounting Standards Board Preliminary Views *Financial Instruments With Characteristics Of Equity***,** published in November 2007.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

BASIS FOR RESPONSE

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

5. We are commenting on the Preliminary Views because it is incorporated in a Discussion Paper published by the International Accounting Standards Board (IASB), to which we will also be responding. The Preliminary Views also has implications for the projects on the conceptual framework and on 'Reducing Complexity in Reporting Financial Instruments' being undertaken jointly with the IASB.

MAJOR POINTS

Welcome for the Preliminary Views

6. We welcome the FASB's contribution to the debate about how to distinguish equity and liabilities, given the problems of the current accounting models, particularly in US GAAP.

7. We set out in paragraphs 8 - 26 below our comments on some of the major issues addressed in the Preliminary Views. We then give our answers to the specific questions asked by the Board in relation to the three approaches, in each case followed by some more detailed comments. We emphasise that all these specific comments are subject to our overriding view that the Board should not develop its strategy as set out in the Preliminary Views, but should rather adopt International Accounting Standard (IAS) 32 *Financial Instruments: Presentation* as an interim measure, pending further

improvements to IAS 32 and the completion of the work being carried out with the IASB on the conceptual framework (see paragraphs 18 -19 below).

Scope of the proposal

8. The scope of the proposals in the Preliminary Views does not cover all debt and equity instruments, as it is confined to only those 'financial instruments with characteristics of equity'. The scope is also limited to present ownership. Consequently, these proposals are not a comprehensive examination of all the issues relevant to the debate on debt/equity and thus, were the proposals taken to a final standard, they would reduce but not eliminate the plethora of US literature in this area. Absent a comprehensive approach, questions will undoubtedly arise about overlaps and possible contradictions which will have the potential to lend themselves to structuring opportunities to achieve an accounting purpose.

9. An indication of the issues that arise in the absence of a comprehensive standard is demonstrated by the differing approaches taken in the Preliminary Views when considering the different models. For example, in the basic ownership model, paragraph 35 states that 'Instruments for which there are no existing measurement requirements should be measured using the existing framework'. However, when considering the ownership-settlement approach, the equivalent paragraph, A34, specifies (in subparagraphs a - e) the requirements that should be applied to instruments and components that have no other specific measurement requirements. Overall, this does not present a comprehensive consideration of the issues.

The definitions of equity and liability

10. As we point out in paragraph 23 below, a company's perspective on what is equity and what is a liability will differ depending on the nature of the business, to whom it is reporting and its specific financing structure. Many preparers and users may not be so concerned about exactly where the bright line division between equity and liabilities falls, as long as sufficient disclosure is given about each class of instruments. However, preparer (and possibly user) views might be very different if they were to consider the implications this has for measurement. This is particularly relevant in an international context in view of the IASB's proposals to simplify IAS 39 in the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (which has also been included in an Invitation to Comment from the FASB).

11. Under the existing conceptual frameworks of both the FASB and the IASB, equity is the residual amount. However, under the proposals in the Preliminary Views, liabilities would become the residual. By adopting this approach, the Preliminary Views purports to arrive at a definition of equity without defining a liability. We do not believe that the Board has laid sufficient groundwork for adopting the conceptual approach that equity can be defined, and liabilities left as the residual category. While this might ultimately be the approach to defining a liability adopted in the joint conceptual framework, it is contrary to existing US GAAP and IFRS, and we see it as premature to adopt it before the framework has been established.

12. Phase B of the joint conceptual framework project is reported as moving towards defining a liability as an economic obligation, and the FASB apparently intends to test the working definition to ensure that it will be

compatible with the proposals in the Preliminary Views. We are concerned at the implication that that the FASB has pre-empted the development of a definition of a liability under the joint project by requiring that it must be compatible with the Preliminary Views. We are also concerned that defining different elements as the residual under the two projects increases the risk that the two are not compatible. That is, certain instruments may meet the definition of liability under the conceptual framework but equity under the Preliminary Views, yet others may not meet the definition of equity under the Preliminary Views but also not meet the definition of liability or asset under the conceptual framework.

13. Moreover, we do not believe that a robust definition of equity can be achieved without a corresponding definition of a liability. The definition of a liability has important implications in other areas, such as revenue recognition, and needs to be contrasted with other concepts such as business risk.

14. We therefore believe that the Boards should focus on the whole of the conceptual framework, and as a matter of priority. A rigorous consideration of what constitutes equity and what constitutes a financial liability must be approached in the context of the conceptual issues that surround it. It would therefore have been helpful to:

- define the purpose and target user of the definition of equity;
- address the basic issues of reliability, relevance etc;
- explore a wider range of models;
- set the discussion of different definitions against the measurement and performance reporting implications of adopting each one.

15. In particular, we believe it is essential to understand that the importance of the distinction between equity and liabilities is principally because of the practical consequences of the resulting measurement differences. It is therefore insufficient to consider only the balance sheet, since determining equity determines what is a return of capital or a distribution that does not go through profit or loss versus what is reported through the income statement. It also determines what is interest and what should be treated as a dividend.

16. There are also legal considerations in many jurisdictions that impose an additional layer of complexity in distinguishing between debt and equity. For example, retained earnings comprise the profits that have not been distributed to owners, and capital maintenance rules in certain jurisdictions may impose restrictions on distribution. Such retained earnings therefore appear to have the characteristics of equity. In the absence of a robust underlying principle, it is not possible to satisfactorily resolve how this and similar issues should be dealt with. This emphasises the need for a comprehensive and principled consideration of the whole of the debt/equity concept.

17. Overall, we are not convinced that the Preliminary Views explores the issues in sufficient breadth or depth to underpin the Board’s tentative preference for the basic ownership approach.

A phased approach with an interim solution

18. We understand the Board's eagerness to press ahead with improvements in this area, given the existing problems of US GAAP. We suggest that a simple short-term solution would be to adopt International Accounting Standard (IAS) 32 *Financial Instruments: Presentation*. IAS 32 is operational in the majority of circumstances and delivers results that users find helpful; it has been successfully applied in the European Union for two years. We acknowledge that IAS 32 does have problem areas such as contingent settlement features, 'fixed-for-fixed', derivatives on equity, and indirect obligation/economic compulsion. However, these are peripheral to the experience of most companies and a body of consensus has built up as to how to deal with these issues in Europe and the rest of the world, outside the US. Moreover, IAS 32 is a comprehensive standard dealing with the classification and presentation of all debt and equity instruments, and therefore a viable replacement for all US debt/equity literature covering the same issues. A similar approach should also be taken to US literature on the recognition and measurement of financial instruments with a replacement by a single comprehensive standard. It cannot be that difficult. After all, the basis of IAS 39 *Financial Instruments: Recognition and Measurement* was originally assembled by distilling the existing US literature at that time into its essentials necessary to have a comprehensive recognition and measurement standard. We would oppose any strategy under which instruments covered by the US proposal would be carved out of IAS 32's scope.

19. With IAS 32 as a globally accepted base, the two Boards could then work jointly on an improvement project. Ultimately, the improved IAS 32 could be used as a basis on which to build in the light of the conceptual framework. Adopting IAS 32 as an interim solution for 2011 would have the additional advantage of quickly achieving convergence in this area, reducing the problems arising from the different definitions of equity and liabilities in US GAAP and IFRS.

An overview of the different approaches

20. Of the three approaches considered in the Preliminary Views, we believe that the basic ownership and the ownership-settlement approaches are most worthy of further investigation. The basic ownership interest has the benefit of simplicity, and the ownership-settlement approach is probably the closest to IAS 32. However, we would prefer to see the FASB adopt IAS 32 itself as a short-term measure (see paragraphs 18 -19 above). We can see very little merit in the reassessed expected outcomes (REO) approach (see paragraph 70 below).

21. Of the other approaches considered by the Board, we believe that the claims approach and the loss absorption approach are also worthy of further consideration. We note that the loss absorption approach has been recommended in the Proactive Accounting Activities in Europe (PAAinE) Discussion Paper *Distinguishing Between Assets and Liabilities*, published in January 2008. We suspect that it is somewhere between the basic ownership and ownership settlement approaches, and while we do not at this stage necessarily advocate adopting it, the Discussion Paper contains an analysis of the debt/equity concept that the Board could build on, and perhaps some of its thinking could usefully be imported.

Other issues

22. We do not at this stage believe it is productive to get drawn into a wider debate on the use of fair values, but we note that until there is a consensus on appropriate measurement bases for financial instruments, including how fair value movements are presented in performance statements, there will be widespread concern about increasing the number and types of instruments measured at fair value.

23. A company's perspective on what is equity and what is a liability will differ depending on the nature of the business, who it is reporting to and its specific financing structure. Likewise, a user's needs will differ and often conflict, depending in particular whether they are equity investors, debt investors or regulators. It is important to bear in mind in this context that, while it is desirable to avoid unnecessary complexity in the analysis so as to avoid burdening preparers and users, complex instruments necessarily involve complex accounting. We do not regard it as appropriate to reject accounting models purely on the grounds of complexity.

24. The implications of measuring equity and liabilities differently mean that the focal point of narrowing the definition of equity will be movements in the income statement for long-term funding instruments, particularly if these are reported at fair value. Ultimately, it may not be possible to draw a bright line between equity and liabilities, and this would point to a substance-based solution requiring consistent polices to be applied by individual entities, and adequate disclosure.

25. All this suggests that there may be alternative approaches that will suit the needs of preparers and users that are not at the moment under consideration. We understand why the Board might not want to consider such approaches as part of a short-term solution, but we have already suggested IAS 32 as appropriate in this regard. A long-term solution is necessarily some way off as it involves difficult issues and impacts so many areas of financial reporting. We are therefore disappointed that the Board has limited its detailed consideration at this early stage rather than fully exploring more radical solutions. These would include:

- the claims approach, in which there is no distinction between equity and liabilities;
- the loss absorption approach, as noted above;
- a 'mezzanine' approach involving three categories of instrument: equity, a middle category and liabilities. This would be convenient for showing instruments that have certain criteria that are indicative of equity categorisation, but are classed as liabilities because of other features;
- other bright-line approaches, but based on ‘look-and-feel’ characteristics: for example, an approach where basic ownership instruments and perpetual instruments with discretionary coupons are equity but all derivatives are liabilities.

We do not discount the difficulties in these approaches, but we believe that they should not be arbitrarily discarded.

Overall conclusions

26. Our major conclusions are as follows:

1. We would like to see the FASB adopt IAS 32 in the short term, while working in the longer term jointly with the IASB towards a principled standard consistent with the joint framework and taking account of measurement and reporting issues.

2. In developing the longer term solution, we would like the Boards to give detailed consideration to a wider range of solutions that do not take the current model(s) as their starting point.

3. Of the three approaches considered in the Preliminary Views, we agree that the basic ownership approach and the ownership settlement model should be further investigated.

QUESTIONS ON THE BASIC OWNERSHIP APPROACH

1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

27. We do not think it is appropriate to form a view on whether the basic ownership approach would improve financial reporting in the absence of agreed criteria for making the assessment. As noted above, the Preliminary Views does not address the fundamental issues attaching to the purpose of differentiating equity from liabilities. Overall, there is a need for a more holistic view of the implications of the approach, including measurement and reporting issues.

28. We agree that the principles underlying the approach are clear, but as noted above we cannot assess whether they are appropriate in the absence of a related consideration of the objectives of financial reporting and the conceptual framework. It seems to us that the Board has attempted to shortcut the debate by drawing a bright line at the most subordinated instrument. Indeed the line being drawn seems more consistent with reporting on a winding up basis than on a going concern basis.

29. We are also concerned at the arbitrary nature of the basic ownership model, which will be susceptible to manipulation. For example, a single $1 share could be designated as the most subordinate, leaving everything else as debt, a position that could be adjusted easily period to period by repurchasing that single share. However, we are conscious that this may well be a problem with other models, such as the loss absorption model.

30. The basic ownership approach certainly provides a simpler approach to classification, but this is likely to introduce much more complexity into measurement. Arguably, more disclosure may be needed for stewardship/accountability purposes, since the accounting will be divorced from legal requirements concerning capital maintenance in various jurisdictions. In any event, it is necessary to balance any purported reduction

in complexity against the need to provide useful information. We agree that structuring opportunities will probably be limited, given that an instrument would have to rank exactly the same as the most subordinated instrument issued by the entity to be classed as equity. However, this approach will result in far fewer equity instruments, and we question whether this is useful for users.

Minority interests

31. The basic ownership model is akin to the parent entity model for business combinations. As the joint project on business combinations is moving towards a single entity model, there is the potential for conflict. Minority interests under a consolidated parent company model would be less subordinated than the ownership interests in the parent.

Treasury shares

31. The paper needs to clarify the treatment of treasury shares under the basic ownership approach. (It may be that the intention is to treat them as under existing standards, in which case it is another example of the paper's non-comprehensive treatment of the issues.) Under the ownership-settlement approach, movements in instruments have to have the same sign as the basic ownership instrument to be included as equity. Would treasury shares in the basic ownership instruments be negative equity, with those held in other instruments (eg, if there are class B shares) being a negative against those instruments under liabilities, in the same way as own debt is currently deducted? If so, would this be true of all three approaches?

Share-based payment

32. Because share-based payments (SBPs) are concerned with future ownership, it appears that a narrow definition of equity concerned only with present ownership will exclude them from equity treatment. This would vary from the current accounting and so the effects on SBPs, such as their classification, how they will be measured and where remeasurements will be reported, need to be specifically dealt with. We consider an approach that simply scopes out SBPs from the eventual standard to be inappropriate.

Probability-weighted (expected) settlement date

33. The probability-weighted expected settlement date would be used when amortising interest-bearing instruments with an uncertain settlement date. We assume that demand deposits would fall within the fixed maturity and settlement amounts. It appears that probability-weighted expected settlement dates are not adjusted until proved wrong, although it is not clear how this relates to paragraph 39 of the Preliminary Views, which requires annual reassessment. Again, we feel that the needs of users have not been fully considered in developing the proposal to use probability-weighted expected settlement dates.

Perpetual Instruments

2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as

preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

Preferred shares

34. In an international context at least, preferred shares may or may not be perpetual. It would therefore be helpful if the Preliminary Views were more precise in its use of the terms. Basing the definition of equity solely on the subordination of the instrument rather than whether it will ever be repaid or otherwise contains an obligation to transfer economic benefits on a going concern basis leads to anomalies that need to be explored. We question whether a standard that results in many or most preferred shares and other classes of ordinary shares being treated as liabilities and measured at fair value is in tune with users' needs. As suggested in paragraph 25 above, it would be useful to consider extending the model so as to include perpetual instruments with the look and feel of equity either in equity or in a mezzanine category.

35. It seems anomalous that an ownership instrument that will definitely be redeemed should be treated as equity (if it has sufficient subordination and will be repaid at fair value) while a perpetual instrument would be classified as a liability (as there is no obligation to redeem or to pay a coupon). The Preliminary Views notes that the Board planned to include these perpetual instruments as equity under the basic ownership approach, but decided that, inter alia, it would be too difficult to operationalise economic compulsion. We think this should be looked at again in the context of experience with IAS 32.

36. We note that assets and liabilities with fixed maturity dates and settlement amounts that are fixed or that change only because of variable interest rates would remain at amortised cost. (The IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments* takes the same line.) This would result in a standard fixed term loan remaining at amortised cost, but we assume a preferred share is likely to be measured at fair value through income merely because it does not have a fixed term or because the entity has discretion over the coupon (which leads to variability). We question whether this provides relevant information, when it seems appropriate that both should be at amortised cost.

3. The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

37. It is disappointing that the Preliminary Views does not address the issue of how to measure perpetual instruments. This is yet another indication that the Preliminary Views is not a comprehensive articulation of debt and equity concepts. For example, there are continuing concerns about companies fair valuing their own debt and therefore picking up fair value movements in their own credit. (IAS 39 and IFRS 7 require fair valuing of the whole instrument, but with appropriate disclosure.)

38. A major concern would be to achieve consistency of measurement with other assets and liabilities. Since the only criterion to be classed as a liability is that

the instrument has less subordination than the most subordinated ordinary shares, the terms of coupon could be discretionary and thus similar to basic ownership instruments that are cumulative or based on a fixed or variable interest rate or a stepped rate, etc. This might mean that different measurement would be needed for different types of instrument in order to be consistent with similar non-perpetual instruments. There is also an issue about disclosure of perpetual instruments in tables of contractual maturity - that is, they do not have a maturity and are not expected to settle, absent any issuer call feature.

39. If ultimately the requirement is for perpetual instruments that are classified as liabilities to be measured at fair value, additional disclosure would be required in order for users to adjust fair value movements out of earnings. Users cannot see any sense in having fair value movements going through earnings for instruments that are never expected to settle.

Redeemable Basic Ownership Instruments

4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

40. In the case of a traded instrument, we assume that requiring redemption at market price would meet the criteria in 20a. However, we are not clear as to whether redeemable basic ownership instruments can normally be traded. In the absence of a market, we presume redemption would be at net asset value, but this needs to be clarified.

Separation

5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board‘s understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

41. We assume this scenario relates to a perpetual instrument with a right only to a fixed dividend and which ranks equally with ordinary shares in a liquidation. We agree that this is a compound instrument, but if it is perpetual then all the value is in the dividend. If the instrument is redeemable, it would require a complex analysis to separate an instrument that it is not useful to separate.

42. We do not agree that if the dividend right does not transfer with the stock after a specified ex-dividend date, then the transaction is not with a current owner. Merely because there is a gap between the dividend becoming due and being paid, during which the owner may have changed, does not make it a transaction with a non-owner and therefore separable. Payment of the dividend is settlement of an obligation due to a current owner at the time the instrument originates.

Substance

6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument‘s classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument‘s classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

43. We agree that there are no unstated factors that are likely to affect an instrument‘s classification under the basic ownership approach. But while determining the rankings in a liquidation will be relatively easy, we do not believe that the resulting classification will necessarily reflect the economic substance of instruments where subordination is only important in a liquidation rather than a going concern. For example, instruments may be designed to meet regulatory requirements as core equity, but they could be accounting liabilities in terms of their ranking in a liquidation, although their purpose and loss-absorbing capabilities may be similar to ordinary shares on a going concern basis. How important this is needs further consideration. Certainly there would need to be sufficient disclosure in order for users to make sensible adjustment. But we can also see that the stability and certainty of the proposed definition would also be helpful. In paragraph 63 below, we highlight some aspects of UK GAAP in relation to substance that might be helpful in further developing the model in this respect.

Linkage

7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

44. We are encouraged that the Preliminary Views addresses this issue, but believe it should have gone further with its analysis. Although the purpose of the linkage requirement is to eliminate the opportunity to choose between alternative accounting results by altering the structure of an arrangement, linkage is still likely to be fertile territory for structuring arrangements to achieve favourable reporting. The proposals do not in our view leave sufficient room for judgement and could lead to some transactions being linked even though they are not economically linked (see paragraphs 45 - 46 below). We note that that the IASC Framework on the Preparation and Presentation of Financial Statements addresses ‘substance over form’ and in this context IAS 39’s Implementation Guidance provides some criteria to apply for linkage. In particular, the criteria include a requirement for a substantive business purpose to justify why a transaction that would be expected to carried out in one step has been divided into one or more. If the only justification for such a split is to achieve an accounting treatment that would otherwise not be possible, the split has no substantive business

purpose and thus is disallowed. Such an approach can be summarised as 'when determining the substance of transactions, a group or series of transactions that achieve or is intended to achieve an overall commercial effect should be viewed as a whole.'

45. Under the Preliminary Views, separate transactions may occur for separate reasons (for example, by different parts of the entity) but end up linked because they are entered into at or near the same time. We suggest that requiring that the two transactions are entered into in contemplation of each other would be preferable to requiring them to be at or near the same time with the same or related counterparty. And why should the counterparty have to be the same or related?

46. It is not clear from the example whether any put options issued at any time would change the treatment of the related ordinary shares (ie, the wording of the example could imply that the ordinary shares have been outstanding for some time and it is the written put which changes the treatment). If the reporting entity has a 31 December year end, the example implies that the issue of the put options is an adjusting post balance sheet event for year end classification, including the effect on fair value of a transaction that has not yet occurred.

47. How would linkage apply to an instrument with its payment of coupon dependent on payment of coupon on another instrument (or that prevents payment of coupon on another instrument) but that otherwise ranks equally with ordinary shares? Presumably, unless the holders were willing to risk not getting a set amount returned on a winding up so that they rank the same as ordinary shares, the instrument would be a liability.

Measurement

8. Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

48. At present, some derivatives on own shares are treated as equity and some are derivatives depending on settlement, etc, and it is doubtful whether the result is meaningful to users. In our view, any attempt to distinguish some as equity, whether based on a fixed-for-fixed principle or a directionality/share settlement approach, is arbitrary, and open to structuring, particularly with settlement options, net share settlement, etc. The important thing is to ensure consistency of treatment of items with the same substance. However, this is not without some reservations, as is expressed in the following paragraph.

49. In the context of the model being proposed, which focuses on present ownership interest, we agree with the proposals to exclude derivatives on the entity's own shares, which are potential future interests, from equity. Accounting for all derivatives as derivatives, with disclosure when they relate to equity instruments, would be the most straightforward solution and the most understandable for users. Nevertheless, we are uncomfortable with putting fair value movements on derivatives on own shares through income.

However, where derivatives are written deliberately to generate gains or losses on own shares we would want the gains and losses to be recorded through income. Ultimately we believe this problem can only be resolved through improved performance reporting.

Presentation Issues

9. *Statement of financial position*. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity‘s potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

50. We agree with the separation of redeemable and perpetual basic ownership instruments. More generally, we believe that liquidity information about liabilities is better presented through disclosure and commentary rather than by complying with specific balance sheet disclosure requirements.

10. *Income statement*. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument‘s fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

51. We would be interested in the Board's own views on this issue. It seems to be part of the wider debate about whether interest should be based on fair value rather than being the contractual interest and whether users want fair value movements disaggregated or indeed want the fair value movements to go through the income statement at all. We believe that if an instrument is measured at fair value, a single number change should be shown through the performance statement - ie, there should be no disaggregation on the face of the financial statements. Note disclosure should be sufficient in this case.

52. Another element of a single number fair value movement would be the effect of the entity's own credit, and there does seem to be interest from regulators for this information. However, we question how reliable such a number could be. Narrative disclosure and sensitivity analysis might be more helpful.

53. An example of disaggregating interest from the unrealised gains and losses is the IAS 39.55 requirement for disaggregating interest on available for sale securities on the basis of effective interest rate.

Earnings per Share (EPS)

11. The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the

computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

54. We agree that the approach will have a significant impact on the computation of EPS, but we suggest that this issue is something best discussed with market participants in order to determine what would be the most meaningful information for the markets.

OTHER ISSUES ON THE BASIC OWNERSHIP APPROACH

Basic ownership instruments with redemption requirements

55. The example of separate display in equity on page 10 shows retained earnings after deduction (allocation) of the increase in fair value of redeemable basic ownership interest. The analysis of the various interests in equity is useful, but we do not think the example could arise in practice (ie, we find it difficult to envisage a case where two ownership instruments would rank at the same level as each other but below everything else on liquidation, but with one instrument being redeemable and the other not). If the basic ownership instruments are redeemable (as with some co-operatives), then fair value reporting of these would presumably be either a market value of the company (co-operatives or partnerships are unlikely to have a market value) or the net fair value of all assets and liabilities in the balance sheet, neither of which we would consider to be information that the financial statements should be prioritising.

Only basic ownership instruments classified as equity?

56. We agree that the basic ownership approach corresponds to the proprietary perspective if you assume only ordinary shareholders are owners (see paragraph 61 of the Preliminary Views). Possibly the claims approach would be more in accordance with the entity perspective as it would set out all providers of credit balances to the entity. However, assuming the same measurement (fair value) for all assets and claims, there would be a difference between assets and claims plus retained earnings requiring explanation. There is a potential problem with minority interests (see paragraph 31 above).

57. The definition of a liability in paragraph D11 does not seem to distinguish general business risks that have some probability of happening from actual liabilities. Does the claim have to arise from a contractual (constructive) obligation? We note that the current working definition of a liability under the joint conceptual project is 'a present economic burden for which the entity has a present obligation', where the answer to this question is clear. In the absence of the requirement for a past transaction or event under the basic ownership approach, it seems that the mere possibility or probability of being sued could be classed as a liability.

58. We question whether debt/equity distinctions can be argued in the absence of a capital maintenance concept. For example, paying dividends reduces assets but presumably would not be a claim if paid to basic ownership interests. Equity is not remeasured so net assets will be reduced by redemption at fair value (see paragraph D14).

59. Some entities might find liabilities classified as equity under the basic ownership approach, which if adopted in certain jurisdictions might lead to coupon being regarded as a dividend that can only be paid out of distributable profits. We suggest that any accounting standard based on this approach could usefully state that material legal issues should be disclosed (eg, that a coupon can only be paid out of distributable profits).

QUESTIONS ON THE OWNERSHIP-SETTLEMENT APPROACH

1. Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

60. We believe that the ownership-settlement approach would probably represent an improvement on US GAAP. However, its main attraction from our perspective is that it is the closest of the three alternatives to IAS 32; as set out above, we would advocate moving US GAAP into line with IAS 32 and can see little benefit for either constituency in adopting the ownership-settlement approach instead. Indeed, IAS 32 appears to have advantages in that, for example, it avoids the asymmetrical treatment between call options and written puts.

61. Conceptually, this approach seems to merely adorn the basic ownership approach with additional rules, and on that basis it is difficult to predict how it might work in practice. IAS 32, on the other hand, at least has a track record of implementation.

2. Are there ways to simplify the approach? Please explain.

62. IAS 32 is no simpler, but it would be easier to implement in practice than a completely fresh approach, because a body of knowledge has been built up on how to apply it.

Substance

3. Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?

63. While we support a substance over form approach, we do not believe it can be successfully implemented on the basis of rules. UK GAAP is based on FRS 5 *Reporting the substance of transactions*, under which, in determining the substance of a transaction, greater weight should be given to those aspects and implications more likely to have a commercial effect in practice. Prior to the adoption of IAS 32 and IAS 39, this was augmented by Urgent Issues Task Force Abstract 33 *Obligations in capital instruments*, which required, inter alia, that where there is compelling evidence that the substance of a transaction is of a liability being taken on, the instrument should be treated as a liability. This would depend on whether or not there was 'a genuine commercial possibility' that an option would or would not be exercised; and whether the number of equity shares that would need to be

issued to settle the obligation varied with changes in their fair value (so that the total fair value of the equity shares issued would always equal the amount of the obligation). We believe that there would be benefit in further investigating this approach in the context of applying the principle of substance.

Presentation Issues

4. *Statement of financial position*. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

64. We believe such information is better presented through disclosure of key terms of material instruments and commentary rather than by setting out specific display requirements.

Separation

5. Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?

65. We are sceptical about the concept of 'nascent equity', which seems to be accounting for things before they happen. Rather, we can accept a definition of liabilities which requires an outflow of resources, so that settlement in shares results in equity rather than liability treatment. The operation of separation would be complex, working through outcomes and alternative outcomes, etc, and we are not convinced that the result would be understandable or helpful to the user.

Earnings per Share

6. The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

66. Please see paragraph 54 above.

Settlement, Conversion, Expiration, or Modification

7. Are the requirements described in paragraphs A35–A38 operational? Do they provide meaningful results for users of financial statements?

67. A worked example would have been helpful in understanding how the requirements might work in practice. It would be helpful if the Board could clarify if or how the result would differ under IAS 32. This seems to be a

particular example of the Board putting forward specific requirements without indicating why it thinks they would lead to relevant and understandable information for users, given that the users would still need to look behind the numbers.

OTHER ISSUES ON THE OWNERSHIP-SETTLEMENT APPROACH

68. With regard to paragraph A31, it is hard to make an assessment of the implications without knowing the measurement model. It is not clear what happens if the fair value of basic instrument issued is different from the indirect ownership interest (ie, if the transfer does not clear the balance of an indirect interest that no longer exists). An example would be helpful.

69. We note that the language of paragraph A34 is different from that of paragraph 35. All the models should be comparable in scope and comprehensive in their consideration of the debt/equity split. However, paragraph 35 defaults back to current GAAP, whereas A34 goes wider. The discussion is not comprehensive. For example:

- What if the liability or asset is subject to prepayment (at option of holder or issuer) as well as cash flows varying only according to an interest rate index? (paragraph A34a)
- Is the implication of paragraph A34b that an instrument that has less subordination than a basic ownership interest would be carried at fair value through income and a normal debt security would not?

QUESTIONS ON THE REASSESSED EXPECTED OUTCOMES (REO) APPROACH

1. Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.

70. We had great difficulty understanding this model, and if this is the case for well-informed readers accustomed to dealing with these issues, we question how useful if would be for the average user. We do not believe that the REO approach would represent an improvement in financial reporting. It is complex and the result is far removed from what most users would generally regard as a sensible split. Amongst other things:

- it appears that debt components would be different from other debt;
- the double entries required are unclear and probably not understandable;
- it overstates the ability to determine probabilities and for the impact of probability to be understood.

Separation and Measurement

2. Do the separation and measurement requirements provide meaningful results for the users of financial statements?

71. No.

Earnings per Share

3. The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

72. Please see our answer in paragraph 54 above.

OTHER ISSUES ON THE REASSESSED EXPECTED OUTCOMES (REO) APPROACH

73. We have not addressed the reassessed expected outcomes approach in detail, but note the following issues:

B13 If the two components don't equal the issue price, is there an initial gain/loss?

B14 Why are fair value movements on equity components reported in income? If this is going to happen, why bother separating into components in the first place?

B19 There is no point in not reflecting the actual rate of the instrument itself (this is akin to the fair value interest problem - see paragraph 51 above).

OTHER ALTERNATIVES

1. Some other approaches the Board has considered but rejected are described in Appendix E. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?

74. See our comments in paragraph 25 above.

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