23 October 2006

Our Ref: ICAEW REP 60/06

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

Dear Sir

IAS 32 AND IAS 1 AMENDMENTS

I enclose the comments of the Institute of Chartered Accountants in England and Wales on the Exposure Draft of proposed amendments to IAS 32 and IAS 1.

I would be grateful for confirmation of receipt in due course.

Yours faithfully

Desmond Wright

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ICAEW representation

ICAEW REP 60/06

FINANCIAL INSTRUMENTS PUTTABLE AT FAIR VALUE

Memorandum of comment submitted in October 2006 by the Institute of Chartered Accountants in England and Wales in response to the Exposure Draft of Proposed 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, *published for comment by the International Accounting Standards Board on 22 June 2006.

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INVESTOR IN PEOPLE

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to comment on the Exposure Draft of Proposed 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*, published for comment by the International Accounting Standards Board on 22 June 2006. We have reviewed the Exposure Draft and set out below our response to its proposals.

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR ISSUES

Overall response

4. We do not support the proposed amendments.

5. We support the IASB's development of high quality, principle-based standards. However, we are unable to identify the principle underlying the proposed changes to IAS 32 that is consistent with classification of an instrument, or its components, by reference to the characteristics of the instrument. Instead, the amendments seek to classify an instrument by reference to the characteristics of the entity issuing the instrument. This will lead to different classifications of an identical instrument depending on whether or not the issuer has other equity instruments in issue.

6. Equally, we are concerned that because the classification is entity-specific it will mean that these instruments will flip between equity and liabilities depending upon the issuer's decision to issue and/or redeem more subordinated classes of instruments. This is inconsistent with the contention that these instruments are true equity.

7. It is evident from the strictures and disclosure requirements that the IASB does not really believe that the instruments concerned are equity and therefore the proposals amount to little more than a form of presentation for a liability within equity. This is inconsistent with the current Framework.

8. We are sympathetic to the idea that certain instruments are misclassified under IAS 32 as it stands. However, the proposals in the ED are too narrow in scope and rule-based

to offer an appropriate solution. Furthermore, we are not convinced that the misclassifications arising from the current standard are sufficient to result in misleading or inaccurate financial statements. Other affected entities have been able to adopt the presentational solutions offered in the Implementation Guidance to IAS 32 that are understood, if not well liked. We are not clear why this approach is not appropriate in the circumstances addressed in the ED.

9. Our reservations about the proposals in the ED should not be read to mean that we consider the present IAS 32 is perfect. It is far from that. It is in need of a full rethink in the light of difficulties, inconsistencies and perceived misclassifications that are emerging in practice. If the currently proposed amendments were implemented it would make the standard even more illogical in its classification requirements.

Limited scope

10. The changes proposed in the ED appear to apply only to instruments of a very limited set of entities, which we understand are, principally, agricultural co-operatives in New Zealand. Other entities, despite having legitimate arguments to suggest that their instruments are misclassified, will not generally meet the criteria, because

(a) the instruments are not returned at FV (as, for example, in the case of German partnerships and UK Limited Liability Partnerships); or

(b) there are other more subordinated instruments (for example, management shares in investment vehicles).

We see no conceptual difference between certain instruments of a number of European partnerships and co-operatives and the instruments brought within the scope of the ED. If the Board is to address this issue, it should seek to ensure that a more comprehensive solution is found.

11. We do not in principle support making changes to standards to correct a narrowly-focused problem affecting only a few entities. We question whether it is a good use of the Board's limited time and resources to address issues of very limited application, with no conceptual underpinning, and we suggest that it will encourage further special pleading.

Anomalies in reporting

12. We are concerned that the proposed amendments will lead to anomalies. The proposals are inconsistent with the present principles underlying IAS 32 that instruments, or components thereof, are classified by their characteristics and not by entity-specific factors. For example, two entities that have issued identical instruments could be required to classify them differently simply because one entity has issued subordinated instruments; this is an entity-specific factor.

13. Another feature of making the classification by reference to entity specific factors is the incongruous effect that this will have when an issuer legitimately restructures its capital and decides to issue and/or redeem more subordinated instruments. Flipping puttable instruments between equity and liabilities, and possibly back again, belies

any contention that these instruments are true equity and is not conducive to good financial reporting. Moreover, it is easy to imagine how these rules that are thought to be anti-abusive actually lend themselves to financial engineering.

14. Arbitrary differences in accounting treatment are not conducive to improved financial reporting.

Lack of underlying principle

15. We can discern no sound principle underlying the ED, which is essentially rule-based. Rule-based requirements are susceptible to financial engineering. We question the wisdom of creating exceptions to an exemption, noting that derivatives and minority interests would also be caught by the proposed amendments.

16. The lack of an underlying principle is emphasised by the fact that while instruments within the scope of the proposals are presented within equity for one narrow purpose, these instruments are nevertheless treated as liabilities in relation to, for example, the disclosures that will be required. If these instruments are indeed equity instruments, they should be treated consistently as equity instruments for all purposes. Given the strictures and disclosure requirements, we believe that IASB does not consider these instruments are true equity.

SPECIFIC QUESTIONS

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?

17. We agree that there are instruments puttable at fair value that are true equity and should be classed as equity. However, there are also instruments that are puttable but not at fair value that have equity characteristics yet have to be classified as debt under IAS 32 as it stands, and would still have to be so classified after the proposed amendment. We do not therefore agree that the criteria for equity classification set out in the ED are appropriate. In our view, the proposals in the ED merely achieve a form of presentation of a liability within equity. This is inconsistent with the Framework.

18. We do not believe that the ED adopts a principled approach to identifying the appropriate classification of puttable instruments. In essence, the problem of misclassification of puttable instruments under the present standard can only be corrected by a thorough reassessment of, and change to, the definitions of debt and equity. Furthermore, the approach in the ED is inconsistent with that in IAS 32. IAS 32 looks to the characteristics of the instrument, or its components, whereas the ED

looks to the characteristics of the entity. In the case of puttable instruments, there may be an acceptable solution based on the case of an instrument that can be put back without affecting the economic interests of the other shareholders. As set out in paragraph 10 above, we believe that the Board's examination of potentially misclassified instruments should have much wider scope.

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?

19. In general, our comments above are equally applicable in this case. We are not aware that there is a widespread problem in this regard.

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?

20. We consider that certain of the proposed disclosures reflect the IASB's true belief that these instruments are liabilities which can be specially presented within equity. This accords with what is said in the Alternative View. As stated in paragraph 16 above, we consider that if these instruments are indeed equity instruments they should be treated consistently as equity instruments.

21. If the IASB proceeds with the reclassification proposals, which we do not support, we have reservations about certain of the proposed disclosures. In our view, disclosure of the fair value of the instruments is onerous and has the potential to be commercially sensitive in unlisted entities. Consistent with a contention that these instruments are

true equity then we would only expect disclosures to cover the terms and conditions of these instruments, which differentiate them from other classes of equity instruments that the issuing entity may have.

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?

22. If the Board implements the proposals, we agree in principle with retrospective application. We note the exception relating to compound instruments, but in our view the rules on compound instruments will have limited effect in practice. If the Board implements the proposals, we agree in principle with retrospective application. We note the exception relating to compound instruments, but in our view the rules on compound instruments will have limited effect in practice because the proposals do not permit derivatives that will be settled by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments that are puttable at fair value to be classified as equity.

23. In light of recent IFRIC statements that reclassifications from equity to liabilities are initial recognition of new liabilities at fair value, we consider that the revised standard should address the accounting when instruments are flipped between equity and debt. It is important that the accounting is addressed comprehensively in a standard and that it should be clear on the accounting that applies when there are changes to the contractual terms of an instrument that alters the cash flows under the instrument, the accounting when the terms are modified but have no impact on the expected cash flows and the accounting when there is no change in the instrument's contractual terms and thus its cash flows. This will occur, for example, where the entity issues and/or redeems subordinate instruments that causes the puttable instrument to flip classification.

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