OICV-IOSCO

Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valore

November 21, 2006

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

RE: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation

Dear IASB Members:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for the opportunity to provide our comments regarding the Exposure Draft (ED) of Proposed Amendments to IAS 32 and IAS 1.

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

General Comments

In the ED, the International Accounting Standards Board (the Board) describes the proposed amendments to IAS 32 and IAS 1 as a short-term solution to certain concerns raised by constituents about the accounting and presentation of financial instruments puttable at fair value. Notwithstanding the Board's plans to participate with the Financial Accounting Standards Board (FASB) in a longer-term project on distinguishing liabilities from equity, the Board states that the lack of relevance and understandability of the information produced by the existing accounting guidance for these instruments justifies addressing the accounting for these instruments on an accelerated basis. We are not convinced that the case has been made in the ED for addressing a subset of issues on an accelerated basis that will be more comprehensively addressed by the longer-term project. We presume that as part of the due diligence that led to the issuance of this ED, the Board considered a number of factors, including the number of entities, breadth of industries, and the severity of the effects of the current lack of relevance and understandability in the financial statements of such entities in deciding to proceed with this project. The extent of the Board's due diligence in this regard is not entirely apparent in the ED. If the

Calle Oquendo 12
28006 Madrid
ESPAÑA
Tel.: (34.91) 417.55.49 • Fax: (34.91) 555.93.68
mail@oicv.iosco.org • www.iosco.org

Board proceeds to a final standard on these amendments, it should more fully explain the factors the Board considered in deciding to proceed with this project at the current time, rather than waiting to address the issue in the longer-term project on liabilities and equity.

We believe the Board should articulate in any amendment to IAS 32 a resulting *principle* for what should be classified in equity and should provide a substantive discussion of why this principle is supportable on a conceptual basis. In the ED, the Board does not discuss the conceptual basis for its conclusions that there are some circumstances in which the residual ownership characteristics of puttable equity instruments and the nature of the put feature are such as to offset the existence of the put feature, making classification of such instruments within shareholder's equity appropriate. Instead, the Board presents its conclusion to classify financial instruments puttable at fair value as equity as choosing the least offensive treatment among several short-term alternative solutions. We believe the conceptual case is yet to be made for classifying shares puttable at fair value in equity. Further, if the Board proceeds with the amendment, it should provide a resulting principle for distinguishing debt and equity that can be used to resolve subsequent classification issues.

We are concerned that the proposal in the ED will add to complexity in accounting. For example, it would be possible to structure a puttable share and a convertible bond such that each instrument would leave the holder in an economically similar position. However, under current IAS 32, a puttable share is classified as a liability and convertible debt is generally separated into its liability and equity components. Under the ED, certain puttable shares can be classified as equity. Thus, the IFRS guidance applicable to instruments that represent similar claims on a company's assets will have gone from two classification outcomes (liability or liability and equity) to three (liability, equity, or liability and equity). Having more rather than fewer accounting alternatives in similar situations results in accounting complexity and presents opportunities for accounting arbitrage. In this circumstance, it is unclear whether the costs of the added complexity will exceed the benefits given that the amendment is described as providing a short-term solution pending the outcome of the longer-term project on liabilities and equity.

These General Comments express reservations about the Board proceeding forward with this project. However, if the Board concludes that it is appropriate to issue a final standard, we have some comments on the specific questions posed in the ED. Those comments are presented below.

Question 1 – Financial instruments puttable at fair value
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?

Regarding the criteria for equity classification of financial instruments puttable at fair value, the Board provides no substantive discussion of the basis for requiring these specific criteria. Consequently, the Board appears to provide a detailed list of items that must be met to ensure that the affected instruments are equivalent to ordinary shares except for the put right. Some discussion of these as distinguishing characteristics of equity versus debt would be appropriate. This discussion might also address why instruments redeemable at amounts *other than* fair value should not be allowed to receive equity treatment as well, at least to the extent of the fair value of the instrument.

The ED introduces new criteria for determining whether an instrument is a liability or equity under which the ownership of a residual interest at the most subordinate level can offset the presence of a settlement provision, assuming the settlement provision is at fair value. While the ED limits the circumstances where the ownership relationship "counts," the introduction of new criteria to what is currently a settlement-based model raises the risk of confusion regarding which aspect of the model—settlement or ownership—should be applied to new instruments or new versions of existing instruments, if the answer is not clear.

We have the following observations regarding certain specific criteria or requirements for equity classification of financial instruments puttable at fair value:

a) In the amendment to IAS 32 (paragraph 16), all of the most subordinate class of equity must be puttable at fair value for the instruments to meet the criteria for equity treatment. While the rationale for this requirement to be classified as equity seems to be to ensure that any interest in the most residual class of equity has no priority in timing or amount over any other interest in that class and to reduce structuring opportunities, it is not clear that this requirement results in a meaningful distinction. The existence of one type of instrument (puttable) or several types (puttable and nonputtable) in the most subordinate class of equity does not change the economics related to puttable instruments. In both situations the puttable instruments require the use of company assets to settle the put rights prior to the liquidation of the company. Thus, this requirement is likely to result in economically similar situations being accounted for differently. Further, if one accepts the premise that instruments puttable at fair value should be eligible for equity treatment, the requirement that all of the equity at the most subordinate level be puttable for any to be classified as equity seems overly restrictive and may limit the number of companies that can take advantage of providing what the Board has argued is more relevant and understandable financial information.

b) The amendment of IAS 32 will treat the residual equity interests of subsidiaries that are puttable at the option of the holder or upon liquidation as a liability in consolidation (paragraph AG29A). This conclusion appears to be based on the fact that the subsidiary shareholders have a priority claim to a portion of the consolidated net assets and concerns regarding structuring opportunities. The Board should consider whether the significant purchase accounting issues that arise from liability treatment of redeemable or puttable minority interests, such as whether to apply step acquisition accounting when additional interests are acquired from the minority, would justify allowing the exception from liability treatment for such instruments to apply in the consolidated financial statements as well. Because of some similar concerns, the FASB deferred the application of Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, indefinitely for certain mandatorily redeemable minority interests.

c) The Board should consider providing for separate display requirements within the equity section for financial instruments puttable at fair value, if they are not the only class of equity. This situation could arise, for example, if a company that has perpetual preferred stock classified as equity also has its only class of common stock puttable at fair value.

d) Regarding the definition of "financial instrument puttable at fair value," one could read the amendment of the language in paragraph 11 of IAS 32 to only apply to instruments "puttable" at fair value and not to include those instruments that are mandatorily redeemable at fair value. This interpretation would appear to be incorrect because criterion (b) of the definition of "financial instrument puttable at fair value" indicates that the instrument "entitles the holder to require the entity to repurchase or redeem…" the instrument. As worded, the criterion does appear to encompass mandatorily redeemable instruments. However, the use of less confusing terminology than "puttable", e.g., "redeemable", would reduce the likelihood of misinterpretation.

Question 2 – Obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation
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?

Our observations (a)-(b) above regarding the specific criteria or requirements for equity classification of financial instruments puttable at fair value are also applicable to obligations to deliver a pro rata share of the net assets of an entity upon its liquidation.

Paragraph 25 of IAS 32 discusses the accounting for an instrument with a contingent settlement provision that is beyond the control of the issuer or the holder. If such an instrument could require settlement with cash or another financial asset only upon liquidation of the entity, it would not be classified as a financial liability. Given the criteria enunciated for equity treatment in this ED, it is not clear why this exception (in paragraph 25) from liability treatment should be continued without change. Specifically, it is not clear why an instrument with a contingent settlement provision as described should not be subjected to the same requirements as financial instruments puttable at fair value or other instruments due at liquidation of the entity, i.e., the settlement amount should be a pro rata share of net assets.

Question 3 – Disclosures
(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?

We agree with the requirement to disclose additional information about financial instruments puttable at fair value. The requirement to disclose the fair values of such instruments does not appear particularly onerous and is an important disclosure regarding the potential for future cash outflows from the entity.

(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?*

We agree that it is appropriate to require disclosure of information about the reclassification of financial instruments that are the subject of this ED. We believe that changes in terms or circumstances that cause reclassification of such instruments is information that users would find useful in evaluation of the financial position and expected future cash flows of the entity.

Question 4 – Effective date and transition
Are the transition provisions appropriate? If not, what do you propose, and why?

We agree with the decision to provide for retrospective treatment. This treatment seems particularly appropriate because of the Board's belief that the prior accounting lacked relevance and understandability.

Regarding the exception from retrospective treatment (paragraph 97A), it is unclear what types of instruments qualify for this exception. For example, would convertible debt qualify if the conversion is into an obligation for a pro rata share of the net assets of the entity upon its liquidation? Since the conversion feature in a compound instrument is nothing more than an embedded warrant, why should the conversion feature qualify for equity treatment, if a warrant on the same instrument would not qualify for equity treatment? To eliminate confusion, it would be helpful if the ED more fully explained the types of instruments that qualify for this exception and why.

Other

- Regarding paragraph AG14B in the application guidance for an instrument that is convertible into puttable shares, it does not appear that the fair value of the puttable shares will equal the fair value of the convertible instrument unless the conversion occurs at maturity. The convertible instrument includes both the time value of the conversion option and the intrinsic value of the underlying shares.

- The Board should consider incorporating the guidance in IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* into the amendments to IAS 32. This would reduce the number of sources of guidance that constituents would have to consult on accounting for puttable equity instruments.

* * * *

We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 202-551-5300.

Sincerely,

Scott A. Taub

Scott A. Taub
Chairman
IOSCO Standing Committee No. 1