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Organización Internacional de Comisiones de Valores
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September 5, 2008

Discussion Paper: Financial Instruments with Characteristics of Equity
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Discussion Paper: Financial Instruments with Characteristics of Equity: An Invitation to Comment

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 International Accounting Standards Board (IASB or the Board) Discussion Paper, *Financial Instruments with Characteristics of Equity* (the Discussion Paper or the Paper), which incorporates by reference the FASB Preliminary Views document (FASB PV or PV) of the same name.

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 (SC1) 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 SC1 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.

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General Observations

Conceptual Basis for Conclusions

SC1 members encourage the IASB and the FASB (the Boards) to provide in any future ED a more thorough discussion of the conceptual basis for the conclusions on the defining characteristics of an equity instrument than is provided in either the IASB Discussion Paper or the FASB Preliminary Views document. There are other characteristics of equity besides being the most residual interest, such as voting rights and current rights to share in returns, which are not addressed in the PV. The PV seems to imply that there is no economic concept that the definition of equity is trying to capture, however inexactly. That is, the PV seems to suggest that where the line is drawn between liabilities and equity is primarily a pragmatic decision, leading the FASB to choose the simplest solution. While avoiding accounting arbitrage and simplicity in application are welcome characteristics in an accounting standard, SC1 members believe that the Boards should not adopt an accounting standard that classifies instruments that most believe to be equity as liabilities or liabilities as equity, merely to achieve simplicity and avoid arbitrage. We believe that the Boards should adopt a distinction between equity and liabilities that is developed from a sound conceptual basis that is well articulated either in the standard itself or in the conceptual framework.

Conceptual Framework

SC1 members note the existence of the FASB/IASB joint project to update the Conceptual Framework. We believe that the Boards should adopt an approach that will be consistent with the conceptual view of what constitutes a liability and an equity instrument. In addition, merely defining a liability as the residual after any basic ownership instruments seems to diminish the conceptual notion of an obligation, which may form the fundamental basis for recognition in other accounting guidance. Specifically, there is concern that the definition of liability used here could be inconsistent with that used in other projects (revenue recognition or in the conceptual framework).

Presentation and Disclosure Issues

SC1 members believe that, regardless of the classification approach adopted, it is important to provide clear presentation on the income statement of amounts attributable to changes in the fair value of an entity's own equity-indexed instruments that are accounted for as a liabilities or assets. SC1 members also believe that if multiple classes of ownership interests meet the definition of equity, redeemable ownership instruments should be presented separately from nonredeemable instruments. Separate presentation provides important information for assessing liquidity and solvency. Furthermore, for a similar reason, we believe financial statement users would find it helpful to have a separate presentation, whether on the face of the balance sheet or in the footnotes, of instruments required (or allowed at the entity's option) to be settled with equity instruments and instruments classified as liabilities (if any) that have no settlement requirements.

Improvements in Accounting for Liabilities and Equity Contracts

SC1 members believe that the Basic Ownership (B-O) approach would result in substantial improvement to IAS 32 as it provides clear method for distinguishing financial instruments that are equity instruments versus liability instruments. While the guidance in IAS 32 is not as complex as the applicable U.S. GAAP accounting standards we believe that an accounting model that consistently treats all of an entity's equity-indexed indirect ownership instruments as liabilities or assets and that eliminates the requirement to separate convertible instruments would be an improvement over the IAS 32 model. We believe that while the Ownership Settlement (O-S) approach may result in an improvement to the complex U.S. GAAP guidance in this area, it is less clear that it would result in a significant improvement to IAS 32, as it leads to similar results to IAS 32 in most cases.

SC1 members generally believe that a model that treats similar items similarly represents an improvement in financial reporting. The current IAS 32 guidance allows some arbitrage among instruments, such as convertible debt and puttable common stock, with traditional convertible debt receiving a more favorable separation treatment and puttable common stock accounted for entirely as a liability (unless it meets particular criteria). Achieving this consistency may result in reporting more equity-indexed instruments at fair value through profit and loss. However, we believe that presentation formats can be developed in this project, or more generally in the financial statement presentation project, to address concerns that may arise as a result of reporting within profit or loss remeasurement adjustments attributable to changes in an entity's own stock price.

That said, SC1 members have some concerns about the application of the B-O model and the classification outcomes in certain cases. Those concerns are discussed below. Where it is not clear how the B-O model will be applied, we believe any future exposure draft should provide clearer guidance.

- *Multiclass and Noncorporate Structures*

The focus on the "lowest residual claim" in the definition of a B-O instrument appears too narrow. It appears primarily driven by a corporate model with one class of common stock. We do not understand why two classes of common interests could not both be equity, even if one has a preference in liquidation over the other, or why limited partnership interests should be treated as liabilities because they often have a priority in liquidation to a general partnership interest. Determining the priority in liquidation in limited partnerships and other noncorporate structures can be more difficult because the order of distribution is more likely to be affected by the cumulative amount of distributions to each class of ownership interests prior to liquidation. Furthermore, concluding that the lowest priority instrument is the only instrument that qualifies for equity treatment seems more inherently arbitrary in certain noncorporate structures because

differential payouts for interests that share in profits and losses of the entity is common.

- *Scope of the Project*

SC1 members believe that the scope is likely adequate to address most instruments that generally raise issues of classification as it covers all instruments that are basic ownership instruments, others that are legally ownership interests, and any that are settled in or indexed to a basic ownership instrument, even if not equity. However, it does appear somewhat circular to have a scope that is dependent on knowing what a basic ownership instrument is, when that instrument is one of the terms being defined in the document. More fundamentally, however, it is not clear why it is necessary to narrow the scope to the enumerated financial instruments or even to financial instruments generally. As the distinction between liabilities and equity classification is a fundamental distinction, it is not evident why the FASB Preliminary Views (FASB PV or PV) limits the scope to some financial instruments.

While the B-O model as written would result in most share-based payment awards being treated as liabilities, we are concerned that in the PV, the FASB indicates that it would have to consider at a future date whether the B-O model would apply to such awards. We believe that much of the simplicity of the model would be lost if exceptions were made allowing certain indirect ownership instruments to be classified as equity.

- *Noncontrolling Interests*

It is not clear whether the guidance on determining equity or liability classification at the subsidiary level (paragraph 29 of FASB PV), with retention of such classification at the consolidated level, is consistent with the principle that a basic ownership instrument have a claim to a share of the assets of the entity that has no priority over any other class of claims if the entity were to liquidate on the date of the classification decision. Since the noncontrolling holders of subsidiary shares do not directly own a residual interest in the parent, it is difficult to reconcile lack of a direct ownership interest with treating such noncontrolling interests as equity at the consolidated level. At the consolidated level, while noncontrolling interest holders may have a claim on a portion of the net assets of the parent, they have no claim to the consolidated assets of the parent. If the Boards believe noncontrolling interest holders' lack of rights to consolidated net assets can be reconciled to applying the B-O criteria at the consolidated level, then any future exposure draft should provide the rationale of this reconciliation.

- *Redeemable Basic Ownership Instruments*

It is not clear whether most of the instruments that would qualify for equity treatment under IFRIC No. 2, *Members' Shares in Co-Operative Entities And*

Similar Instruments (IFRIC 2) or the amendments to IAS 32 and IAS 1, *Puttable Financial Instruments And Obligations Arising On Liquidation*, would qualify for equity treatment under the B-O approach. SC1 members find it surprising that the IASB, which recently adopted amendments to IAS 32 and IAS 1 to remedy what the Board characterized as the “lack of relevance and understandability of the current accounting treatment” of the equity interests of many entities would consider an alternative approach that may negate such changes. Perhaps the B-O approach does not in fact disqualify as many co-operative entity instruments from equity treatment as one might think. However, because neither the FASB’s PV nor the IASB’s Discussion Paper directly address how the typical features of such entities’ shares would be treated under the B-O approach, it is difficult to determine what the effect will be. For example,

- It is not clear whether the guidance in the FASB PV document on shares puttable at a formula based on book value is intended to be similar to the guidance in IAS 32 amendment for puttable shares.
- IFRIC 2 indicates that an instrument is not redeemable if the entity management under law, regulation or corporate charter has an unconditional right to refuse redemption. This guidance has not been explicitly incorporated in the B-O approach.
- IFRIC 2 would allow an amount of paid-in-capital to remain classified as equity even if all equity instruments are redeemable, if a law, regulation, or the corporate charter unconditionally prohibits redemptions of equity below a specified level. This guidance may not be relevant under the B-O approach.

We suggest that at a minimum any exposure draft provide an in-depth discussion of the reconciliation of the Boards’ current views with respect to redeemable ownership instruments with IFRIC 2 and the recent amendments to IAS 32 for puttable shares. Alternatively, the Boards could adopt the guidance in IAS 32 with respect to puttable shares (and IFRIC 2 to the extent it can be reconciled to the B-O approach) rather than developing entirely new criteria as in the PV.

- *Disclosures to Enhance Comparisons Over Time*

The B-O approach requires that the classification of the financial instrument be re-assessed at each reporting date. If a new equity instrument were issued during the latest reporting period that has the characteristics of the most subordinate instrument, then the previous basic ownership instruments would be reclassified to liabilities. Thereafter, any distributions made on the reclassified instruments would be presented as interest expense rather than as dividends. SC1 members believe that the ability to compare financial statements over time is an important characteristic of financial statements and consequently recommend that in these circumstances appropriate disclosures be provided to highlight for users the changes in classification that have occurred.

In summary, while SC1 members generally believe that the B-O approach would be an improvement to existing IAS guidance, the members have reservations regarding the

application of the B-O criteria in certain cases and believe the Board should consider revisions that would broaden the definition of equity interests somewhat, while retaining the simplicity and consistency that arises from classification of all indirect ownership instruments as liabilities or assets and from the lack of separation of convertible instruments.

Responses to Questions and Specific Comments

Responses to the IASB Discussion Paper questions are provided below. SC1 members' views on many of the questions in the FASB PV document are addressed in a general manner either under General Observations above or in the responses below.

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

As discussed under General Observations - *Improvements in Accounting for Liabilities and Equity Contracts*, SC1 members believe that the B-O approach is a suitable starting place to improve IAS 32. It is less clear that the O-S approach would improve and simplify IAS 32. For example, for indirect ownership interests, it is not clear how the requirement that such an interest have "a basic ownership instrument as its predominant underlying" will work in practice. Thus, it is not obvious that this criterion is an improvement over the "fixed for fixed" criterion in IAS 32 or what types of embedded features or derivatives this "predominant underlying approach" could classify as equity. The O-S model also will likely involve significant judgments about substance, when to link instruments, what are separate outcomes, and generally when and what to separate under the model. Thus, though the O-S approach model would be acceptable, its application might be as complex or more so than the existing IAS 32 guidance with seemingly little change in classification outcomes, and therefore SC1 members do not believe that it provides a suitable starting point for a long-term improvement project of IAS 32.

The Reassessed Expected Outcomes (REO) approach does not appear to be a suitable starting place because the answers it provides are not intuitive, it does not seem consistent with the conceptual framework, and it has operationality issues due to the greater amount of separation required and the need to constantly update fair values based on expected outcomes.

B1 (a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

The B-O and O-S approaches appear feasible to implement. The B-O approach requires more instruments to be carried at fair value than existing IAS 32, but those instruments can generally be valued by existing option-pricing and other valuation models. The O-S approach is closest to existing IAS 32 and hence it is reasonable to expect it can be applied most readily. As discussed in response to question B(1), the Reassessed

Expected Outcomes approach is complex to apply because it requires bifurcation of most instruments and continual fair value remeasurement of certain instruments.

B1 (b) Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?

The FASB PV document mentions several alternative models including a claims approach, where there is no distinction drawn between liabilities and equity, a mezzanine equity approach, where certain instruments are classified in a section between liabilities and equity, and EFRAG's loss absorption approach, which classifies instruments as equity if the instrument's claim on net assets is reduced if the entity incurs a loss. While the PV rejects these approaches with limited discussion, SC1 members believe that a more in depth discussion of the advantages and disadvantages of such approaches would have allowed constituents to better evaluate the merits of the B-O approach by comparison with other approaches. If, as recommended above, the Boards prepare a more thorough analysis of the conceptual basis for the B-O approach, the Boards may find certain concepts from the other approaches useful in developing the conceptual basis for the distinction between liabilities and equity.

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

See the discussion above under General Observations – *Scope of Project*.

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

SC1 members believe that the principles of the B-O approach appear generally appropriate for common equity interests of corporations but less so for noncorporate entities, such as partnerships and trusts, for example. See further discussion above under General Observations - *Multiclass and Noncorporate Structures*.

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

See the discussion for Question B3 above.

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

Issues Raised in IASB Discussion Paper

While paragraphs 15-34 of the IASB Discussion Paper raise a number of issues that have arisen under IAS 32, the Paper itself does not necessarily explain how the B-O or other models will resolve these issues. For example, paragraphs 24-25 address a situation where redemption of an instrument is almost certain, but no contractual obligation exists. While this is an existing problem under IAS 32, it is not entirely clear from the discussion paper how the B-O approach addresses the issue of economic compulsion. A perpetual preferred stock with an increasing rate dividend would be required to be classified as a liability under the B-O approach because it is not a basic ownership instrument, i.e., it has a preference in liquidation, not because of economic compulsion. While the classification of preferred stock as a liability may address a significant subset of situations in which economic compulsion arises, there is no explicit discussion of how the issue of economic compulsion is generally addressed by the B-O model. It would be helpful in any future ED, if the Boards could explain how known problem areas in IAS 32 are being addressed by the proposed model.

Substance

Regarding the substance principle, (paragraph 44 of the FASB PV), SC1 members generally agree with the objectives of this principle, which are to reflect the economic substance of a transaction whether or not it is reflected in the stated terms of the instrument. However, SC1 believes that some clarifications could be made regarding how the criteria are to be applied.

- It is not clear in paragraph 44 what is meant for a term of the instrument to affect the outcome in “more than a minimal way” apart from assessing whether the likelihood of occurrence is remote. Based on the examples provided in paragraph 45 of the PV, it would seem that a term that only affects the outcome based on a remote event is not considered in determining the instrument’s classification under the substance principle. Thus, it is not clear why the phrase “in more than a minimal way” has been combined with the remoteness criterion (paragraph 44(a)). If the phrase is meant to exclude terms that would result in insignificant liability or equity components, i.e., that the instrument is in substance all debt or all equity, then it would be clearer for the definition to separate the remoteness and minimal effect criteria.
- How broadly must an entity search for “factors that have more than a remote chance of affecting the instruments outcome in more than a minimal way” as described in Paragraph 44(b) of the PV? Greater guidance in this respect would be helpful.
- The concept of substance appears relevant even under the B-O approach, because it seems that a “penny” warrant (see example on substance in the FASB PV) is considered a basic ownership instrument, not an indirect ownership instrument, after application of the substance concept. However, it is not entirely clear how the penny warrant falls within the principles used to articulate “substance” in the PV, because in this case a stated term or characteristic of the instrument (the optional exercise) is being ignored not because it has only a remote chance of affecting the instrument’s outcome in more than a minimal way; but because the optional exercise is a foregone conclusion. That is, one could argue that the

holder is economically compelled to exercise the instrument. The relationship of substance and economic compulsion should be clarified.

- Is the substance principle intended primarily to serve an anti-abuse function or is it intended to serve a broader role? Is the substance principle intended only to be invoked in a unidirectional manner, that is, can substance be evoked to classify an instrument as an asset or liability but not to classify an instrument as equity? Or, is it expected that many instruments with redemption features based on a remote occurrence will fall under the substance principle and consequently be classified as equity? In the latter situation, even if a redemption event is remote, the feature does seem to provide a protection that is not afforded to a normal equity holder.

Linkage

Regarding the linkage principle (paragraph 41 of the FASB PV), SC1 members agree with the objectives of this principle, which are to reflect the economic substance of a transaction, regardless of the number of contracts that may be issued to accomplish the transaction. However, SC1 believes that some clarifications could be made regarding how the criteria are to be applied. An instrument can be considered part of the same arrangement if it is determined that the same result could be achieved as simply or more simply with a single instrument. Is this “simplicity” analysis a key part of the evaluation? Or, is the point really that if a similar economic outcome can be achieved in a single instrument with different accounting, then the two instruments should be combined regardless of simplicity? In this regard, how is simplicity to be evaluated? Is there not a case to be made that one instrument is always simpler than two?

Other Observations on Redeemable Basic Ownership Instruments

In addition to our comments in *General Observations - Redeemable Basic Ownership Instruments*, we have the following more specific comments regarding how the criteria for such instruments are to be applied.

- If an instrument is not redeemable at fair value, per se, must it be redeemable based on “book value” as the language in paragraph 21 of the PV seems to imply to qualify for equity? We observe that a formula put based on a multiple of EBITDA or other cash flow measure is one of the more common put features for nonpublicly traded entity shares but that is not based on book value and hence seems likely not to meet the criteria for a redeemable basic ownership instrument.
- It seems unlikely that a fixed formula put, such as eight times EBITDA, could be designed to approximate fair value or net asset value at all times, as these rules of thumb change over time. It is not clear whether the test of “designed to approximate fair value of the instrument or the share of assets” need only be met at the classification date or whether it is expected to be true in perpetuity.
- As is acknowledged in paragraph 57 of the PV, it is not clear that the current fair value of a share equals the share of “net assets” the holder would be entitled to if it were to liquidate on the classification date. In applying the guidance related to “as-if liquidation”, what is the unit of

account? Is the model assuming that the individual assets and liabilities of the entity will be sold or that the entity as a whole will be sold? If it is assumed individual assets will be sold then any goodwill would be ignored in the liquidation value.

- The criterion in paragraph 20(b) of the PV may have to be added to equity instruments with redemption features because it does not seem likely that a common feature of most redeemable instruments is that they forbid their own redemption if it would impair the claims of a more senior interest. It is far more likely that instruments with senior claims forbid redemptions of less senior instruments than the reverse.

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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,



Julie A. Erhardt

Chair

IOSCO Standing Committee No. 1