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20 October 2006

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

Email: CommentLetters@iasb.org

Dear Sir David,

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

Deloitte Touche Tohmatsu is pleased 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* (referred to as 'the ED' or 'the proposed amendments'). Our responses to the questions raised in the ED are set out in the Appendix to this letter.

We agree that the Exposure Draft ("ED") meets the objective of a limited scope exception. However, we question the technical justification for this change and why this proposed amendment is warranted when it has limited application, adds further complexity to the definition of liability/equity in IAS 32 (which already forms part of a wider modified joint project with FASB) and there are plenty of other issues with IAS 32 which are subject to that wider IASB project, on which these amendments have an impact.

Our main concerns therefore, as explained in more detail in our responses to the questions posed by the ED, are as follows:

- The ED proposes fundamental changes to one of IAS 32's underlying principles. A principle within IAS 32 is that a financial instrument is equity if there is no obligation for the issuer to pay cash (with derivatives on own equity subject to a principle of an exchange of fixed

cash for fixed shares). When the current version of IAS 32 was issued in December 2003 the IASB recognised that many entities, such as investment funds, would have no equity because a holder of an interest can always request the issuer to reacquire their interest for cash. The IASB acknowledged this concern by offering preferential disclosure as illustrated in Example 7 of IAS 32. We support this disclosure, which is most relevant when the entity's assets are measured at fair value, as it recognises that the net assets are attributable to the unit holders, and that the entity cannot claim to have equity, since clearly in accordance with IAS 32 it does not.

- The amendment appears to introduce a new category of "quasi-equity". It applies to instruments puttable at fair value, which would be equity under the proposals, but does not apply to derivatives over those instruments (e.g. a written call at a fixed strike price) that would be classified as a liability, unlike other derivatives over equity instruments which specify an exchange of a fixed number of equity instruments for a fixed amount of cash.

- The amendment results in equity classification being subject to a string of exceptions. It also introduces practical difficulties as to how it is determined whether the amount payable equals the fair value of the net assets of the entity and introduces a new concept of "subordination". We believe these exceptions conflict with the IFRS Framework and result in inconsistencies with other parts of IAS 32

We are not sure that the IASB, excluding the two Board members that voted against the proposal, are entirely convinced by the technical merits of the ED. The fact that the ED requires disclosure of the fair value of these instruments, as if they were liabilities, even though they are equity, is evidence of this. We do not understand why, if an entity genuinely has equity under this proposal, it should be required to disclose its fair value. This is compounded by the fact that, under the proposals, derivatives over these instruments cannot be equity, but derivatives over other equity instruments can be. We discern from this that the Board does not consider these instruments to meet the definition of equity as described in the Framework, but instead some form of "quasi-equity".

The ED has successfully highlighted that, for certain instruments, IAS 32 does currently lead to some counter-intuitive treatments. We believe there are many more examples of these that this ED does not address. As is indicated in BC6 of IAS 32, there are instruments that have characteristics "similar" to ordinary shares in that the holder has a residual interest in the net assets of the entity, yet equity treatment does not apply. We acknowledge this issue and believe it has far wider implications than the specific type of instruments addressed by the scope of these proposed amendments.

Our preference is that, irrespective of whether this ED is approved or not, the IASB accelerates the modified joint liability/equity project with the FASB. We believe this

a better use of staff and Board resources as changes arising from this project would benefit the widest range of entities.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

Appendix A

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 classifications 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?

If an entity is required to repay an amount equal to the fair value of the net assets of the entity, the entity has an obligation irrespective of the amount that will be paid. IAS 32 as currently drafted is consistent with the Framework in this respect. By changing this principle, the proposed amendments introduce a conflict with the Framework. Although we understand the reasons why the IASB considered it necessary to put forward this proposal, we do not consider this amendment necessary nor do we consider an amendment that introduces a conflict with the Framework to be a sound improvement to financial reporting. As stated in the introduction to this letter, we support disclosure, such as in Example 7 in IAS 32 in the instance of instruments puttable at fair value, as opposed to rewriting the liability/equity distinction.

We consider that it is anomalous that a share that is puttable at the fair value of the net assets of the entity would be classified as equity under these proposals, whereas, if an issuer writes a put that allows the holder of that put to force the entity to buy its shares at future fair value, the entity would be required to recognise a gross liability for the amount it will be required to pay. In the former case, the holder cannot sell their share to another party other than the issuer, and therefore the amount at which the holder will put back their shares is equal to fair value. In the latter case, the holder can force the issuer to buy shares at fair value. Under the exposure draft's proposals, in the former case, the share would be classified as equity, in the latter, as a liability. We do not see any justification for this difference and therefore believe that the proposed amendment creates inconsistencies within IAS 32.

The Exposure Draft ("ED") appears to introduce a "quasi-equity" category of instrument. The proposals state that derivatives over instruments that are puttable at fair value are not subject to its requirements. The amendment therefore introduces one rule for instruments puttable at fair value, but does not extend this rule to derivatives over those instruments. We cannot see any justification for this. Where an entity writes a physically-settled call option at a fixed strike price over own equity this derivative would be classified as equity. However, a written call at a fixed strike price over an instrument puttable at fair value would not be classified as equity but as a liability.

This implies that the instruments within the scope of the ED are not really equity, but rather are "equity-like" as they appear not to be subject to the same guidance on derivatives on own equity. Carving up the liability category between derivatives and

non-derivative instruments in this way has no technical justification, creating an additional category which leads to confusion, as highlighted further below.

We recognise that this proposed amendment could offer equity classification to some entities that previously have presented liabilities. We know that this is the case in New Zealand, and that input from New Zealand's standard setter has proved useful in recognising this problematic area in the first place. However, we are concerned that this ED will have such limited application and that other genuine concerns regarding IAS 32 and far more common instances where entities currently have no equity, for example, partnerships, have been overlooked.

For example, many partnerships allow partners to buy their partnership interest at a discount to net asset value; on exit from the partnership the amount invested is returned. The partners' interests are the most subordinated class of instruments, dividends are discretionary, and if the partnership were to be liquidated, the partner would receive their proportionate share in the net assets of the business based on their number of shares held. The offer to a new partner to acquire a partnership interest at a discount to net asset value is economically a distribution from the other current partners. On exit from the partnership the partner forgives an interest in the net assets of the partnership (i.e. the amount that could be obtained at liquidation which under this ED could achieve equity treatment) in return for getting their initial investment back. In turn, this interest will be offered to the next new partner at a discount, and so on. Throughout the partner's life as a holder of a share in the net assets of the business, the partner is exposed to the underlying performance of the business as they hold the most subordinated interest in the entity. Although we recognise that IAS 32 would require the partnership interest to be classified as a liability because of the entity's obligation to return an amount of cash on exit of a partner from the partnership that is not equal to a share of the net asset value of the partnership, we consider that these arrangements have very similar characteristics as those within the scope of the ED, yet get the opposite treatment: liability classification rather than equity. Greater consideration of other arrangements, such as partnership interests that possess characteristics similar to equity, is essential before the definition of equity and liability is subject to change. This can only be achieved through the wider liability/equity project that IASB has on its agenda.

We also object to the new concept of "subordination" that the amendment introduces: for the instrument to be equity, it must be in the most subordinated class of instruments issued by the reporting entity (whether by the company, in its individual financial statements or in the case of the consolidated financial statements, the group). Subordination is not defined anywhere in IFRSs. We do not know how the concept fits with the IFRS Framework. We do know that it is a concept that is difficult to apply in practice. We do not know how it may be understood or applied in different legal jurisdictions.

Therefore, we do not believe that the introduction of subordination in determining classification, in this limited set of circumstances, improves financial reporting. If the IASB genuinely believes that the level of subordination is an important characteristic of equity then this should be considered as part of the wider liability/equity project.

Furthermore, whether an instrument is subordinate to other instruments issued by an entity or group is fundamentally a legal question which, in practice, will be difficult to evidence. In some jurisdictions, liquidation procedures are applied on an entity by entity basis. For example, there may not be compensation of intragroup transactions within entities of the same group even if all entities of the group were to liquidate. Therefore, determining which instruments issued by which entity, are more senior in a group may not be possible. Even if subordination can be determined in various legal jurisdictions, in practice, it may be the case that instruments that are puttable at fair value obtain equity treatment in the company-only financial statements, but then fail to obtain minority interest treatment in the consolidated financial statements simply because the subsidiary, let's say a fund, is part of a larger financial institution group. The introduction of subordination could have the knock-on effect that equity of a subsidiary, in the absence of any parental guarantees that would otherwise result in minority interest, is now a liability. We cannot see how this new concept of 'subordinated minority interest' being a liability is justified.

We have some specific drafting concerns. For example, we note that the ED assumes that, prior to classifying the instrument, the entity has net assets and not net liabilities. It would be helpful if the ED stated what the classification would be if the entity has net liabilities upon initial issue of the financial instrument. It is not clear to us whether the instrument would be classified as equity.

We note that the revised definition of a financial liability in (a) (ii) and (iii) refers specifically to the instrument being in the most subordinated class of instruments. When the definition of a *financial instrument puttable at fair value* is stated overleaf it makes no reference to subordination. However, the definition of a *pro rata share of the net assets of the entity* does. It would be clearer to refer to subordination in these two definitions and to remove it from the definition of a liability (please see our suggested wording in Appendix B).

Part (a) (i) of the financial liability definition should be amended from "… an obligation to deliver to *another entity*" to "… an obligation to deliver to *the holder of the instrument*" [emphasis added].

In July 2006 IFRIC proposed a rejection notice with wording that stated that a change in terms of a financial instrument which resulted in reclassification from equity to liability, should be reclassified at fair value. Paragraph AG14E states that if new more subordinated instruments are issued, previously classified equity instruments will need to be reclassified to liability. In the light of IFRIC's proposed rejection, it would be helpful for users if AG14E is expanded to state whether the recognition of that liability will be at fair value in accordance with IAS 39.43. We presume that it would be or otherwise there would be an immediate gain/loss in income on subsequent measurement to the puttable amount. We presume that the difference between the fair value of the liability and the initial amount recognised in equity when the instrument was issued would be recognised in equity. Clarification of this point would remove any ambiguity.

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 type of instruments, why?

We consider that there are more persuasive conceptual arguments in classifying as equity instruments those that are only payable on liquidation, compared with instruments that are puttable at fair value by any individual investor at any point. The conceptual argument is that at liquidation all instruments held by all holders, whether equity or liability for the issuer, will become payable and economically all are therefore exposed to differing degrees to the residual assets of the entity depending on their status on liquidation. This compares with an instrument puttable at fair value where an individual investor in effect liquidates their share of their interest in the entity prior to liquidation of the entity, and any payout to that investor is effectively borne by the other current investors. Ignoring payments due on liquidation in determining liability and equity classification is similar to the assessment of contingent settlement provisions in IAS 32.25 whereby contingencies that result in payment only on liquidation do not result in liability treatment. However, similar to our response to Question 1, we are not convinced that a limited amendment to IAS 32 in this respect is the right approach. Our preference is for a more fundamental rethink of what equity is as part of the wider liability/equity project.

Our comments regarding subordination in Question 1 apply equally to this question.

Question 3 – Disclosures

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

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

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

As discussed in our covering letter, we do not believe that it is necessary, if the proposals are adopted, for an entity to disclose the fair value of its equity instruments. This introduces a new disclosure requirement that does not apply to other equity instruments. We believe that introducing such a disclosure requirement gives the impression that instruments within the scope of the ED are not really equity but are only "equity-like" as evidenced by paragraph BC6. Also, we note that requiring disclosure of fair value is inconsistent with the measurement guidance in IAS 39.AG81 and the disclosure requirements in IFRS 7.29(b) that permit an entity not to determine fair value for equity instruments that do not have a quoted market price in an active market.

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?

We agree with the transition provisions.

Appendix B

Proposed revision to the definition of a financial liability:

A *financial liability* is any liability that meets either of the following conditions.

(a) It is a contractual obligation either

to deliver cash or another financial asset to another party or

to exchange financial assets of financial liabilities with another entity under conditions that are potentially unfavourable to the entity. For this purpose, a contractual obligation does not include:

(i) an obligation to deliver to another entity upon its liquidation a *pro rata share of the net assets of the entity*; or
(ii) an obligation to redeem or repurchase a *financial instrument puttable at fair value*.