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29 August 2008

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

Submitted via the "Open to Comment" page at [www.iasb.org](http://www.iasb.org).

Dear Sirs

**Discussion Paper: Financial Instruments with Characteristics of Equity**

I am writing on behalf of LIBA (the London Investment Banking Association) to comment on the IASB's 28 February Discussion Paper: *Financial Instruments with Characteristics of Equity* ("the DP"). LIBA is, as you know, the principal UK trade association for investment banks and securities houses; a list of our members is attached.

We should state at the outset that our members have considerable reservations over the approaches taken in the FASB Preliminary Views document circulated with the DP ("the FASB PVD"), particularly in relation to FASB's preliminary conclusion that the "basic ownership approach provides more decision-useful information to investors while significantly simplifying accounting requirements for issuers and their auditors". Although we did not comment as an association on the FASB PVD, we broadly support the views expressed in ISDA's 30 May comment letter to the FASB on the PVD ("the ISDA letter"): there is of course a significant degree of overlap between the membership of LIBA and that of ISDA. We also note that some LIBA members have supplied their own comments to the FASB.

Given the fundamental importance of defining equity and liabilities, and the possibility that the FASB may place a higher priority on the current project than the IASB, we believe it is essential that the two Boards make every effort to reach a joint position on these definitions, and that the workings of IAS 32 should be fully considered as a part of that debate.

In our view the "additional questions for respondents" set out in Appendix B to the DP also cover our key concerns over the over the FASB PVD, and our more detailed comments are therefore confined to our responses to those questions, which are set out 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?***

We do not believe that IAS 32 is so fundamentally flawed that the IASB should consider its replacement by a model based on the FASB PVD without significant debate and justification. Indeed, we are not convinced that the three approaches expressed in the PVD are the best starting point for an IASB project to improve and simplify IAS 32; we consider that a preferable approach would be to start with the existing standard and to review those areas where implementation issues have arisen in practice.

As noted above, we disagree with the FASB PVD's underlying approach to the definition of equity. Paragraph D9 of the PVD provides that "a basic ownership instrument clearly is a residual because it is the lowest priority claim and thus does not depend on the definition of a liability".

Our members consider that it is more appropriate to define equity as a residual interest in the assets of an entity after deducting all liabilities. That is, its definition should depend on the definition of a liability. This is in line with the current definition in paragraph 49(c) of the IASB Framework for the Preparation and Presentation of Financial Statements and more appropriately reflects the nature of a residual. Such an approach also ensures that no instrument could fall between stand-alone definitions of a liability or equity.

***(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?***

As already noted, we support the detailed analysis of the FASB PVD contained in the ISDA Letter, specifically:

- \* We do not support the Basic Ownership Approach since it lacks conceptual merit and results in disparity between the economics of an instrument and how it is reported in the financial statements.
- \* We broadly support the Ownership-Settlement Approach since it provides the most accurate reflection of the economic substance of a financial instrument.

The above being said, we also consider that adopting a new accounting model for equities/liabilities would be a fundamental change, and therefore a significant undertaking for preparers of financial statements to implement. Where there is obvious benefit to warrant such a change, the work involved in understanding and implementing the new model is justifiable in terms of providing more relevant information to management and users alike. However, in assessing whether any of the FASB approaches should replace the current model in IAS 32, we believe there are significant cost and feasibility issues.

In particular we consider that the IAS 32 model is preferable and conceptually superior to the Basic Ownership Approach (see the ISDA Letter for a discussion regarding the perceived inadequacies with the Basic Ownership model). As a result

we do not consider that it would be feasible or justifiable (in terms of costs and benefits) to replace the IAS 32 model with the Basic Ownership model.

Similarly we cannot see the justification for replacing the IAS 32 model with the Reassessed Expected Outcomes (“REO”) Approach. Consistent with the ISDA Letter, LIBA would not support the REO Approach since it “would introduce undue complexity in financial reporting outweighing any perceived benefits”. Not only would the REO approach be extremely onerous to implement and maintain, it is our view that it results in financial information that is considerably less meaningful than currently provided under IAS 32. As a result we do not consider that the REO approach would be feasible to implement.

Finally although we prefer the Basic-Ownership Settlement Approach in the context of the approaches set out in the FASB PVD only, we consider that an application of the Ownership-Settlement Approach does not result in financial information that is significantly different from the IAS 32 model. In comparing the Ownership-Settlement Approach to IAS 32, we consider that the IAS 32 model is grounded on clearer principles i.e. equity is a residual. Further the generally clearer definitions of equity and financial liabilities in IAS 32 combined with broad application in practice makes it substantially easier to understand, explain and apply than the Ownership-Settlement Approach. Given this outcome, we question the incremental benefit, and hence the feasibility, of implementing the Ownership Settlement Approach.

*(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?*

As already noted, LIBA does not consider that IAS 32 is so fundamentally broken that it requires full replacement by any of the models proposed in the FASB PVD. In particular, IAS 32 does not in many cases give results in financial reporting that is significantly different from those produced under the Owner-Settlement Approach. Therefore we consider that the IASB should first consider amending IAS 32 to address specific areas that have caused issues in application, in particular:

\* **Economic compulsion**

It has been concluded (see IFRIC discussion March 2006) that economic compulsion, by itself, would not result in an instrument being considered a liability under IAS 32. The role of substance is limited to considering the instrument’s contractual terms.

It is our view that all stated and implied terms of an instrument should be considered in determining whether an instrument is equity or a liability. In particular, the substance of an instrument’s terms should be considered both in the context of the instrument itself, as well as considering external factors and conditions (including economic compulsion). We concede that considering the substance of terms broadly will require judgment and hence make assessment more difficult for preparers: we also consider, however, that allowing such judgment will result in instruments being more appropriately

classified as either liabilities or equity. Disclosure could be used to describe relevant accounting policies and material impacts of substantive decisions, including descriptions of key terms.

Alternatively, the IASB could seek to incorporate language similar to the contingent settlement provisions in paragraph 25(b) of IAS 32: i.e. making an assessment as to whether the settlement obligation is “genuine”.

\* **Linkage**

We believe that tighter, more explicit linkage rules would assist in the substance of instruments/transactions being more accurately reflected under the IAS 32 model. Although we do not support the somewhat complex and confusing criteria in paragraph 41 of the FASB PVD, we do consider that the current linkage criteria in IAS 39 IG B.6 *Definition of a derivative: offsetting loans* and IG F.1.14 *Concurrent offsetting swaps and use of one as a hedging instrument* could be used to create explicit linkage criteria in the IAS 32 model. We consider that strengthening and making more explicit the linkage criteria in IAS 32 could be used to address other issues (see our comments below on the treatment of forward purchases and written puts).

\* **Indirect obligations**

We find the indirect obligations language in paragraph 20 of IAS 32 to be unclear but understand that these provisions apply to implicit contractual obligations created by the application of explicit contractual terms and should be differentiated from constructive obligations that are created by factors existing outside of the contract, such as economic compulsion. We consider the IASB should clarify the language in paragraph 20, or alternatively incorporate its provisions into any resulting guidance on economic compulsion and linkage (see comments above).

\* **“Fixed for fixed”**

Although we understand the principle underlying the requirements of paragraph 16(b)(ii) of IAS 32 (i.e. the “fixed for fixed” condition), we have seen that it has caused a significant number of issues in practice, some examples of which are set out below.

One area where this requirement causes an issue is where instruments with characteristics of equity include other risks such as foreign exchange: for example foreign currency convertible bonds issued either by a reporting entity or by a subsidiary with a functional currency that is different to that of its parent in whose shares the bond is settled. LIBA members do not believe that the existence of other risks such as foreign exchange should impact the determination of whether all or part of such an instrument should be classified as equity, and we therefore do not believe that the currency of denomination of a convertible bond should impact the classification of any part of the instrument.

The “fixed for fixed” condition also causes issues where the number of shares to be delivered varies so as to maintain the holder’s level of economic interest in the equity of the issuer when certain events occur, such as rights or bonus issues and changes of control over the issuer. Such instruments provide the holder with a direct economic interest in the equity of the issuer, the level of which is maintained in the event of certain corporate actions taking place through the variation in the number of shares to be delivered. We do not believe that such instruments should be precluded from being classified as equity by the issuer.

In addition, market demand has resulted in the creation of many instruments that provide investors with an economic interest in the equity of an issuer that is not fully proportionate to the payoff that an investor would receive from holding ordinary shares of the issuer. Current IAS 32 provides no latitude for such instruments to be classified as equity, even though the issuer has no obligation and the holder does have an interest in the residual assets of the issuer. Therefore, we believe that IAS 32 should be amended to allow equity classification for instruments that contain no obligation of the issuer and provide the holder with a payoff that is indexed to that of the ordinary shares of the issuer (this would include issued instruments such as purchased call options that are economically similar to purchased treasury shares).

We recommend the IASB should consider the issues raised above as part of its review of IAS 32, and/or as part of the conceptual framework project (equity definition, or as part of the determination of a reporting entity).

\* **Treatment of derivatives that meet the definition of equity**

Many LIBA members have had significant, and what some may consider “inequitable”, results when issuing physically settled written puts and forward purchase agreements on their own or their parent’s shares. The “contra” equity treatment of recording forward purchases and written puts on own shares seems inconsistent with other contracts that require physical settlement (i.e. forward sales, purchased puts). This inconsistency is even more apparent where an entity is still required to recognise a liability and reduction in equity where settlement options exist (see IAS 32 IE6).

We understand that the different treatment afforded to forward purchases/written puts was to ensure consistency with puttable and redeemable shares. However we consider that consistency between puttable/redeemable shares and forward purchase/written puts would be better addressed with stronger linkage criteria as stated above.

\* **Puttable Shares**

In our letter of 17 October 2006 commenting on the IASB’s June 2006 ED of Proposed Amendments to IAS 32 and IAS 1 we expressed considerable reservations over the ED proposal that financial instruments puttable at fair value should, provided that specified criteria are met, be classified as equity. Inter alia, we stated that: “We disagree with the equity classification of

financial instruments puttable at fair value in this circumstance. This position does not reflect a view on the underlying question of whether such instruments should be reported as equity or liabilities, but rather whether it is appropriate to amend the provision of IAS 32 for what we consider to be a fairly narrow and specific situation.” At the time, we felt it would have been preferable to deal with the results of the IAS 32 model using disclosures rather than amending the standard. Given the limited amendment made as a result of that ED, we remain firmly of the view that a preferable approach would have been to apply consistent principles with relevant disclosure.

\* **Settlement options**

Many LIBA members do not agree with the current guidance that requires derivatives with cash or net share settlement options to be classified as liabilities, even if it is the issuer that chooses whether or not to exercise the option. We believe that instruments that include a cash or net share settlement option which the issuer, at its sole discretion, can exercise should not be precluded from equity classification as is currently the case under IAS 32.

\* **Equity as a residual**

As stated above, we consider that IAS 32 is correct in defining equity as a residual. As a result, we believe that paragraph 16 which defines equity is contrary to that principle. Although we support the principles contained in paragraph 16, we consider it should be worded so as to further define the definition of a liability rather than limiting what can be considered 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?***

We agree that the scope of the FASB PVD should be limited to determining the classification of **issued financial instruments** only by the issuer – we agree that the document should not address the accounting by the holder of such an instrument. However the scope appears to be defined in terms of what the FASB PVD defines. We consider that the scope would more appropriately applied to all entities/business enterprises (as appropriately defined) that issue financial instruments.

***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?***

As per our comments above, LIBA does not support the Basic Ownership model and therefore do not consider it appropriate broadly. However, we do not have any jurisdiction-specific reasons that we consider make the model inappropriate.

***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?***

No comment

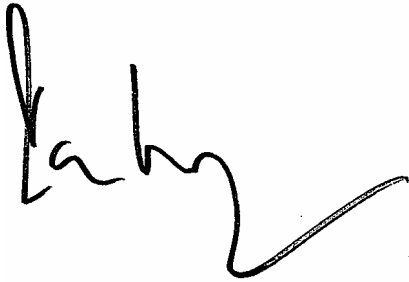
***B5 Please provide comments on any other matters raised by the discussion paper.***

We have no further comments.

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I hope these comments are helpful. We would of course be pleased to expand on any points which you may find unclear, or where you would like further details of our views.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian Harrison', with a long, sweeping flourish extending to the right.

**Ian Harrison**  
**Director**

# LONDON INVESTMENT BANKING ASSOCIATION

## LIST OF MEMBERS

ABN AMRO Bank	ING Bank NV London Branch
Altium Capital Limited	Instinet Europe Ltd
Ambrian Partners Limited	Investec plc
Arbuthnot Latham & Co., Limited	Jefferies International Limited
Arbuthnot Securities Limited	JP Morgan Cazenove Ltd
Arden Partners plc	JP Morgan Securities Ltd
Banc of America Securities Limited	KBC Peel Hunt Ltd
Barclays Capital	Kaupthing Singer & Friedlander
Bear, Stearns International Limited	Landsbanki Securities (UK) Limited
BlueOar Securites Plc	Lazard & Co., Limited
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