Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

23 September 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Discussion Paper on *Financial Instruments with Characteristics of Equity*

The Hong Kong Institute of CPAs is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Discussion Paper which is based on the FASB's Preliminary Views published in November 2007. Our letter includes comments only to the questions included in Appendix B of IASB's Discussion Paper.

We support the IASB's effort to improve the requirements in IAS 32 *Financial Instruments: Presentation*. We agree that the application of the principles and rules in IAS 32 sometimes results in an inappropriate distinction between equity instruments and non-equity instruments. The emphasis on the existence of a contractual obligation to deliver cash or other financial assets, while ignoring economic compulsion, sometimes lead to instruments with economic characteristics of liabilities being classified as equity. In addition, the principles and rules established regarding derivatives over own equity are difficult to apply, and frequently result in liability classification for instruments that have the economic characteristics of equity.

While we acknowledge these shortcomings in the current standard, we do not believe that this warrants the development of a substantially new conceptual approach to equity and liabilities at this stage. As further explained in the Appendix, we therefore do not view the approaches set out in the FASB Preliminary Views document as a suitable starting point for this project. In our opinion, IAS 32 is operating appropriately in the majority of circumstances and it is a comprehensive standard dealing with the classification and presentation of financial instruments. A measurement model for financial instruments not classified as equity already exists in IAS 39 *Financial Instruments: Measurement.* We have, however, included in our response to question B1(b) the most significant problems with applying IAS 32 that we believe need to be addressed, as they result in classification that appears to be inconsistent with the economic characteristics of the instruments concerned.

Our suggested approach will allow US GAAP to 'catch up' with where IFRS is currently in this area, and will result in a similar classification of most instruments (to the extent that the FASB chooses to either adopt the Ownership-Settlement approach, or to simply adopt a revised IAS 32).

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While we wish to retain the underlying principle in IAS 32 of defining a financial liability in the first instance with equity as the residual, on the grounds that this is a model that is well-understood by users and preparers, we recognise that any line drawn between liabilities and equity is to some degree arbitrary; both categories of instrument provide finance to the entity. One solution, therefore, could be a 'claims approach', where no line is drawn between all of the claims on the entity. However, we do not support this in the medium term, at least until presentation has developed sufficiently to separate financing activities from operating activities, assets and liabilities in the primary statements.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

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Deputy Director, Standard Setting Department

SO/WC/ac

Hong Kong Institute of CPAs

Comments on the IASB Discussion Paper on *Financial Instruments with Characteristics of Equity*

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?

(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?

(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?

(a) We do not believe that the three approaches set out in the FASB's Preliminary Views document are a suitable starting point for a project to improve and simplify IAS 32. Preparers, users and auditors are already familiar with the requirements of IAS 32. Each of the proposed models introduces new complexity, either in classification or measurement, with little apparent benefit. We believe that a greater benefit would be obtained through modifications to IAS 32 that eliminate certain incongruity of classifications requirement by the current standard (see our response to B1(b)).

Basic Ownership Approach

The Basic Ownership Approach defines equity very narrowly in an effort to reduce complexity in classification (at the expense of measurement complexity, based on the existing requirements of IAS 39). This reduction in complexity results in the classification as liabilities of many instruments with the fundamental characteristics of equity.

We believe that any conceptual definition should be based on the terms of an instrument, so that instruments with similar economic characteristics and risks should be classified the same way regardless of the capital structure of the issuer. The proposed definition of a Basic Ownership Instrument focuses on the existence, or otherwise, of claims with a lower priority were the entity to be liquidated at the reporting date. Classification of identical instruments therefore would differ between entities depending on their capital structure. Indeed, classification could change over time when an entity either issues or redeems other instruments that are more subordinated.

In addition, we consider the proposals of focusing solely on reporting the most residual claims as equity seems to be a proprietary perspective-based approach, which is apparently inconsistent with the entity approach adopted in the conceptual framework project. We recommend that the IASB should consider the underlying definition of Liabilities/Equity within the Conceptual Framework project.

As noted above, we are concerned that while the Basic Ownership approach will simplify the classification of instruments, this is likely to introduce much more complexity into subsequent measurement and valuation as more financial instruments would be required to be remeasured at fair value. Therefore, we do not believe that the Basic Ownership approach would represent an improvement and simplification of IAS 32.

Ownership-Settlement Approach

The Ownership-Settlement approach would give similar results to that in the current models under IAS 32 and would, in some areas, be an improvement to IAS 32. We agree that introducing the concept of indirect ownership interests would be an improvement to the "fixed for fixed" principle as it permits equity classification for most equity derivatives that have rights and economic characteristics that are consistent with the ownership of an entity's residual interests. Under current IAS 32, if a convertible bond is issued in a currency that is not the functional currency of the issuer, the whole of the convertible bond is classified as a financial liability as it violates the "fixed for fixed" requirement. Under the Ownership-Settlement approach, the conversion option would be classified as equity as its value is linked to the price of its underlying Basic Ownership instruments. We therefore believe that the Ownership-Settlement approach will better reflect the economics of equity-linked instruments in the financial statements. However, we are concerned that there may be circumstances where the fair value change of an equity instrument may not be in the same direction as the fair value of that Basic Ownership instrument (such as a purchased put acquired by the entity).

The FASB's Preliminary Views document could be interpreted as requiring that all perpetual instruments in the legal form of ownership instruments would be classified as equity. We believe that the IASB should clarify whether perpetual instruments, such as non-redeemable preference shares with a fixed dividend requirement, should be separated so as to recognise a liability in respect of the fixed dividend.

Reassessed Expected Outcomes Approach

We do not support the Reassessed Expected Outcomes (REO) approach as we are not convinced that linkage of returns on an instrument to an entity's equity share price is an appropriate conceptual definition of equity. In addition, we believe that this approach adds excessive complexity and would be extremely difficult for users of financial statement to understand, or preparers to apply. It requires a greater use of valuation expertise, such as the use of option-pricing models to separate and value instruments and a greater reliance on probabilities on an ongoing basis.

In the light of the above, we do not believe that the REO approach would represent an improvement in financial reporting.

(b) We would prefer the IASB to work on improving the existing standard rather than considering a fundamentally new approach to the classification of financial liabilities and equity instruments. We believe that such a limited scope project should amend the current 'fixed-for-fixed' requirements in IAS 32.16(b)(ii). The

principles set out in A4-A9 of the Preliminary Views document might be a starting point for such an improvement, although we note that further consideration needs to be given to whether this gives an appropriate classification for purchased put options over own equity.

We also believe that the issue of economic compulsion should be built in to any revised standard.

As noted in our covering letter, the evolution of IAS 32 should consider other approaches in the longer term. However, such approaches will require substantial developments in the presentation of financial statements.

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 believe that the scope of the project is too narrowly focused. The FASB Preliminary Views document only covers the classification of Basic Ownership instruments (and contracts settled in, or whose fair value is determined by prices of, such instruments) and other instruments that are ownership instruments in legal form. The present 'suite' of financial instrument standards in IFRS (IAS 32, IAS 39 and IFRS 7) does not focus on legal form of instruments within their scope, and we believe that any revised equity and liabilities standard should contain a similar scope.

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 stated in our cover letter, we do not believe that a fundamental change to the approach taken by IAS 32 in classification of equity and liabilities is required. Since IAS 32 first defines a financial liability, with equity as the residual, there seems to be no need to define a Basic Ownership Instrument under our preferred approach. Nevertheless, under the Basic Ownership approach, one of the criteria for defining a Basic Ownership instruments is that the most subordinated claim in the event of a liquidation (paragraph 18a of the FASB Preliminary Views document). We consider under the following situation the principles in the Basic Ownership approach may not provide a faithful representation of capital:

- Limited partnership: Many partnership agreements contain complex income sharing and distribution provisions. It is a common situation that the rights of a limited partner to the net assets of the partnership in liquidation are senior to a general partner and accordingly, result in the limited partnership interest being classified as a liability. However, the general partner does not represent the in-substance residual share in the business. It is unclear as to how these partnership interests would be classified.

- Participating perpetual instruments: We believe that instruments that are perpetual and on which the entity has discretion not to pay dividend should be classified as equity. Although a perpetual instrument with discretionary coupons may not be the most subordinated instrument issue, the holder is exposed to risk of non-payment of dividends if insufficient profits are available.

- Consolidated financial statements: Paragraph 29 of the FASB Preliminary Views document states that "instruments would retain their Basic Ownership nature in the consolidated financial statements unless their characteristics are different in the context of the consolidated financial statements". This raises a conceptual concern that equity represents the most subordinated class of interest that is neither limited nor guaranteed. The non-controlling interest included in equity in the consolidated financial statements represents interests that are limited only to the residual assets of the specific subsidiaries to which they relate. According to FASB Preliminary Views document, "subordination" is to be determined legally. We are concerned in many jurisdictions, liquidation only occurs at the level of a single entity. It is unclear how this requirement would be applied at the level of the group.

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?

We support both the inclusion of a linkage principle and the criteria governing its application; this principle may have wider applicability throughout IFRS.

We also support the inclusion of a substance principle, and the guidance provided for its application.