The Corporate Reporting Users' Forum

Liz Figgie
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

17 September 2008

Dear Liz,

Financial Instruments with Characteristics of Equity

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to comment on the Discussion Paper, *Financial Instruments with Characteristics of Equity,* which expanded on the FASB Preliminary Views report on the same topic, issued in November 2007. We would also like to thank you for taking the time to present the issues to us at one of our recent meetings.

Whilst we agree that this is an important area for debate, we believe that any change, prior to completing the Conceptual Framework project, should only be carried out where there is clear evidence that something is broken with current accounting. Whilst we accept that US GAAP is not working well, we are less convinced that IAS 32 is creating fundamental distortions, although we accept that it is not perfect. We find disclosure is currently adequate in allowing us to disaggregate components of equity which we believe have debt like characteristics, such as perpetual fixed coupon preference shares. We would therefore be inclined to defer this project until such time as the Conceptual Framework is finalised and then ensure that GAAP in this area, along with many others, is realigned to it.

Notwithstanding the above concerns about the need for the project at this time, we would like to make a number of observations about the proposals:

Principles Based Standards
We support principles based standards to ensure that economic substance always over-rides legal form and accounting rules. We believe that the definition of a Basic Ownership Instrument creates a "bright line" rule which will allow structuring and not ensure that instruments with similar economic characteristics are treated in similar ways. This will reduce comparability. In particular we believe that many unlisted companies and partnerships have instruments, which share in the gains and losses of the enterprise without limit, but will count as financial liabilities using this rule.

We do see merit in the "Loss Absorption Model" that was proposed in the EFRAG discussion paper, Distinguishing between Liabilities and Equity, issued on behalf of PAAinE. We believe, however, that there is a conceptual problem with the model as debt will, at some stage, start to absorb losses of the enterprise if there is distress. Structuring will also be easier as *de minimis* contractual loss absorption might allow an instrument to be treated as equity when it is economically debt.

Implications
We are particularly concerned that if instruments, that have no contractual obligation for repayment and share in the "marginal" gains and losses of an enterprise, are treated as financial instruments, they will eventually need to be carried at "fair value" as other IASB papers suggest. This outcome would require a valuation of the company be performed at each period end. We do not believe that financial statements are the correct place to show a valuation of the net present value of all operational flows into perpetuity. The ultimate outcome of this might be for shareholders' funds to equal the market capitalisation of the company at the period end. The main reason for our objection is that we do not believe that it is possible to generate estimates that are sufficiently reliable to be represented in the accounts of a company. We believe users are more interested in operational flows in the financial year.

We also would consider the fair value movements in these instruments from one year to the next less useful for listed companies than just observing the share price movements from one day to the next where the market votes on the prospects for the company in real time.

Suggestions
We recognise that it is easy to criticise proposals without providing an alternative and thus we would like to make some suggestions for improvements. As owners of businesses, equity providers share in the marginal returns of the enterprise as they are generally the most subordinate class of stakeholder. We therefore do find some attractions in the basic ownership instrument rule and believe that it will provide a sensible and materially correct outcome for most large listed companies. However, as outlined above, the truth is more complex. To illustrate how we would "draw the line" it is perhaps best to explain how we, as users, perform valuations. What we attempt to do, in many cases, is to assess the value of the operating entity, deduct the fair value of other financial stakeholders (debt, pension deficit etc.) and allocate the residual to equity and then compare this to the listed equity value. Where a component of "other financial stakeholders" share proportionately in the incremental cash flows of the business, there will be circularity in this analysis and therefore such instruments should also be included within Equity. We would therefore prefer to have a principle based on "Equity Participation" which we would state as follows:

Definition
Equity participations are those financial instruments issued by the entity which participate without upward limit in the proceeds of a disposal of the reporting entity or a business within the entity.

All other financial instruments shall be within the scope of IAS 39.

Recognition
Equity participations shall be recognised when issued.

Where a financial instrument or other contract contains an equity participation component, that component shall be separated at inception.

Initial and subsequent measurement
Equity participations shall be carried at the fair value of the instrument on issue and shall not be re-measured.

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Derecognition
Equity participations shall be derecognised when they are extinguished or they expire.

Income and equity
Any difference between the fair value of the equity participation on issue and the fair value of cash, other assets or goods, services or intangibles received [or paid] shall be charged [or credited] to income.

The cost [or benefit] of extinguishing equity participations shall be recorded in equity.

Presentation
The balance sheet shall contain a total of all equity participations including any undistributed reserves.

Disclosure in the notes should be in tabular form and be adequate to distinguish material variations in rights and returns of all equity participations including but not limited to: votes, liquidation preference, dividends, optional and mandatory cash flow commitments, proportionate share in gains and losses, and any other terms of derivative instruments.

The notes shall also contain an analysis of equity participations issued and redeemed during the year.

The disclosure regarding mandatory cash flow commitments, where an equity participation is payable at a date that is not wholly within the discretion of the board to defer until liquidation of the entity, must include the current fair value and expected payment date of each class of instrument. Fund raising plans should be explained if settlement is expected to require the entity to arrange additional sources of finance.

Additional disclosure for quoted companies should include the fair value of each derivative either directly or derived from quoted market prices, with a sensitivity analysis indicating how the fair value will move with price changes in the underlying equity instrument. Quoted companies should also disclose EPS where the number of shares in issue is a derived "common stock equivalent" total reflecting the average fair values of all equity instruments during the period.

It follows logically that cash settled options would qualify as equity but perpetual fixed coupon preference shares would not. This treatment of the cash settled options, whilst a cash obligation, is consistent with the way that most equity analysts would look at these instruments as we believe that the method of settlement does not impact the value of other equity which we are attempting to calculate. We would find the disclosure accompanying the equity notes very helpful as it would become very much easier to allocate our calculated equity values to the correct instruments.

We believe that debt instruments at issuance are always issued without a presumption that the entire business has to be valued unless the equity participation can be disaggregated as a derivative on another equity participating instrument.

We believe that our proposal will result in a similar outcome to the EFRAG discussion paper, in most cases, but avoids the conceptual difficulties that we highlighted.

Please feel free to contact us, initially through Jed Wrigley, if you would like to seek clarification of any points.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was formed in 2005 as a discussion forum with the aim of helping its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of the International Accounting Standards Board.

The CRUF is a discussion forum. It does not seek to achieve consensus views, though at times its participants will agree to make joint representations to standard setters or to the media. The chairmanship of the CRUF rotates at each meeting and different individuals take leadership in discussions on different topics and in the initial drafting of representations.

CRUF participants include individuals from both buy and sell-side institutions, and from both equity and fixed income markets. The forum includes individuals with global or regional responsibilities and from around the world. The CRUF meets on a regular basis in London, Frankfurt and Sydney.

Its participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Notwithstanding this, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. The members of the Forum that have specifically endorsed this response are listed below.

Yours sincerely,

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