

May 22, 2008

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

Dear Sir/Madam,

Discussion Paper: Financial Instruments with Characteristics of Equity

The Israel Accounting Standards Board is pleased to have this opportunity to comment on the IASB's Discussion Paper on Financial Instruments with Characteristics of Equity published on February 2008 which is based on the FASB's Preliminary Views published on November 2007. Our letter includes comments only to the questions included in Appendix B of IASB's Discussion Paper.

Question 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 support the IASB's effort to improve and simplify IAS 32. Yet, in our opinion the three approaches expressed in the FASB Preliminary Views document include some inherent disadvantages.

The basic ownership approach may be simple, but it narrows significantly the instruments that will be classified as equity. We believe that such a reduction in equity is unjustified. For example, if the entity issued two classes of ordinary shares that are not equal in priority only the class with the lowest priority would be a basic ownership instrument, although both instruments are shares that the entity has no obligation to redeem or to pay their owners any dividends. If this approach will be adopted, entities will have difficulties in meeting their financial covenants.

The REO approach is complicated since it requires extensive calculation each period of the probability-weighted outcomes of all financial instruments in order to separate and classify the instruments.

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

We support an alternative approach according to which the classification requirements currently included in IAS 32 will be amended in the following manner:

Currently, according to IAS 32 (Paragraph 16) a financial instrument is classified as equity if:

"

- (a) ...
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. ...

..."

Foreign currency

According to paragraph 16 of IAS 32, warrants issued by an entity in a foreign currency (a currency other than the entity's functional currency) are classified as financial liabilities. This classification results in an odd financial performance. When the entity is successful, the fair value of its shares and share warrants increase. Accordingly, the entity is required to recognise an expense due to the financial liability's measurement at fair value.

IAS 39 (paragraph 11) requires the separation of any embedded derivative from its host contract if and only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG 33);
- (b) ...
- (c) ...

Paragraph AG33 to the Application Guidance of IAS 39 sets out examples in which the economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract. Paragraph AG33(d) determines that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

- (i) ...
- (ii) ...
- (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

We suggest to alter paragraph 16 of IAS 32 in such a way that a derivative that will be settled by the issuer exchanging a fixed number of its own equity instruments for a fixed amount of cash or another financial asset denominated in a currency that is commonly used in the economic environment in which the issuer operates will be classified as equity instrument.

We believe that issuing such derivatives that will be settled in an amount that is denominated in a currency that is commonly used in the economic environment of the issuer is part of the normal activity of the business and that such derivatives should not be classified as financial liabilities. The same logic that lead the IASB not to require the separation of a foreign currency derivative in a currency that is commonly used in the economic environment of the issuer should apply to the issuance of derivatives in a commonly used currency.

Linkage to the Consumer Price Index

According to paragraph 16 of IAS 32, warrants issued by an entity that require on settlement the exchange of an amount linked to the CPI for equity instruments of the issuer are classified as financial liabilities. As in the above-mentioned case, this classification also results in an odd financial performance. When the entity is successful, the fair value of its shares and share warrants increase. Accordingly, the entity is required to recognise an expense due to the financial liability's measurement at fair value.

Paragraph AG33(f) to the Application Guidance of IAS 39 determines that an embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii)

We suggest to alter paragraph 16 of IAS 32 in such a way that a derivative that will be settled by the issuer exchanging a fixed number of its own equity instruments for an amount of cash or another financial asset that is linked to an inflation-related index (such as a consumer price index) will be classified as equity instrument.

We appreciate the opportunity to provide our comments.

Sincerely,

Dov Sapir, CPA, Chairman

Israel Accounting Standard Board