

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

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Grant Thornton International
Regent's Place
7th Floor
338 Euston Road
London NW1 3BG

Submitted electronically through the IASB Internet site (www.iasb.org)

Discussion Paper Financial Instruments with Characteristics of Equity

Introduction

Grant Thornton International Ltd. is pleased to comment on the International Accounting Standards Board's (the Board) Discussion Paper *Financial Instruments with Characteristics of Equity* (the IASB Paper).

Grant Thornton LLP responded to the Financial Accounting Standards Board's Preliminary Views document (the PVs Paper) on 30 May 2008. Grant Thornton International Ltd. supports the views and comments in that letter. The purpose of this additional letter is to respond to the further matters raised in the IASB Paper's Invitation to Comment.

Our responses to the additional questions are set out below.

Responses to additional invitation to comment questions

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 believe that the basic ownership approach is a suitable starting point for this purpose. The main advantage of this approach is its simplicity. We do not believe that simplicity should be viewed as an objective of financial reporting in its own right. However, if a distinction is to be made between liabilities and equity instruments at all, we see advantages in making the distinction in a way that the classification of each type of instrument will be readily apparent to users.

Nonetheless, as noted in our response to question B3 below, it is not obvious that the underlying principles behind the approaches in the PVs Paper are superior to the basic principle of IAS 32. We believe that both papers suffer from the absence of a compelling explanation of the purpose of distinguishing between liabilities and equity, or how the usefulness of financial statements is enhanced or impaired by 'drawing the line' in any particular place.

We recognize that the IASB has not yet formed any views on the alternative approaches in the PVs Paper. In forming its views, and in order to build support for changes in this sensitive area, it will be important to explain how any alternative approach will lead to more useful information in practice.

(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?

We believe the basic ownership approach would be relatively simple to implement. We note however that the measurement and presentation of non-equity perpetual instruments will be a very significant part of the overall approach under basic ownership.

On a more detailed point, we note that paragraph 20b of the PVs Paper sets out a condition that redeemable instruments are equity only if redemption is prohibited if higher priority claims would be impaired. We question whether this rule is meaningful - it can be argued that any cash outflow will to some extent impair other claims.

The Grant Thornton LLP letter raises a number of operational concerns over the ownership-settlement approach. That letter also expresses the view that the REO approach is overly complex. We do not believe the REO approach would be feasible for that reason.

(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?

The most obvious alternative approach would be to start with the current requirements of IAS 32 and address the areas that are problematic. The IASB Paper discusses various criticisms of IAS 32 in paragraphs 15 to 34. Notwithstanding those criticisms, we consider that IAS 32 is not fatally flawed.

More specifically we believe that:

- IAS 32's basic approach (which can be described as classifying an instrument as equity if it is not a financial liability) seems at least as satisfactory as any alternative approach;
- some of the perceived application problems, such as the determination of when a contractual provision exists or a contingent settlement provision is 'not genuine', are matters requiring professional judgement to a degree that we consider reasonable and appropriate (and possibly inevitable) in a principle-based system;
- other problems are capable of being addressed by amending IAS 32. We particularly highlight IAS 32's 'fixed for fixed' rule. In our view, a narrow or mechanical reading of the fixed for fixed rule yields anomalous results. We suggest that IAS 32 would be improved by replacing this rule with a principle along the lines that settlement in 'own shares' is consistent with equity classification if the settlement terms preserve the rights of the instrument holders relative to the rights of other equity shareholders.

We acknowledge however that an approach based on limited amendments to IAS 32 might not be consistent with the objective of achieving short-term convergence with US GAAP.

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 the scope in paragraph 15 of the PVs Paper is not appropriate in an IFRS context. This is because:

- it is narrower than IAS 32, which covers all financial instruments subject to limited and specific exemptions;
- if the aim of an eventual Standard is to define equity, including some components of the definition of equity in the scope seems redundant or circular;
- the reference in paragraph 15(b) of the PVs Paper to 'ownership interests in legal form' seems inconsistent with both Boards' current thinking on faithful representation. It is also likely to prove difficult to interpret and apply;
- the scope as expressed will capture many instruments that are presently within the scope of IFRS 2 *Share-based Payments*. Although we believe there is a strong case for reviewing IFRS 2 in due course, the liabilities and equity project is not in our view the appropriate place for such a review.

We therefore consider that IAS 32's current scope is preferable to the scope in the PVs Paper.

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?

We are not aware of any specific jurisdictional issues that would result in the principles behind the basic ownership instrument being more or less appropriate. The terms of legal-form ownership instruments are of course significantly affected by jurisdictional legislative requirements and commercial practices. Examples of such requirements include:

- laws in many jurisdictions that restrict redemptions and distributions based on a concept of distributable profits;
- requirements to distribute a minimum or fixed percentage of profits in certain jurisdictions (Greece and Brazil for example);
- restrictions governing puttable and mandatorily redeemable instruments;
- capital structures of specific types of entities such as co-operative, partnership structures and collective investment vehicles.

We suggest that it will be important to test the application of any proposed approach in the context of such requirements.

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?

The Grant Thornton LLP letter comments on each of these principles. We have not identified any other specific jurisdictional issues that would render these principles more or less suitable in the context of the basic ownership approach. We would however emphasise the concerns raised in that letter regarding the substance principle as articulated in the PVs Paper. As described the substance principle does not sit comfortably with IAS 32's notion of substance over legal form. Rather, the PVs Paper takes a narrow view of substance that addresses:

- the requirement to assess classification taking account of both stated and unstated terms (which seems broadly consistent with the requirement in paragraph 5 of IFRIC 2 *Members Shares in Co-operative Entities and Similar Instruments* to consider relevant laws etc); and
- the likelihood of stated and unstated terms affecting the settlement outcome.

The Grant Thornton LLP letter acknowledges that the substance principle may be largely redundant in the context of basic ownership. It would however be very important in the context of ownership-settlement.

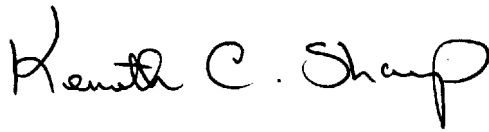
B5 Please provide comments on any other matters raised by the discussion paper.

The requirements set out in the PVs Paper for redeemable instruments to be equity differ from the February 2008 amendment to IAS 32 *Puttable Financial Instruments and Obligations Arising on Liquidation* (the puttables amendment). We do not regard that as a problem in itself and acknowledge that the puttables amendment was intended to be temporary and limited in its scope. We also regard the puttables amendment as overly complex and rules-based. We would therefore welcome an alternative that is simpler to apply and interpret and has fewer 'anti-abuse' type rules. However, we believe that a comprehensive analysis of the differences should be undertaken in order to develop an approach that draws on the best features of both. We make the following suggestions on some of the more significant differences:

- we prefer the PVs Paper's emphasis on redeemable instruments to IAS 32's narrower focus on puttable instruments;
- the PV Paper requires the redemption amount to be based on a share of net assets or fair value (paragraph 20a and 21) while the puttables amendment looks to the total expected cash flows over the instrument's expected life. We prefer the IAS 32 approach in this case;
- we note the same entity could classify as equity both redeemable and perpetual instruments under basic ownership. This result appears inconsistent with identifying the most residual class of instrument. Such an outcome would be impossible (or at least very unlikely) under IAS 32. The IAS 32 approach might therefore be argued to be more robust at a conceptual level. However, IAS 32 also leads to outcomes that we find counter-intuitive. For example, some entities in the investment sector issue puttable 'units' that would be equity except for the existence of a single, more residual founder share or management share. On balance, we believe the approach in the PVs Paper provides better information;
- we support the PVs Paper proposal that redeemable instruments that are equity would be remeasured at current redemption value.

If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,

A handwritten signature in black ink that reads "Kenneth C. Sharp". The signature is written in a cursive style with a large initial 'K' and a distinct 'S'.

Kenneth C Sharp
Global Leader - Assurance Services
Grant Thornton International