Grant Thornton

FICE Sub 1

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4 August 2008

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Dear David

Discussion Paper *Financial Instruments with Characteristics of Equity*

Grant Thornton Australia Ltd. (Grant Thornton) 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's response reflects our position as auditors and business advisers both to listed companies and privately held companies and businesses.

Grant Thornton LLP responded to the Financial Accounting Standards Board's Preliminary Views document (the PVs) on 30 May 2008 (copy attached). Grant Thornton 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. This submission has benefited with input from our clients, Grant Thornton International which will be finalising a global submission to the IASB by its 5 September 2008 deadline, and discussions with key constituents.

Our responses to the additional questions are attached as an Appendix.

If you require any further information or comment, please contact me.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

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Keith Reilly
National Head of Professional Standards

APPENDIX

Discussion Paper Financial Instruments with Characteristics of Equity

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 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. 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 20a of the PVs document 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 a degree of professional judgement that we consider reasonable and appropriate (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 highly 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 other equity shareholders.

We acknowledge however that an approach based on limited amendments to IAS 32 might not be consistent with achieving 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 document 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 appears redundant or circular;
- the reference in paragraph 15(b) of the PVs document to 'ownership interests in legal form' seems inconsistent with both Board's 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 mechanism for such a review.

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

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 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 redemptions and distributions are permitted only out of distributable profits;
- requirements to distribute a minimum 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 document. As described the substance principle does not sit comfortably with IAS 32's notion of substance over legal form. Rather, the PVs document 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 paragraph 5 of IFRIC 2 *Members Shares in Co-operative Entities and Similar Instruments* requirement to consider relevant laws etc); and
- the likelihood of stated and unstated terms affecting the settlement outcome.

We acknowledge in the Grant Thornton LLP letter that the substance principle may be largely redundant have significant practical effect 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 instrument to be equity differ from the February 2008 amendment to IAS 32 *Puttable Financial Instruments and Obligations Arising on Liquidation* (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 an 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 approaches. We make the following suggestions on some of the more that the most 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 that the redemption amount 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;
- we note the same entity could classify as equity both redeemable 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, the IAS 32 also leads outcomes that we find counter-intuitive. For example, some entities in the investment funds 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 provides better information.

- we support the PVs' proposal that redeemable instruments that are equity would be remeasured at current redemption value.

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LETTER OF COMMENT NO. 47

May 30, 2008

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Re: File Reference 1550-100

Grant Thornton LLP appreciates the opportunity to comment on the Financial Accounting Standards Board (the Board) Preliminary Views document *Financial Instruments with Characteristics of Equity*. We support the Board's effort to improve accounting for liabilities and equity and to converge the accounting for financial instruments with characteristics of equity with the International Accounting Standards Board (IASB).

We support the Board's preliminary view that the basic ownership approach will result in financial reporting that best meets the needs of financial statement users while, at the same time, simplifying the requirements for preparers and limiting the opportunities for structuring.

While the ownership-settlement approach is more fundamentally consistent with the conceptual definition of a liability and might result in better financial reporting for certain users, the many issues associated with it make the basic ownership approach a significantly better alternative. The ownership-settlement approach has many of the same fundamental flaws that exist in the current accounting model for liabilities and equity. We believe that the inevitable complexity associated with the ownership-settlement approach will lead to incorrect and inconsistent application and allow for structuring opportunities. We also believe that different measurement methods for two financial instruments that have the same economic profile, but different settlement requirements, results in a flawed accounting model.

Our comments are organized to correspond with the questions within the notice for recipients of the Preliminary Views.

Questions on the Basic Ownership Approach

1. *Do you believe that the basic ownership approach would represent an improvement in financial reporting?*

   Yes, we believe that the basic ownership approach would represent an improvement in financial reporting because it reduces complexity, should limit structuring opportunities, and will result in more consistent measurement for financial instruments with characteristics of equity.

Are the underlying principles clear and appropriate?

Yes, we believe the underlying principles are clear and appropriate.

Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

Yes, the basic ownership approach will significantly simplify accounting for all equity instruments other than common stock; however, it will add complexity to the measurement of these instruments. We believe that guidance to assist preparers in measuring indirect ownership instruments at fair value would help promote consistent application. We also believe that the basic ownership approach will reduce incentives for structuring and thus limit structuring opportunities.

Perpetual Instruments

2. *Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?*

   This approach will require more extensive analysis by many users, including regulators. Presentation guidance will be important to facilitate this analysis.

3. *The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.*

   We believe that instruments without issuer call options should not be remeasured, but that dividends should be reported as an expense at regular intervals. We do not believe that remeasurement at fair value would be the proper measurement method. We believe that the expected dividend stream should be discounted for perpetual instruments for which the issuer has a call option or options.

Redeemable Basic Ownership Instruments

4. *Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?*

We believe that "would impair the claims of any instruments with higher priority" is not operational as this would be open to significant interpretation.

We believe that for the redemption provisions in paragraph 20 to be operational, all basic ownership instruments would need to be subject to the same redemption provisions to be classified as equity. We believe that a financial instrument with a put option at fair value is not the equivalent of the same financial instrument without a put option and the two instruments are not equal in priority. Also, allowing an exception whereby some common shares have a fair value put while others do not will lead to structuring opportunities. We believe that guidance in the recent revisions to IAS 32, *Financial Instruments, Presentation,* should be considered when providing the exception in paragraph 20.

Separation

5. *A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?*

We believe that Board has properly interpreted the facts; however, we believe that required dividend payments that are indexed solely to earnings should not require separation into a liability component while a required fixed dividend payment should be separated as a liability component.

Substance

6. *Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?*

We believe that the substance principles are not necessary under the basic ownership approach. Including the substance principles might lead to more complications and incorrect application. We also believe that basic ownership generally results in classification that is consistent with the economic substance.

Linkage

7. *Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?*

We are not aware of any circumstances; however, we believe the linkage principle should be consistent with the guidance in other literature such as Statement 133 Implementation Issue K-1, *Determining Whether Separate Transactions Should Be Viewed as a Unit*, Statement 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, and FSP FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, to the extent possible. Any differences in linkage guidance should be justified.

Measurement

8. *Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?*

We agree with the result stated above. While the basic ownership approach will result in more complex remeasurement for many instruments that are not currently subject to remeasurement, we believe that consistent measurement of instruments with similar economic payoff is a significant improvement and benefit of the basic ownership approach.

Presentation Issues

9. *Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

We strongly support presentation of redeemable basic ownership instruments separately from perpetual instruments. We believe that perpetual instruments should be classified separately from other liabilities. Requiring separate presentation of perpetual instruments would provide users with information about the liquidity requirements of the reporting entity in a consistent manner and help overcome the biggest drawback of the basic ownership approach. We do not believe that separate presentation should be required for other instruments such as liabilities that require settlement with equity instruments. However, an entity should be allowed the flexibility to present these instruments separately if they believe the information would be helpful to users.

10. *Income statement. The board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.*

    We believe that measurement changes attributable to perpetual instruments should be separately displayed. Entities could choose to separately display changes associated with instruments that are required to be settled with equity instruments, but we do not believe that entities should be required to present separately.

Earnings per Share (EPS)

11. *The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

    If equity instruments are the most residual claim and, as we suggest in our response to question 4, all such equity instruments would have to possess the redemption requirement, we do not believe that there would be significant EPS implications.

Questions on the Ownership-Settlement Approach

1. *Do you believe the ownership-settlement approach would represent an improvement in financial reporting?*

   No, we believe that the ownership-settlement approach has many of the same fundamental flaws that exist in the current accounting model for liabilities and equity. We believe that the inevitable complexity associated with the ownership-settlement approach will lead to incorrect and inconsistent application. We also believe that it will provide for structuring opportunities. In addition, we believe that different measurement methods for two financial instruments that have the same economic profile, but different settlement requirements, results in a flawed accounting model.

   We also believe that the principle in paragraph A4 will require considerable implementation guidance to make it operational. Merely requiring that the terms of an indirect ownership instrument result in changes in fair value that are directionally consistent with changes in fair value of a basic ownership instrument will result in structuring opportunities.

   Do you prefer this approach over the basic ownership approach?

   No

2. *Are there ways to simplify the approach? Please explain.*

We considered an approach that would remeasure all indirect ownership instruments at fair value, with changes in fair value recognized in earnings if the instrument is a liability and changes in fair value recognized in equity if the instrument is equity. This approach would result in more meaningful balance sheet and EPS presentation and potentially reduce the incentive for structuring. However, we concluded that the basic ownership approach with enhanced presentation could be operational without adding the undue complexity of the ownership-settlement approach. For this reason we believe that the basic ownership approach is preferable.

Substance

3. *Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?*

For the reasons stated in our response to Question 6 to the basic ownership approach, we do not believe it is operational as it might lead to more complications and incorrect application.

Presentation Issues

4. *Statement of financial position. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

Yes, under the ownership settlement approach we believe it would be preferable to present separately those liabilities that are required to be settled with equity instruments from those that are required to be settled with cash.

Separation

5. *Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?*

While potentially more operational than current GAAP, we do not believe they are sufficiently operational to resolve the issues that currently exist. Separation does not result in decision useful information when economic results are similar but measurement is not at all similar.

Earnings per Share

6. *The board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

   The issues are similar to those that currently exist. Different earnings treatment and EPS treatment under the ownership-settlement approach for two financial instruments that have the same economic profile, but different settlement requirements does not result in financial reporting that meets the needs of users.

   The only method that would result in consistent EPS treatment for instruments with similar economic payoffs is one that would result in much of the measurement complexity associated with the basic ownership approach being shifted to calculations of EPS under the ownership-settlement approach.

Settlement, Conversion, Expiration, or Modification

7. *Are the requirements described in paragraphs A35-A38 operational? Do they provide meaningful results for users of financial statements?*

   We believe that the requirements are overly complex and do not result in meaningful results when compared to the basic ownership approach.

Question on the REO Approach

1. *Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.*

   No, we believe it is overly complex.

We appreciate the opportunity to comment on the preliminary views document and would be pleased to discuss our comments with Board members or the FASB staff. If you have any questions, please contact Mark Scoles, Partner, Accounting Principles Group at 312 602 8780.

Very truly yours,

/s/ Grant Thornton LLP