22 September 2006

The Chairman

Australian Accounting Standards Board

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Dear Sir

Proposed amendments for financial instruments puttable at fair value and obligations arising on Liquidation (the "Proposal")

Introduction

The Property Council of Australia welcomes the opportunity to comment on the proposed amendments to AASB 132 *Financial Instruments: Disclosure and Presentation* (AASB 132) and AASB 101 *Presentation of Financial Statements* (AASB 101).

The Property Council is the peak body representing the interests of investors in Australia's $320billion property investment industry. Approximately 2000 companies are members of the Property Council, ranging from Australia's largest institutions to private investors and developers covering the four quadrants of real estate investing, public, private, debt and equity.

As such, our members represent a significant proportion of the Australian Property Trust market and are affected by the Proposal.

The Property Council supports the Propøsal providing there is further clarification to ensure that dividend distribution requirements do not prevent the financial instruments from being considered equity.

Whilst the Proposal is a pragmatic solution to part of the debt/equity issues in AASB 132, we are concerned that the amendments have a narrow focus which excludes a large number of Australian Property Trusts where AASB 132 is producing results that do not reflect economic reality under the debt/equity distinction.

We consider that financial instruments which are fundamentally similar in economic substance, and otherwise meet the Proposal's requirements for classification as equity, may continue to be classified as debt due to uncertainty surrounding AASB 132's current requirements for distributions.

Furthermore, the Property Council notes a number of other changes that we believe should be made to ensure that the amendments operate consistently across affected entities:

1. Determination of "fair value" under the standards should allow entities to use the "last sale price" as an approximation of value (consistent with market practice), providing information is furnished by the entity to establish that it is market practice;
2. Clarify that instruments in entities with multiple classes of units which are entitled to a share of the pool of assets are also classified as equity;

Without these changes a substantial number of Australian Property Trusts will be unable to reclassify their instruments as equity. This would be an unfortunate result for the sake of what are reasonably technical changes and result in inconsistent accounting treatments amongst investment vehicles that

are for all practical purposes similar. There is no doubt that the inconsistent treatment would result in confusion.

The Background

Australian Property Trusts or Australian Real Estate Investment Trusts ("Aus REITs") represent one of the most sophisticated capital markets in the world and are one of the most popular storehouses of wealth for ordinary Australians and as well as an increasing investment choice for foreign investors. Australia has the second largest real estate capital market globally. There is approximately $100bn invested in the current Aus REIT business model.,

In the case of Aus REITs, the implementation of IAS 32 means that the considerable assets of the trust have to be recognised as debt due to the fact that the trusts have often had an 80 year mandatory redemption clause. They are limited life entities with an obligation to return funds to the unitholders (ie: put back funds) and under AASB 132 as currently drafted they represent a "puttable" instrument, which is regarded as a liability.

The adverse effects include:

1. distributions to property trust unitholders are treated as a finance cost;
2. trust assets are reduced to virtually zero;
3. lack of financial comparability with foreign investment vehicles, which do not face the same issue;
4. artificially increased gearing ratios.

Whilst some entities have been able to amend their constitutions at considerable cost to remove the limited life clause, a large proportion of trusts were unable to amend under special ASIC class orders due to legal, tax and cost ramifications.

This standard has caused considerable problems for the Aus REITs:

1. The entities are forced to reconcile the accounts to reflect a "true and fair view" where the standard does not easily produce results that reflect economic reality, which is a significant compliance burden for the industry.
2. The entities are forced to provide additional reporting and disclosure to the market to ensure investors are not misled, representing a considerable cost
3. Aus REIT's do not have financial comparability with foreign investment vehicles operating in the same industry which is one of the aims of Australia's adoption of equivalents to International Financial Reporting Standards.

The Aus REITs have a number of specific characteristics which need to be properly addressed under AASB 132:

1. Many unlisted trusts have instruments that require the entity to repurchase or redeem the instrument;
2. Many trusts have limited life clauses which require redemption of the instrument upon liquidation;
3. Many trusts have constitutions (internal governance rules) conferring an obligation on the trustee to pay a distribution each year. Many such distribution clauses are driven by tax considerations;
4. Many trusts are valued at the "last sale price" (what was paid) rather than the "bid price" (what a purchaser is now willing to pay);
5. Many trusts have multiple classes of units which are entitled to a share of pooled assets for the class of unit rather than a share of the net assets of the entity;

In the case of characteristics 1 and 2, the Proposal appears to provide a solution allowing the trusts to reclassify their instruments as equity, however, a large majority of the trusts in question will subsequently be caught under one or more of issues 3 to 5. These trusts will not be able to reclassify their instruments as equity and the problem will remain.

Regarding 5 above, please confirm through a suitable amendment that the "assets of the entity" can mean the relevant pool of assets over which an entity has claim.

Regarding 4 above, the Proposal should reflect the economic realities for determining fair value since although fair value can be regarded as the "bid price" for a unit, the Australian funds management industry will use "last sale price" to approximate fair value.

The standard should indicate that "last sale price" is a suitable approximation of fair value where information is furnished by the entity to show that it is market practice.

Of greatest concern however is issue 3 which affects the majority of Aus REITs that are caught as liabilities under AASB 132. The Proposal should confirm that income distribution clauses in trust constitutions do not prevent the instrument from being classified as equity. If the Proposal does not resolve this issue, the debt/equity problem will remain for the sector, and continue to hamper the growth of capital markets. This is discussed in greater detail below.

The Proposal

A. IASB Questions

As requested, in answer to the questions posed by the IASB in the exposure draft, we make the following comments:

1. Financial Instruments puttable at fair value.

The Property Council in principle supports the reclassification of financial instruments puttable at fair value as equity as we believe that this reflects the economic substance of such instruments – the units in the trust represent the residual interest in the assets of the trust after deduction of Trust's external liabilities other than to its members.

2. Obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation

The Property Council supports the equity reclassification of instruments with a unit repurchase/redemption obligation upon liquidation. We equally support its application to limited life entities. This more consistently reflects the economic reality that an instrument is not a liability simply because it can be bought back by the entity even if the liability will be triggered in the future.

3. Disclosures

The Property Council supports additional disclosure to determine the fair value of these financial instruments to the extent that it is not unreasonably difficult to obtain.

4. Effective Date and Transition

The Property Council agrees that the amendments should be retrospective to allow the entities concerned to provide consistent accounts for the relevant periods, in line with the standards.

B. Trust Income Distribution Clauses

As noted above, in addition to the above IASB questions, the Property Council considers that the Proposal should confirm that income distribution clauses in trust constitutions do not prevent an instrument from being classified as equity.

The classification of trusts with dividend distribution clauses must be clarified in the Proposal for AASB 132 to apply consistently across all affected entities and in a manner which reflects the substance of the unit holder's relationship with the Trust.

Examples of such clauses include:

- A requirement that the trustee distribute all taxable income arising in the year, but allow the trustee discretion in the distribution of capital income;
- Clauses stating that unitholders are presently entitled to profit at the year end; and
- Clauses requiring the trustee to distribute all operating income plus any additional amount (including capital) that the trustee has determined is distributable.

The characterisation of the Aus REIT business model requires the trusts to distribute taxable income under Division 6C of the *Income Tax Assessment Act 1936* to prevent the trust incurring tax at the entity level. As such, the dividend entitlement clauses are typically driven by tax considerations and the impact of the distribution is to optimise the post tax return to the trust, thereby enhancing the return the unit holders.

Except for these distribution clauses, under the proposed amendments to AASB 132, the units in those trusts would be classified as equity.

We note that paragraph 17 of the proposed amended AASB 132 states:

> *"Except as stated in paragraph 17A, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party."*

We also note that paragraphs AG 25 and 26 state:

> *"AG25 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.*
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> *AG26. When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:*
>
> *(a) a history of making distributions;*
>
> *(b) an intention to make distributions in the future;*

(c) *a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);*

(d) *the amount of the issuer's reserves;*

(e) *an issuer's expectation of a profit or loss for a period; or*

(f) *an ability or inability of the issuer to influence the amount of its profit or loss for the period."*

The requirement to distribute dividends is effectively determined by the unit holders through the constitution. All unit holders will typically be subject to the same distribution entitlements, and there is no more subordinated class of equity. As noted above, the dividend entitlement clauses are typically driven by tax considerations to ensure the trusts are not assessable on certain income if it is distributed on an annual basis under Division 6C of the *Income Tax Assessment Act 1936*.

In substance, such instruments are equity, and the impact of the distribution is to optimise the post tax return to the trust, thereby enhancing the return to its members, the unit holders.

We consider that AASB 132 is not sufficiently clear and results in inconsistent classification of instruments by entities as financial liabilities or equity.

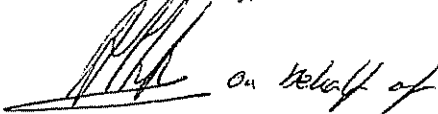
Such inconsistency not only has an adverse impact on investors and users of the financial statements in the Australian market, but also disadvantages Australian trusts in the global financial market when such trusts are required to classify instruments that are fundamentally equity in nature, as financial liabilities.

The characterisation of this obligation should not taint the entire instrument in a similar way that a limited life obligation on insolvency does not taint the entity from being considered equity.

If this change is not included in the amendments, the Proposal will have a very narrow application and there will be a significant inconsistency in accounting treatments for similar investment vehicles based on a technical difference

We look forward to having the opportunity to consult with you further to resolve these remaining issues and create a practical, workable proposal.

Yours sincerely,



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