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VINCENZO LA VIA Chief Financial Officer

Financial Accounting Standards Board Technical Director

Re: File Reference No. 1550-100

The World Bank appreciates the opportunity to comment on **Preliminary Views: Financial Instruments with Characteristics of Equity.** We believe that resolution of and convergence on this issue for both the FASB and IASB is an important agenda item.

We support an approach which focuses more fundamentally on what equity is and does not make the definition dependent on the definition of a liability. We recognize that this and some of the issues that we discuss below may have an impact on the conceptual framework project. Further, we appreciate the FASB's willingness to consider the difficult classification issues presented by shares which are puttable at the option of the holder; a topic that we have been monitoring closely, particularly in the development of IFRS. We believe that the recent developments in the amendment of IAS 32 are useful for this project.

# Definition of Equity - Basic Ownership Approach

We agree that the starting point of evaluating the class of instruments with the most residual claim is a very appropriate one as this has been widely viewed as a classical characteristic of equity. Therefore, we think that the criteria of paragraph 18 are a good starting point.

## Redeemable Basic Ownership Instruments

We also view the criteria in paragraph 20 to be an appropriate start for considering the issue of shares redeemable at the option of the holder (puttable). But it is here that we think the recent approach of IAS 32 on puttable shares, wherein the underlying characteristics of equity are considered, should be reviewed and the outcome better incorporated. Both the preliminary views and IAS 32.16A stipulate that the lowest level of subordination must be present. IAS 32.16 also states that all the instruments in the class that is subordinate to all other classes have identical features. (all puttable and all redeemed using the same method to determine the repurchase/redemption price). We believe the next due process document should incorporate the same requirements.

As you no doubt are aware, the IASB IAS 32 amendment project ultimately rejected a classification approach based on the principle of shares "puttable at fair value" given the various difficulties surrounding the definition of fair value, particularly in cases where shares are not traded in liquid markets, or may not be permitted to be traded at all. Instead, the IASB ultimately avoided attempts to explicitly define "fair value" with respect to the redemption value

for such instruments and instead provided what is stated in IAS 32, paragraphs 16A and 16B. We would like to suggest that a similar model be employed in the FASB's views, rather than reintroducing the "puttable at fair value" concept directly into the classification criteria.

However, if that is not possible then we would also like to observe the following about the current approach of the Preliminary Views document: Paragraph 21 incorporates the concept of "fair value" in relation to the puttable shares. We view paragraph 21 as attempting to provide the definition of "share of the issuer's net assets" used in paragraph 20. While we are supportive of the option of using book value if there is no active market for the instrument or the instrument can only be exchanged with the reporting entity, we are unclear about the objective of paragraph 21(a) and would suggest it be removed or redrafted for added clarity. In other words, we believe that if the conditions in 21(b) are met and if the class of instruments is subordinate to all other classes and all the instruments in the class have identical features, then a redemption amount based on book value is acceptable.

The remainder of our responses to questions contained in the Preliminary Views document is attached as Annex A.

Thank you for the opportunity to engage in what we hope will be a useful and fruitful discussion around an important topic.

Sincerely,

Vincenzo LaVia Chief Financial Officer World Bank Group

### Preliminary Views: Financial Instruments with Characteristics of Equity

#### Responses to Questions on the Basic Ownership Approach

Q: Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles 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?

A: Because of the virtue of its relative simplicity, with due consideration given to the features of instruments which inherently embody the most residual claim, we believe that the basic ownership approach represents an improvement. Our comments on the underlying principles have been articulated in the body of our letter. We do believe there are opportunities to introduce greater clarity in certain principles.

#### Redeemable Basic Ownership Instruments

Q: 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?

A: As stated in the body of our letter, we view the criteria in the amended IAS 32.16A and 16B better suited for this purpose. However, we do believe the criteria in paragraph 20 are operational provided that paragraph 21(a) be removed.

Additionally, we observe that paragraph 21(a), as currently written, can be read either as:

"The redemption formula is designed to approximate fair value of the instrument or it [the redemption formula] is designed to approximate the share of [net] assets to which the holder would be entitled"

or, it can also be read as:

"The redemption formula is designed to approximate fair value of the instrument or it [the redemption formula] is designed to approximate the fair value of the share of [net] assets to which the holder would be entitled".

We believe the current wording can lead to different interpretations and therefore, would suggest that paragraph 21(a) be reworded for added clarity, if not removed.

#### Substance

Q: 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. 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?

A: The discussion and illustration provided of the "substance" principle raised a question regarding the application of the effect that consideration of the "probable outcome" would have for example, on the assessment of shares puttable at the option of the holder under the basic ownership approach. If probability and optionality are to be considered in the classification of the instrument (but ignored for purposes of measurement) we are uncertain of the intention and impact of that concept with respect to a puttable share example. Is it correct to infer from the substance discussion and example that a puttable share, exercisable at the option of the holder would, if the put is extremely remote, be a feature that should not be considered in the classification? And therefore, would

automatically be an equity instrument rendering moot the requirement to assess the other conditions in paragraphs 20-21? It is unclear to us how this element of the substance discussion would interact with the classification assessment of puttable shares (exercisable at the option of the holder). Further clarification would be helpful.

Generally, we believe the substance principle in the basic ownership approach has the potential to undermine the objective of simplicity and create inconsistency and therefore we do not view it necessary.

#### Presentation Issues

Q: 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?

A: We believe that the existing disclosure requirements for liabilities and cash requirements are generally sufficient and that preparers should be free to determine the display approach which is most appropriate for their circumstances.

Regarding the display of equity, we were uncertain as to how the display approach indicated in paragraph 32 would function for an organization that has only one class of equity, which is puttable at the option of the holder and for which the current redemption value is a pro-rata share of net assets. In such a case the "change" in the redemption value will merely be the current year's change in retained earnings and other comprehensive income (OCI). Applying the illustrative example in which the change is deducted from retained earnings and reported as a change in the value of the redemption amount of the shares instead would result in reporting the entire change in retained earnings and OCI under the change in the value of redemption amount. In this particular example it looks like the entire retained earnings and accumulated OCI would be presented as the cumulative change in current redemption amount. Is this the intention, or are we not understanding it correctly? It would be useful if such a scenario was contemplated in the next document and more clarity provided.

Q: 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 instruments 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.

A: We believe issues of display such as these elements (particularly the issues of unrealized changes resulting from valuation) should be addressed as part of the Financial Statement Presentation project that is currently underway rather than an attempt made in this project to create a principle that may preempt or take a potentially different direction than the broader project.