CL 58C

Dear Sirs,

Re: Invitation to Comment on the Proposed Improvements to IAS 32 and IAS 39

PMP Limited endorse the comments on the proposed amendments to IAS 32 and IAS 39 as detailed in the attached letter form Saloman Smith Barney dated 11th October 2002.

Yours faithfully,

Richard Allely
Chief Financial Officer
PMP Limited

SALOMON SMITH BARNEY
A member of citigroup

11 October 2002

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

Dear Sirs

Re: Invitation to Comment on the Proposed Improvements to IAS 32 and IAS 39

Below we provide comment on the proposed amendments to IAS 32 and IAS 39 IAS 32. We have, with apologies, missed the AASB's deadline to route our comments through the AASB. We are, however, also sending the comments to the AASB.

Introduction
We have a major concern with the accounting treatment of certain hybrid securities under proposed paragraphs 22C and 22D of IAS 32. The comments below concern certain securities that these paragraphs classify as financial liabilities, which we feel strongly is incorrect and not useful for users of the financial statements, and hinders use of appropriate financing structures.

We use as an example throughout this submission the following representative hybrid security structure. A company issues preference shares that pay a discretionary dividend of 6% p.a., and convert on a mandatory basis to ordinary shares after three years. The conversion ratio is the face value of the preference share divided by the ordinary share price prevailing at the time of conversion.

Outlined below is the basis for our argument, and a suggested solution to this issue.

These comments are outside the four focus issues raised in the Exposure Draft, but we believe these amendments (and their predecessors) represent an area that is in critical need of reform. We have not provided comment on any other aspect of the amendments.

Discussion of Paragraphs 22C and 22D
We believe the required liability classification of certain hybrid securities (as in the example) as required under paragraphs 22C and 22D is arbitrary in that the treatment conflicts with the broader definition of liabilities.

Starting with the definition of "equity" in paragraph 5:

> *"An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities."*

SALOMON SMITH BARNEY AUSTRALIA SECURITIES PTY LIMITED
ABN 64 003 114 832
Level 40, Citigroup Centre, 2 Park Street, Sydney NSW 2000
GPO Box 557, Sydney NSW 2001

TELEPHONE
FACSIMILE

Salomon Smith Barney Australia Securities Pty Limited is a licensed Securities Dealer and Futures Broker,
a participating organisation of Australian Stock Exchange Limited and member of Sydney Futures Exchange Limited.

The question is raised as to what type of financial instruments remain after deducting liabilities, other than equity instruments. Without contradictory guidance the usual conclusion would be that residual interests are interests in the net assets after deducting liabilities.

Paragraph 22D, however, provides guidance on the question of when a residual interest is not an equity:

> *"If the number of an entity's own shares or other own equity instruments required to settle an obligation varies with changes in their fair value so that the total fair value of the entity's own equity instruments to be delivered always equals the amount of the contractual obligation, <u>the counterparty does not hold a residual interest in the entity</u>. In addition, the entity may have to deliver more or fewer of its own equity instruments than would be the case at the date of entering into the contractual arrangement. Therefore, such an obligation is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments."*
> *[emphasis added]*

The securities referred to in this paragraph include convertible securities as in the example hybrid outlined.

Under the test set up in this paragraph a security of the example type is not a "residual interest" because the number of ordinary shares issued on conversion is calculated to ensure their aggregate value equals the original value of the convertible security.

A residual interest must absorb the loss in value of assets before solvency is threatened. It is unarguable that the example hybrid absorbs losses, since the entity can accumulate a retained loss but remain solvency provided the loss is less than the value of the hybrid. Moreover, if the hybrid funding had instead been raised as a debt, then the entity would have had to cease trading once the losses wiped out other shareholders funds.

Issuing the hybrid protects the entity in all relevant circumstances from the features of a debt. There is no obligation to deliver an asset in the future regardless of any future circumstances. Debts have to be repaid through providing assets. Liabilities have to be satisfied by delivering assets. There is no future asset delivery under these securities.

For these reasons regulators of financial institutions in the US, Europe, Asia and Australia have approved certain securities such as the example hybrid as "Tier 1", or equity, capital because they provide loss absorption for the issuer, even though holders of these securities are investors who are not seeking "equity upside" like equity investors in ordinary shares or common stock.

The result of not treating hybrid securities as appropriate residual interests is that they fail the definition of equity, and are then classified as liabilities. They do not, however, meet the definition of a liability because there is no "…obligation to …deliver cash or another financial asset…" on the part of the issuing entity.

They should not be regarded as meeting the definition of a "financial liability" in IAS32, as they do not incorporate an obligation to *"…exchange financial instruments with another entity under conditions that are potentially unfavourable"*, since conversion at the future market value cannot be unfavourable as that market value has been received for the ordinary shares that are created on conversion.

Such securities represent a fixed share of the value of the net assets, realisable by their conversion value and resulting dilution of ordinary shareholders (only considering what happens as a going concern). They are therefore fixed value residual interests. The value of these securities is a fixed share of the net assets because under the terms of the issue the ordinary shareholders interests in the net assets increases or decreases by virtue of the conversion formula, as a function of a rise or fall in the share price between issue and conversion respectively.

In contrast to these convertible fixed value residual interests, a non-convertible perpetual preference share would also be a residual interest, and its classification would not be affected by guidance in 22C and 22D. Such a perpetual preference share would be "equity" applying the definition in IAS32 (assuming no other special features and assuming dividends on them are payable at the directors' discretion).

These preference shares are also residual interests in the usual meaning, as they are not liabilities since they entail no future obligation to deliver any asset of the issuer to the holder. They represent a fixed share of the value of net assets, so they are also fixed value residual interests.

The difference between the convertible example security and the non-convertible perpetual preference share is the conversion feature, which returns to the convertible holder the original investment value at the cost (or for the benefit) of ordinary shareholders (depending on whether the ordinary shares have fallen or risen since the hybrid issue). It is this feature, this transfer of interests in the net assets between residual interest holders illustrated by the conversion mechanics that the board seems to have decided is significant enough to warrant introducing into the standard this manufactured treatment of variable convertible hybrid securities. It is the conversion mechanics rather than the fixed value feature that seems to be important, since the perpetual preference share is also a fixed value share of net assets and will impact the value of the ordinary shares in the same way as if they were convertible.

From the viewpoint of the users of the financial statements there is no gain from application of this standard. Creditors will not place importance on the relationship between the residual interest holders, provided the financial instruments they hold are all residual interests then there degree of participation in the net assets and how that changes is essentially irrelevant. On the other hand the liability treatment resulting from paragraph 22C and 22D will be relevant as it may require a special carve out from standard covenants that are typically seen limiting the incurrence of financial liabilities.

From the viewpoint of the ordinary shareholders the terms of the security are very important. The degree of possible dilution resulting from the conversion terms is a critical consideration in deciding the outlook for the ordinary shares, as is the dilution resulting from the issue of preference shares. Whether that possible dilution is regarded a positive or negative depends on that shareholders' assessment of the outlook for the shares.

It is clearly the case that if the firm had borrowed funds and decided that it would issue ordinary shares at maturity of the borrowing, then that combination ultimately has an equivalent economic outcome measured by dilution after the repayment and subsequent share issue. However, it is not appropriate to rely on the post issue experience since unlike this debt example the hybrid does not include an obligation to repay 'come what may'. Moreover, the analogy will not hold up where debt is not available for the purpose (eg. if regulatory requirements would not accommodate additional debt for the intended purpose of the fundraising, or where other commercial considerations would limit the use of debt eg. intention to maintain a rating, or compliance with financial covenants in existing debt arrangements). The analogy is not an equivalent transaction, although it may after the event produce an equivalent outcome.

The only party that the different treatment seems relevant to is the ordinary shareholders. The terms of the hybrid are important to the ordinary shareholders. However, to illustrate the differentiation in the position of the different residual interests by requiring such a hybrid to be a treated as a liability, even though it does not meet the definition of a liability is illogical. If the balance sheet, rather than the notes, needs to reflect this difference in economic outcome then there needs to be a different presentation to the balance sheet.

Resolution

An appropriate solution would be to present sub-groupings within shareholders funds, just as liabilities are presented in current or non-current categories (which is a critical piece of information). This approach would allow the balance sheet to retain meaning, and to allow the standard to have integrity so that the definitions are consistent and usable, and accord with ordinary meanings.

SALOMON SMITH BARNEY

A member of citigroup

These amendments would address the apparent concern to delineate between different types of residual interests, while also providing usable information to the users of financial statements without unnecessarily penalising the issuers of such securities. The additional balance sheet sub-category would provide a focal point for key interested parties, such as lenders, equity research analysts and regulators where applicable, to decide how such non-liability securities should be evaluated for their additional purposes. The re-format of the balance sheet would also be consistent with the conceptualised restructure of the income statement.

Yours faithfully

Bryan Davies
Managing Director
Structured Capital Markets, Australia

Copy to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins St West VIC 8007