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THE MAURITIUS ACCOUNTING AND AUDITING STANDARDS COMMITTEE

Invitation to Comment (IAS 32)

The Board would particularly welcome answers to the questions set out below. Comments should indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

Agreed.

Question 2 - Separation of liability and equity elements (paragraphs 28 and 29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

Agreed.

Question 3 - Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G)

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

No comments.

Question 4 - Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

IAS 32 and IAS 39 both concern Financial Instruments and work together. Therefore it would be advisable to have a single Standard dealing with recognition, measurement, presentation and disclosures. However, hedge accounting could stand on its own in a separate standard.

Other comments

Comment No. 1

Liability vs. Equity

A number of investment holding companies in Mauritius have a very small capital (typically US$2) and a large loan from shareholders to finance their investments. These investment holding companies generally hold an investment and describe the loan from shareholders as "Capital Contribution". The reasons for the large loan are that it is more efficient for tax purposes and simpler to refund than through a redemption of shares or a reduction in share capital. The loan can only be refunded when the company receives a dividend or sells the investment.

IAS 32.18 provides that a financial instrument shall be classified as a liability or as equity in accordance with the substance of the contractual arrangement. Unfortunately IAS 32.20 reverts back to a rule (and form) when it states that the critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation to deliver cash or another financial asset.

We do not believe that having the capital contribution as a liability reflects the substance of the transaction. The capital contribution is in effect "quasi" capital. Had the capital contribution been structured as a preference share redeemable only at the Company's option, it would have been shown as equity. It is not right that the legal form should decide on how a financial instrument is classified. The Standard should be amended to provide that the substance of the arrangement should decide how a financial instrument is classified.

Comment No. 2

Paragraph 21A – Last sentence

"The costs of an equity transaction that is not completed are recognised as an expense."

The word "completed" is confusing and could lead to the absurd interpretation that costs incurred in respect of an equity transaction that straddles the year end are expensed. The word "completed" should be replaced by "abandoned".

Invitation to Comment (IAS 39)

The Board would particularly welcome answers to the questions set out below. Comments should indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Question 1 - Scope: loan commitments (paragraph 1(i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

Agreed.

Question 2 - Derecognition: continuing involvement approach (paragraphs 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

Agreed.

Question 3 Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

Agreed.

Question 4 - Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Partly agreed. While making the designation irrevocable will eliminate the possibility of profit manipulation in future years, we believe that the Standard should provide for the possibility to move from one category to another should circumstances genuinely change.

Question 5 - Fair value measurement considerations (paragraphs 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

Agreed.

Question 6 - Collective evaluation of impairment (paragraphs 112 and 113A-113D)

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

Agreed.

Question 7 - Impairment of investments in available-for-sale financial assets (paragraphs 117-119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

No, we do not agree. This treatment is inconsistent with the provisions of IAS 36. If we can objectively determine that a debt or equity instrument has been impaired, there is no reason why the reversal of an impairment cannot be determined as objectively.

Question 8 - Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

No comments.

Question 9 - 'Basis adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

No comments.

Question 10 - Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

No comments.

Other comments

Comment No. 1

IAS 25.45 to 25.47 catered for the circumstances of specialised investment enterprises whereas the latter's constitution prohibits the distribution as dividends of profits on disposal of investments and requires a distinction to be drawn between income arising from interest and dividends and the gains and losses arising on the disposal of the investments. These enterprises exclude from income all changes in value of investments whether or not they are realised. IAS 25 has been superseded and accounting for such investments now falls under IAS 39.

The draft IAS 39 provides that changes to the fair value of financial assets should be recognised in the profit or loss for the period if the financial assets are classified as held-for-trading. For those assets classified as available-for-sale, fair value changes are recognised directly in equity until the financial assets are derecognised at which time the cumulative gain previously recognised in equity is recognised in the profit or loss for the period.

For those specialised investment enterprises where the constitution excludes from income all changes in value of investments, while the enterprise can always transfer the profit from retained earnings to reserve if a profit is made on disposal, in the case of a loss arising on disposal, transfer of the loss from retained earnings to reserve is not allowed. The effect is a reduction in the retained earnings of these enterprises thereby affecting their ability to distribute dividends.

We believe that the Standard should be amended to reintroduce the provisions regarding Specialised Investment Enterprises set out in IAS 25.

Comment No. 2

The transitional provision of the existing IAS 39, (IAS 39.172(d)) prescribes that at the beginning of the financial year in which IAS 39 is applied, any adjustment of the previous carrying amount should be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which this standard is initially applied. This also applies even if the entity chooses the policy of reporting all fair value changes in equity.

The transfer of any unrealised gain to retained earnings has the effect of making this unrealised balance available for distribution and may lead to an abusive distribution policy. In addition the transfer is not consistent with the accounting treatment to report further fair value changes to equity as allowed by the existing IAS 39 and as required in the draft IAS.

It would make more sense to recognise this adjustment as an adjustment to a "fair value reserve"

We therefore welcome the transitional provision (para. 39.171) that the Standard shall be applied retrospectively and that “The opening balance of retained earnings for the earliest prior period presented and the other comparative amounts shall be adjusted as if the Standard had always been in use.”

Comment No. 3

Paragraph 172
Question 172- 1
Transition rules: available- for- sale financial assets previously carried at cost

If available-for-sale (AFS) financial assets previously had been carried at cost, IAS 39.172(d) requires that on initial application of IAS 39 the adjustment to fair value should be an adjustment of retained earnings. If an enterprise had made the accounting policy choice under IAS 39.103(b)(ii) of reporting fair value changes of AFS assets in equity, the cumulative gain or loss on that asset that has been recognised directly in equity, including the amount of the adjustment of retained earnings on initial application of IAS 39, is included in net profit or loss for the period at the time the AFS asset is sold.

Apart from affecting earnings per share in the period of the sale, the transfer from retained earnings into the profit or loss for the period does not seem to serve any other purpose. It is not practical to keep track of the amount relating to an AFS previously adjusted to retained earnings and if the adjustment has already been distributed as discussed in Comment No 2, then no transfer will be possible and this defeats the purpose of showing the effect on the profit on sale of the AFS.

In addition, the recycling of gain on disposal (with reference to cost) through the income statement is inconsistent with IAS 16 whereby only the difference between the disposal proceeds and the carrying amount is taken to the profit or loss for the period.

We believe that there should be no recycling from fair value reserve and retained earning to the profit or loss for the period.

Comment No 4

Paragraph 172
Question 172- 3
Transition rules: previous revaluation under IAS 25

Prior to IAS 39, an entity measured certain investments at fair value under IAS 25 and reported the revaluation gains directly in equity.

If the entity adopts the policy of reporting changes in fair value in net profit or loss or directly in equity until the investment is sold, collected, or otherwise disposed of, the pre- IAS 39 revaluation gain that had been reported in equity will continue to be reported as a separate component of equity if the investment is classified as AFS.

The transitional provision of the existing IAS 39 could result in a situation whereby an entity which had revalued its investments prior to IAS 39 to an amount which was not quite the fair value, would have:

(i) its pre-IAS 39 revaluation gain reported in equity to be reported as a fair value reserve in equity;
(ii) the difference between the carrying amount (which is the revalued amount but not the fair value) and the fair value under IAS 39 to be transferred to retained earnings on first time application of IAS 39; and
(iii) future changes in fair value to be reported in equity (if the company adopts this policy of reporting changes until derecognition).

Such a bizarre situation of having the gains on an investment being reported in various reserves with varied consequences on the distribution ability would be resolved by requiring any adjustments to be made on initial application of IAS 39 to a "fair value reserve".

Comment No 5

Paragraph 69(c), 101 and 102 – Draft IAS 39

IAS 39.69(c) provides that investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured shall be measured at cost. In practice it is extremely difficult to decide when the variability in the range of reasonable fair value estimates is so significant or the probabilities of the various estimates within the range cannot be reasonably assessed and used in estimating fair value.

In Mauritius, we have a large number of investment holding companies that have invested in companies in China, India, Indonesia, Malaysia, Thailand, Zimbabwe, etc.

In lesser-developed countries, an “accurate and reliable” fair value cannot be found due to the fundamental subjectivity of estimates made in the valuations e.g. volatility of markets for EBIT and P/E, lack of corporate governance, accuracy of projected results/cash flows, etc. Management, including managers of funds, are generally reluctant to fair value such investments. The result of this is that a large number of audit reports will be qualified for non-compliance with IAS 39.

Given the difficulties of assessing fair values in these markets, we believe that the exemption from fair valuing in paragraphs 69(c), 101 and 102 should be extended to cover these situations.

Comment No. 6

Paragraph 62 should be clarified. The last sentence gives the impression that the debtor will have to recognise 2 liabilities and no asset.