CL 155A

SPEAKING NOTES FOR THE IASB ROUNDTABLE

There are in issue a variety of capital instruments which can be constructued with identical economic substance for the issues, viz.,

- Preference shares
- Directly issued preferred securities
- Indirectly issued preferred securities (using an SPE).

The key advantage to the issuer is that the coupon payments for directly and indirectly preferred securities are tax deductible in some jurisdictions but the securities are identical as far as the holder is concerned.

At present, there can be different accounting treatments for each of these instruments under IAS, UK and US GAAP. Some can be treated as equity, with coupon payments treated as distributions and others as debt with coupon payments treated as interest.

There are two ways of looking at the debt/equity issue:

1. Equity instruments should be only those instruments that have a residual interest in the assets of the entity after deducting liabilities and all other instruments are liabilities (this view would make preference shares liabilities); or alternatively

2. Equity instruments should be only those instruments where there is no <u>legal</u> obligation to repay principal or to make a coupon payment.

That is, the issue can be resolved by looking either wholly at the definition of a liability or wholly at the definition of equity. It is not clear that either approach will ensure instinctively correct classifications in all circumstances. Tensions between the definitions will form a large part of the longer-term project In the short term, I believe it is possible to base the split on the definition of a liability.

There is, however, the further question of what economic compulsion is and whether it provides sufficient reason to create a liability.

Economic compulsion can range from adverse business consequences of not acting (for example, stopping or reducing a dividend on ordinary shares) to incurring a penalty (for example, a prohibition on payment dividends on ordinary shares while dividends on preference shares are in arrears, or a step-up clause which increases coupon payments after a period of time for directly or indirectly issued preferred securities). However, any description of economic compulsion must explain why the dividends on ordinary shares are not within range.

Barclays' view is that all instruments with the same underlying economic effect should be accounted for in the same way, irrespective of their legal form. We accept that the line could be drawn in different places. The key is that there is consistent treatment of economically identical instruments.

Therefore, we were surprised to see the removal of the second part of paragraph 22 of IAS 32 in the proposed amendments. The original text helped define what is meant by economic compulsion and made clear that a preference share subject to economic compulsion should be treated as a liability. The removal of that text now casts doubt as to the Board's intention. We believe that either the example in the original text should be reinstated in some form, if that reflects the Board's intention, or that it should be made clear what the Board does in fact mean. (If, for example, the Board believes that economic compulsion does not create classification as a liability where there is no legal obligation, it should say so clearly.)

The principles should apply consistently to the variety of legal forms which can be created to achieve identical underlying economic substance.

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