

IAS 32 and IAS 1 Amendments
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

The Association of
Investment Companies
24 Chiswell Street,
London EC1Y 4YY
Telephone 020 7282 5555
Fax 020 7282 5556
enquiries@theaic.co.uk
www.theaic.co.uk

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Dear Sir / Madam

**Exposure draft of proposed amendments IAS 32 and IAS 1:
Financial instruments puttable at fair value and obligations arising on liquidation**

The Association of Investment Companies (AIC) is the trade body representing some 300 investment companies, managing assets of over £60bn.

Our Members are closed-ended investment companies whose business is to invest in a diversified portfolio of shares and securities, property and other assets. Many of our Members, therefore, both invest substantially in financial instruments, as well as issue financial instruments. Our responses to the specific questions are set out in the **attached** Annex. We set out some more general comments below.

As our Members do not issue financial instruments puttable at fair value, our comments, unless otherwise stated, should be construed as referring to obligations arising on liquidation.

Background

Unlike most open-ended funds, investment companies are generally not restricted in the types of shares they can issue. Investment company capital structures vary enormously, with some companies having a single class of share and others two or three different classes, each with different rights as to the income and capital profits arising on the underlying investment portfolio. It follows that IAS 32 and IAS 39, and questions relating to the classification of share capital as equity or liabilities, are of extreme importance to our Members.

In addition, perhaps uniquely for listed companies, many of our Members were formed with a limited life (e.g. a company is launched with a fixed life of, say, 10 years with the intention that, at the end of that period, it will be wound up unless, at that time, shareholders decide something else).

As a further complication, many of our Members who do not have a fixed life have offered a regular 'continuation vote' to their shareholders. This means that shareholders are given the formal opportunity to determine the future of the company, up to and including liquidation, at regular intervals, even, in some cases, annually. We are aware that questions have been asked as to whether a company with a continuation vote should fall to be treated as a quasi fixed life entity, although to date we understand that no conclusion to this effect has been reached.

Following the introduction of IAS 32, many stakeholders in the industry, whether it be directors, shareholders, analysts, auditors or others, were perplexed when it finally emerged (and it was a very long process before a consensus view did emerge) that most of our Members formed with a limited life would be presenting their primary statements with no equity. It is no exaggeration to say that the "consensus" view of the auditing profession went full circle (from liability to equity and then back again) on more than one occasion over a period of many months, creating great uncertainty.

Where individual Members were concerned, a final view was only reached after detailed analysis of the precise terms of the Articles of Association, and in some cases legal opinions being sought as to the nature of a "contractual obligation". In some cases, similar shares, which are essentially identical in terms of the function they perform, and how they were viewed by investors and management, were classified differently as a result of nuances in the wording of the liquidation provisions of the relevant company's Articles. We are not convinced that this is what is intended by the principle of "substance over form".

General comments on proposals

Unfortunately, due to the complicated and largely prescriptive nature of the proposed changes, we believe that this unwelcome episode is likely to be repeated. After long consideration of the proposals, we have found it extremely difficult to reach any firm conclusions as to whether the proposals would enable limited life investment companies with a split capital structure to classify any of their shares as equity. Even if we could reach a view, and this was one which was shared by the auditing profession, we have no confidence that a different view would not emerge at a later date.

Such an analysis would again require a detailed and exhaustive analysis of the Articles of Association, to establish whether any form of "preferential right" exists (and it is not clear from the text whether this is limited solely to preferential rights to assets of the company, though it does not appear to be the case). We expect that, buried within the Articles of some of our Members, such rights might well exist. We are not certain whether some of our Members have any "most subordinated class of share", as some companies issue shares which have competing claims to the assets of the company depending on the circumstances arising on liquidation. Our assumption, therefore, is that none of these share classes could be classified as equity.

Even if one class of share is classified as equity, we believe that it might still be possible for the entity to be showing negative net assets in the circumstances where the

assets of the company are insufficient to meet its obligations to its other classes of share, even though:

- a) those obligations will ultimately be based on rights and entitlements set out in the entity's articles and generally be limited to assets available. This limiting factor is not expected to be reflected in the balance sheet value of share classes treated as liabilities; and
- b) those obligations will only become payable on a wind-up of the entity.

We believe that the vast majority of shareholders wish to see the financial statements reflect their entitlement to the assets based on the entity's articles reflecting the current financial status of the entity.

Given the complications described above, and difficulties of interpretation, we are unable to recommend specific drafting changes. We have therefore taken a different approach.

Key recommendation

For reasons which we expand on in the Annex, **we recommend that the definition of a financial liability excludes any contractual obligation arising in respect of shares which only results in an outflow of resources on the liquidation of the entity regardless as to whether or not the share class is the most subordinated.** We believe that this proposal would better reflect the reality of what distributions on liquidation are and how they are perceived by the financial reporting community and other stakeholders.

If this proposal is not acceptable, we would be grateful to understand the IASB's reasoning as to why it considers that this more straightforward approach does not achieve the desired outcome.

Conclusion

If you have any questions on our response, or require any further information, please do not hesitate to contact me on 020 7282 5605 or john.stevens@theaic.co.uk.

Yours sincerely



John Stevens
Finance Director

The Association of Investment Companies

Responses to Specific Questions

Question 1 – Financial instruments puttable at fair value

Our Members do not issue financial instruments puttable at fair value. However, we are broadly supportive of the proposals and consider that other parties are better placed to comment on the specific wording.

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

As explained in our covering letter, we are unable to give a definitive view of whether the proposals would achieve a desirable outcome, as we believe that there are too many variables and questions of interpretation that would need to be resolved. However, our expectation is that the proposals would not result in the desired outcome for a number of limited life companies.

We therefore recommend that the definition of a financial liability excludes any contractual obligation arising in respect of shares which only results in an outflow of resources on the liquidation of the entity.

Reasoning

The requirement to present share capital as a liability presumably arises from the desire to report to users of the financial statements the fact that the reporting entity faces, at some point in the future, a reduction in the economic resources that it can exploit.

This view is supported by the definition of a liability, namely:

“A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.”

However, in the case of a liquidation, when looked at from the reporting entity’s perspective, there is no “outflow of resources” in any meaningful sense, as it is inherent in the nature of a resource that it is something an entity is capable of exploiting for its own benefit. Before liquidation there will be no contractual outflow of resources. In liquidation the liquidator’s task is simply to liquidate the assets and return them to shareholders in accordance with their established rights. The entity itself has no say over how these “resources” are deployed.

Similarly, highlighting the fact that there is an expected “outflow of resources” in respect of shares, when these only arise on liquidation, is of little value to users of the accounts, as the entire “resources” of the company will be distributed in one way or another on liquidation.

We therefore see no reason why contractual obligations arising in respect of shares which only result in an outflow of resources on the liquidation of the entity cannot simply be ignored for the purposes of determining whether a share should be classified as an equity or a liability and that such shares should automatically be classified as equity.

Question 3 - disclosures

With regard to the additional disclosures, we are broadly in favour of what is proposed.

With regard to disclosure generally, we would make the point that current disclosure in circumstances where an investment company has no equity is confusing and unhelpful to all parties. A 'one sided' balance sheet or a balance sheet that stops at the 'net assets attributable' line is difficult for users to understand, particularly when details of share capital is still shown in the notes.