STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Comment letter feedback—puttable exception and IFRIC 2 instruments		
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Objective

1. In this paper the staff summarise the detailed feedback received from comment letters and outreach with stakeholders on Question 4 of the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP) which deals with the puttable exception in IAS 32 *Financial Instruments: Presentation* (requires issuers to classify financial instruments with particular features as equity, even though the instruments meet the definition of a financial liability). Feedback from users of financial statements has been incorporated where appropriate and mentioned separately. This paper also summarises the detailed feedback received from comment letters and outreach on instruments in the scope of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* (IFRIC 2 instruments or members' shares or co-operative shares).

2. This paper is structured as follows:

   (a) Background and questions in the DP (paragraphs 3-8);

   (b) Key messages (paragraphs 9-13);

(c) Puttable exception (paragraphs 14-39); and

(d) IFRIC 2 instruments (paragraphs 40-49).

Background and Questions in the Discussion Paper

3. The Board's preliminary view set out in the DP is that particular requirements of IAS 32 should be carried forward largely unaltered, including:

   (a) the exception to account for some financial liabilities as if they are equity instruments if they meet the conditions as set out in paragraphs 16A–16B or 16C–16D of IAS 32 (puttable exception); and

   (b) the conclusions in IFRIC 2.

Puttable exception

4. Applying the Board's preferred approach in the DP without any exception, an instrument that can be put back to the entity would meet the definition of a financial liability because the instrument contains an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation. The same conclusion would also apply to financial instruments that contain an obligation to deliver a pro rata share of the net assets of the entity only on liquidation, if liquidation is at a specified time or at the option of the instrument holder.[1] Although such instruments impose an obligation only on liquidation, because liquidation is at a specified time (as with for example, a limited life entity) or liquidation is at the option of the holder, the entity has a contractual obligation to transfer cash or another financial asset at a specified time. In this paper we refer to instruments described in this paragraph as 'puttable instruments'.

[1] The DP (footnote 24) states that if liquidation is contractually specified, such as in a limited-life entity, or occurs in tandem with a particular event or at the option of the holder, information about obligations to transfer economic resources at such dates will also be relevant to assessments of funding liquidity and cash flows. For the purposes of the DP, liquidation does not include contractually specified liquidation. Therefore, references to contracts that require a transfer of economic resources only at liquidation include only perpetual contracts.

5. As described in the DP, the puttable exception would continue to be required under the Board's preferred approach. The Board came to this view because:

   (a) applying the Board's preferred approach to financial instruments that meet the exception might address some, but not all, of the previous concerns that led to the inclusion of the exception in IAS 32. In particular, the incomplete recognition and measurement of assets and liabilities means that if at least one claim is not recognised and measured as a residual, the usefulness of the statement of comprehensive income is reduced.

   (b) the scope of the puttable exception is restricted to a narrow set of circumstances in which no other financial instrument or contract is more subordinated and holders of the puttable instruments represent the most residual interest in the entity's net assets.

   (c) the Board is not aware of any significant issues with the application of the puttable exception as set out in paragraphs 16A–16B or 16C–16D, of IAS 32.

6. In addition, the Board noted the current disclosure requirements in paragraph 136A of IAS 1, which provide some information on the entity's redemption obligations relating to puttable instruments so that users of financial statements can estimate the potential cash outflows from these instruments. If the puttable exception is retained, the Board therefore thinks the disclosure requirements in paragraph 136A of IAS 1 should also be retained.

7. The feedback described in this paper related to the puttable exception is based on the responses provided by stakeholders on the following question in the DP.

> **Question 4**
>
> The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

IFRIC 2 instruments

8. As stated in IFRIC 2 and as noted in the DP, IFRIC 2 was developed for a specific fact pattern. In developing the DP, the Board decided not to reconsider that interpretation, nor apply the analysis in that interpretation more broadly. Paragraph 1 of IFRIC 2 states:

> Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to…as 'members' shares'.

Key messages

9. Most of the respondents to Question 4 in the DP agreed with retaining the puttable exception. However, some respondents disagreed with the proposal and suggested some alternative approaches that would overcome the need for the puttable exception.

10. Some respondents that agreed with retaining the puttable exception highlighted application issues arising in practice for example, relating to identifying the most subordinated instrument or determining whether puttable instruments have identical features and recommended the Board provides guidance to address these application challenges. A few respondents that disagreed with retaining the puttable exception suggested the Board undertake further work to establish the extent to which the puttable exception is used in practice, the application challenges arising from it and whether potential improvements to paragraphs 16A-16D of IAS 32 could be identified before deciding whether to retain the exception.

11. Some respondents considered the impact of the puttable exception on classification of financial assets in IFRS 9 *Financial Instruments* from the holder's perspective and encouraged the Board to assess whether the classification

criteria from the holder's perspective should be the same as from the issuer's perspective.

12. Almost all the respondents that commented on the classification of IFRIC 2 instruments strongly supported the requirements in IFRIC 2 being carried forward and believed that co-operative shares that meet the IFRIC 2 conditions and represent the most subordinated claim should be classified as equity under any classification approach.

13. Some respondents were concerned that the Board's proposals with respect to the amount feature would affect the equity classification outcome of IFRIC 2 instruments.

Puttable exception

14. We received feedback on this issue from over 80% of all respondents that sent comment letters. Respondents said that the classification of puttable instruments is relevant to many entities including investment funds, investment trusts, mutual investment structures, collective investment schemes, mutual funds, co-operative banks and co-operatives, finite life entities, partnerships, real estate investment trusts and private equity limited life vehicles.

Respondents that agreed

15. Most respondents agreed that the puttable exception should be retained. In addition to agreeing with the Board's rationale explained in the DP (see paragraph 4), respondents provided the following reasons:

    (a) the puttable exception and the related disclosures in IAS 1 help provide useful financial information. Financial statements prepared without any equity (except for undistributed income) will be counter-intuitive and can be misleading.

    (b) the puttable exception is restricted to a narrow set of circumstances so the possibility of its misuse is limited. Also, the stringent criteria mean that not meeting the puttable exception will ensure classification as a financial liability in some circumstances which would provide information relevant to assessing funding liquidity and cash flows for users of financial statements.

(c) the qualifying criteria are generally reasonably well understood.

(d) retaining the exception will result in classification outcomes consistent with IAS 32. It is therefore a pragmatic solution consistent with the scope and objective of the project.

(e) removing the puttable exception could lead to a significant reduction of equity in some entities which could potentially lead to negative consequences on financial markets.

16. Many of the respondents that agreed with retaining the puttable exception still believed that including an exception undermines the Board’s principles-based approach to standard setting. A few respondents said that the fact the exception is still needed is in their view an additional indicator that the Board’s preferred approach is not the optimal solution or is not superior to IAS 32 and the Board should only replace existing standards if a new accounting model is conceptually sound (ie not requiring exceptions). Some respondents expressed the preference for having a consistent set of principles that could be applied across all financial instruments with similar economic characteristics instead of requiring an exception to accommodate specific types of instruments. They said that having an exception reduces comparability and increases the complexity of financial statements. However, in spite of this preference or subject to them understanding how much the puttable exception is actually used in practice or the Board finding an alternative approach that does not require an exception, they believed retaining the exception has merit and therefore supported it.

17. A respondent that agreed with retaining the puttable exception, believed that a part of equity representing the present value of the puttable obligation should be distinguished within equity using a separate line item in the financial statements to make it clear to users of financial statements how much would have to be paid out on request of the instrument holders.

18. A few users of financial statements specifically mentioned that they would support the retention of the puttable exception.

19. A few respondents urged the Board to consider expanding the term ‘liquidation’ in the timing feature of the classification principles to include ‘contractually specified liquidation’. They noted that doing so would eliminate the need for the exception in paragraphs 16C and 16D of IAS 32 for example, for finite life entities. They further noted that to the extent that financial statements are prepared on the going concern assumption, there may be little basis for a different classification of a claim representing a residual interest at liquidation, depending on whether liquidation is contractually specified or an indefinite event.

20. An accountancy body suggested the Board reviews the use of the puttable exception and the necessity for anti-avoidance amendments to be included. This is because they had some concerns that the puttable exception has been used for structuring transactions.

21. Another respondent pointed out that some of the wording of the puttable exception conditions will need to be revised to align them with the revised financial liability and equity definitions if the Board moves forward with the preferred approach in the DP.

Respondents that disagreed

22. Some respondents disagreed with retaining the puttable exception because they believe:

    (a) the puttable exception is inconsistent with the classification principles proposed in the DP and retaining it implies the proposed classification principles can be improved to accommodate all classification outcomes.

    (b) the puttable exception is a rule-based requirement which introduces inconsistency and reduces comparability between entities. They are concerned this is also contrary to the Conceptual Framework which says the definition of equity (the residual interest in the assets of the entity after deducting all its liabilities) applies to all reporting entities.

    (c) the consequence of applying the principles (eg no equity is presented) is not counterintuitive if it reflects the actual contractual terms of the instruments. The presentation as financial liabilities would present more relevant information from a cash flow perspective to meet obligations and measuring the liability at fair value would provide updated information on the transaction.

(d) the puttable exception has limited application due to its strict application limitations so some entities would still be without equity.

23. Some respondents who do not favour having an exception to a classification principle suggested some alternative approaches that would overcome the need for the puttable exception. The following suggestions were made:

(a) include a third classification principle (in addition to the timing feature and the amount feature) that at least one claim should be recognised and measured as the residual (ie the most residual claim is always equity).

(b) amend paragraph 10 of IAS 1 to add a new component of financial statements—a Statement of Changes in Assets/Liabilities for entities that have instruments with the features in paragraph 16A and 16B of IAS 32. Another respondent also said they would prefer the Board develop a presentation solution rather than continuing with a narrow exception.

(c) expand the definition of equity to include eg ownership interests in partnerships and unit trusts considering that a redemption option for ownership interests in various forms of entities is very common in practice.

(d) amend the timing feature for liability classification by adding the requirement that the specified point in time to transfer cash or another financial asset has to be predefined on contract inception. This would mean that instruments that are puttable at any time eg partnership interests would not meet the timing feature for liability classification.

Application challenges of the puttable exception

24. One of the reasons the Board proposed to retain the puttable exception in IAS 32 without any changes was because it was not aware of any issues with the application of the puttable exception. However, several respondents provided

feedback on application challenges experienced with the exception in accordance with the current requirements. Although these application challenges do not result from the proposals in the DP, the staff have included the feedback in the analysis as it may be relevant in the context of other feedback.

25. Some respondents noted that several requests have been made to the IFRS Interpretations Committee arising from the application of paragraphs 16A-16F of IAS 32 and in particular, relating to practical difficulties in identifying the most residual or subordinated instrument. These respondents encouraged the Board to reconsider the scope of the puttable exception because of the number of instruments that do not qualify for the exception and provide guidance to address these application challenges.

26. An accounting firm noted that in practice only a very narrow set of instruments have qualified for the puttable exception because many puttable instruments contain terms that fail the strict qualification criteria. Common features they have seen fail the puttable exception are:

    (a) Where the puttable instrument is not the most subordinate class because of the existence of a small class of ‘founder shares’;

    (b) Where there are two equally subordinate classes of puttable instruments with non-identical terms; and

    (c) Where the puttable instruments contain other liability features such as an obligation to distribute current period profit on the holder’s demand based on a pro rata share of the entity’s profit or distribute all taxable income as mandated by the entity’s constitution.

27. Similarly, a few other respondents also mentioned ‘founders’ shares’. These respondents explained that some funds have ‘founders’ shares’, ‘management shares’ or perpetual instruments which legally may be the lowest subordinated claim. However, they are usually of a minimal amount, have no voting and distribution rights and merely exist to facilitate the start-up of the fund. Some practitioners believe presenting these shares as the equity of the funds is misleading as they are not considered to be the 'real equity' of the funds as they do not represent an interest in the net assets of the entity. Another respondent questioned whether the puttable exception could be applied in a scenario where

there is a more subordinated equity class but on a scale much smaller and nominal in value than the class of puttable instruments issued for example, ordinary shares issued to meet minimum requirements for legal purposes but do not support the scale of economic activities of that entity.

28. A few respondents also noted that most funds do not evaluate their financial position based on equity/liability classification under the puttable exception. Instead the alternative presentation of the statement of financial position for entities that do not have equity in Example 7 of the Implementation Guidance to IAS 32 gives sufficient useful information to users of financial statements.

29. An accounting firm gave an example of a subsidiary's shares that are exchangeable at any time by the holder for the parent's puttable shares and questioned whether it is generally appropriate for puttable instruments issued by a subsidiary not to qualify for the exception just because they are not the most subordinate instrument issued by the group.

30. A standard-setting body believes the criteria in paragraph 16B and 16D of IAS 32 allows for ambiguous interpretation depending on how an entity evaluates the implications that its other financial instruments may have on the puttable instrument and whether it meets the puttable exception in the presence of these other financial instruments. This respondent gave the example of partnerships with general partnership managers that have contracts with the entity which stipulate that the management fees are based on the change in the recognised net assets or the change in the fair value of recognised net assets of the partnership. The question arises whether this management contract results in a breach of the criteria in paragraph 16B and 16D of IAS 32.

31. This respondent also explained that there are challenges in determining whether puttable instruments have identical features for example, there may be different voting rights for two series of otherwise identical puttable instruments or different fee structures depending on whether the instrument is issued to a wholesale or retail investor but all other terms impacting the future cash flows of the instrument are identical. This respondent therefore questioned whether the criterion in paragraph 16A(c) of IAS 32 should be narrowed to only require identical features

for those characteristics which have a direct impact on the future cash flows due to the puttable instrument holder.

32. A few respondents commented that the current requirements of the puttable exception do not accommodate members' shares in some co-operatives and the Board should consider reviewing and expanding the scope of the puttable exception. This is because not all countries have amended their co-operative laws or governing charters to introduce members' shares whose redemption can be refused unconditionally by the co-operative. As a result, these co-operatives present no claim as equity.

Disclosures

33. Some respondents specifically noted that the disclosure requirements in paragraph 136A of IAS 1 provide useful information to users of financial statements about the expected future cash flows from puttable instruments and that they should be retained irrespective of whether the puttable exception is retained or not.

34. A few respondents said that paragraph 136 of IAS 1 should clearly state that it applies to instruments covered by paragraphs 16C and 16D of IAS 32.

Interaction with IFRS 9 classification

35. IFRS 9 permits an entity to make an irrevocable election to present in OCI changes in the fair value of any investment in equity instruments that is not held for trading (referred to as the OCI presentation election). Paragraph BC5.21 of IFRS 9 specifies that the term 'equity instrument' is defined in IAS 32. The Board noted that in particular circumstances a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity but such instruments do not meet the definition of an equity instrument. This means that holders of instruments that meet the puttable exception cannot use the OCI presentation election.

36. In line with this, some respondents specifically noted that the distinction between equity and financial liabilities is not only relevant from an issuer's perspective but

also from a holder's perspective. One of these respondents, while agreeing that both liquidity and solvency are determinant to classify an instrument as a liability or equity, believed that what matters from a holder perspective is whether the holder is exposed to share price risk or to credit risk.

37. A few respondents explained the practice issues arising from the requirements in IFRS 9 ie instruments that meet the puttable exception will not be eligible for the OCI presentation election and would also not meet the solely payments of principal and interest (SPPI) condition in IFRS 9. This would result in the instruments having to be measured at fair value through profit or loss for example, shares with a finite lifetime are classified as financial assets measured at fair value through profit or loss. In their view this could increase the volatility in profit or loss and deter long term investors from using such instruments.

38. These respondents therefore encouraged the Board to assess whether the classification criteria from the holder's perspective should be the same as from the issuer's perspective and believed that a further clarification of the concepts 'classification', 'presentation' and 'definition' would help remove the classification asymmetry by the holder and the issuer of the same instrument. A respondent observed that IAS 32 requires the issuer to apply a two-stage process (definition and then classification) for these puttable instruments, but the holder only applies a one-stage process (definition).

39. Some respondents added that the Board should consider eliminating paragraph BC5.21 of IFRS 9 or permitting the OCI presentation election to investments in instruments which qualify for the puttable exception. A respondent explained that the amount criterion may be the most relevant from a holder's perspective since holders pay attention to the potential variability of the expected return on their investments. According to their view, puttable instruments that meet the amount criterion could be eligible for the OCI presentation election.

IFRIC 2 instruments

40. We received feedback related to the classification of IFRIC 2 instruments from approximately 10% of all respondents that sent comment letters. The types of entities affected included co-operatives and mutual banks.

41. IFRIC 2 instruments have specific features which are consistent with the specific objective of co-operatives ie to meet the common economic or social needs of members. These instruments are classified as equity applying paragraphs 7−8 of IFRIC 2 if the issuer has an unconditional right to refuse redemption or redemption is unconditionally prohibited by regulation.

Support for the Board's proposal to carry forward IFRIC 2 conclusions

42. Almost all respondents that commented on the classification of IFRIC 2 instruments or the Board's proposal to carry forward the conclusions in IFRIC 2 unchanged, supported IFRIC 2's continued application. They emphasised that shares in co-operative entities that meet the criteria in IFRIC 2 and represent the most subordinated claims should continue to be classified as equity. This is also in line with a view that there should be at least one class of instruments classified as equity. In addition, some respondents specifically noted that the accounting classification of co-operative shares as equity is the basis for their recognition as CET 1 instruments under the current Basel Accord and should thus be preserved.

43. Most respondents also said they appreciated the Board's decision not to reconsider the conclusions in IFRIC 2.

44. However, some respondents said the Board's preferred approach to classification set out in the DP, the amount feature in particular, creates uncertainty around how it interacts with IFRIC 2. In explaining their concerns regarding the classification of IFRIC 2 instruments under the DP, some respondents noted that in their view, IFRIC 2 currently only deals with the timing feature of the Board's proposed approach. IFRIC 2 requires an entity to classify members' shares as equity if there is an unconditional statutory prohibition on redemption or the entity has an unconditional right to refuse redemption of the members' shares. This applies without reference to the amount that would be paid on redemption or liquidation.

These respondents raised questions about the interaction between the Board's proposals with respect to the amount feature and IFRIC 2 because they were concerned they might be affected by a change in classification of their members' shares especially if the amounts payable on liquidation are independent of the entity's available economic resources. They requested the Board to consider amending the wording of the preferred approach or amending IFRIC 2 if it retains the amount feature to address what occurs upon liquidation so that the equity classification outcome can be preserved.

45. Some respondents emphasised that the very specific features of co-operative shares should be considered by the Board and specifically, the fact that co-operative shares are the most subordinated claim in the event of liquidation. They highlighted that these instruments are considered in prudential regulations as equity and expressed the view that co-operative shares that meet the IFRIC 2 conditions and represent the most subordinated claim should be equity under any classification approach. They believed doing so will help avoid different interpretations across jurisdictions.

46. More than one respondent said they did not share the Board's view that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice. A respondent believes IFRIC 2 defines one parameter for equity classification for a vast number of enterprises all over Europe, which could otherwise have to face discussions regarding their capitalisation. Another respondent specifically disagreed that it has only limited effects because according to them the 300 biggest co-operative groups have a combined turnover of USD 2.400 billion.

47. However more than one respondent agreed that IFRIC 2 was developed for a very specific fact pattern and should continue to be applied for the scope it was originally designed for. A European preparer representative body said that they are not aware of any challenges to its application.

48. A regulator observed that members' shares in co-operatives that are redeemed at nominal value do not meet the puttable exception condition that stipulates a pro rata share of the entity's net assets in the event of the entity's liquidation. Therefore, in their view it was important to retain the equity classification in

IFRIC 2 which applies if local regulations or the entity's governing charter impose unconditional prohibitions on redemption.

49. Many respondents recommended incorporating and integrating IFRIC 2 into a revised version of IAS 32 (or an IFRS Standard that would result from this project, if the Board proceeds) to ensure that the treatment of co-operative shares is established at a fundamental level and to provide a stable framework for co-operative entities. These respondents said that only mentioning in the introduction of the DP that the interpretation will be retained may not be sufficient so they suggested introducing the reasoning and conclusions of IFRIC 2 into the standard itself.