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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

IASB Meeting: **22 February 2006, London**

Project: **Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation (Agenda Paper 5)**

PROPOSED DISCLOSURES (AGENDA PAPER 5)

Introduction

1. At its December 2005 meeting, the Board confirmed its decision to propose amendments to IAS 32 *Financial Instruments: Presentation* to require equity classification of financial instruments puttable at the fair value of a pro rata share of the net assets of the entity ('financial instruments puttable at fair value') and instruments that entitle the holder to a pro rata share of the entity's net assets payable on liquidation ('obligations arising on liquidation'), subject to specified conditions being met.

2. At that meeting, the Board requested that staff consider whether additional disclosures should be proposed, to accompany the proposed amendments to IAS 32.

3. This paper discusses disclosures for those instruments relating to:

   (a) rights attaching to the instruments;

   (b) reclassification between liabilities and equity;

   (c) capital; and

   (d) fair value.

4. For the convenience of Board members, the paper includes relevant extracts from IFRSs.

5. One issue to be considered is where the proposed disclosures should be located. The title of IFRS 7 *Financial Instruments: Disclosures* implies that all disclosure requirements relating to financial instruments reside in IFRS 7. However, the disclosures specified in IFRS 7 primarily relate to financial assets and financial liabilities. Disclosures relating to equity instruments are in IAS 1 *Presentation of Financial Statements*. [1] For example, IAS 1 requires disclosures about share capital and reserves (paragraph 76) and disclosures about capital management (paragraphs 124A-124C). Consequently, staff has proposed that the recommended disclosures be added to IAS 1 and not IFRS 7. However, an alternative is to add the proposed disclosures to IFRS 7 instead.

Rights attaching to the instruments

6. Paragraph 76(a)(v) of IAS 1 requires an entity to disclose, for each class of share capital, the rights, preferences and restrictions attaching to that class of instruments. Hence, for financial instruments puttable at fair value that are classified as equity under the proposed amendments, the entity will have to disclose those instruments' right to put the instrument to the entity at fair value, including any limitations on the right to put (eg a requirement to meet a solvency test). Partnerships with partners that have the right to require the partnership to liquidate and to receive a pro rata share of the net assets of the partnership on liquidation, will be required to disclose those partners' rights under paragraph 77 of IAS 1.

[1] The only disclosure relating to equity in IFRS 7 is when a compound financial instrument with multiple embedded derivatives contains an equity component (paragraph 17, which requires the disclosure of the features of a compound financial instrument with multiple embedded derivatives).

IAS 1 *Presentation of Financial Statements*

76. An entity shall disclose the following, either on the face of the balance sheet or in the notes:

- ***(a) for each class of share capital:***
  - ***(i) the number of shares authorised;***
  - ***(ii) the number of shares issued and fully paid, and issued but not fully paid;***
  - ***(iii) par value per share, or that the shares have no par value;***
  - ***(iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;***
  - ***(v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;***
  - ***(vi) shares in the entity held by the entity or by its subsidiaries or associates; and***
  - ***(vii) shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts; and***
- ***(b) a description of the nature and purpose of each reserve within equity.***

77. An entity without share capital, such as a partnership or trust, shall disclose information equivalent to that required by paragraph 76(a), showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest.

126. An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

- ***(a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);***
- ***(b) a description of the nature of the entity's operations and its principal activities; and***
- ***(c) the name of the parent and the ultimate parent of the group.***

7. Some may argue that it is unclear whether limited life entities are required to disclose their limited life under IFRSs, because there is no disclosure requirement specifically addressing this issue. It could be argued that paragraph 76(a)(v), or 77, of IAS 1 will require such a disclosure, because the shareholders have the right to receive a repayment of capital after a fixed or determinable period. Also, it could be argued that disclosure of the entity's limited life complies with the intention behind paragraph 126 of IAS 1 (see above), which requires disclosure of information about the entity, including its legal form, a description of the nature of the entity's operations and its principal activities. Furthermore, disclosure of the entity's limited life may be necessary to achieve a fair presentation of the financial position of the entity, as required by paragraph 13 of IAS 1.

8. Consequently, in the staff view, an entity with a limited life will be required to disclose that fact under IFRSs. However, if the Board concludes otherwise and would like to require this disclosure, staff recommend amending paragraph 126 of IAS 1 to achieve this.

Reclassification

> IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*
>
> **Disclosure**
>
> 13 When a change in the redemption prohibition leads to a transfer between financial liabilities and equity, the entity shall disclose separately the amount, timing and reason for the transfer.

9. IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* paragraph 13, requires disclosure of the amount, timing and reason for a transfer of members' shares in co-operatives between financial liabilities and equity, when the transfer is caused by a change in the redemption prohibition (see above). This disclosure is also useful when a financial instrument puttable at fair value or an instrument with an obligation arising on liquidation (affecting limited life entities and partnerships) is transferred between financial liabilities and equity.

10. Because the affected instruments have to meet strict criteria to qualify for equity classification, it is conceivable that reclassification may occur due to a change in an entity's capital structure or the instrument's conditions. To illustrate, a consequence of the "all instruments in the most subordinated class must be puttable" condition is that the classification of instruments puttable at fair value could be changed by the issuance or redemption of another class of financial instrument that is in the most subordinated class. For example, say a company has issued only one class of instrument (Class A), which is puttable at fair value and is classified as equity. At a later date, the entity issues a second class of instrument (Class B), identical in every way to Class A except it is not puttable. Immediately upon the issuance of any of the Class B instruments, all of the Class A instruments must be reclassified as financial liabilities. Furthermore, if at a later date all of the Class B instruments were repurchased or redeemed by the company, the Class A instruments would be reclassified back to equity.

11. Moreover, the disclosure of reclassification of the affected instruments between financial liabilities and equity is important as their categorisation affects their measurement (eg financial instruments puttable at fair value classified as financial liabilities will be measured at fair value, whereas financial instruments puttable at fair value classified as equity will not be remeasured).

12. However, the disclosure requirements in paragraph 13 of IFRIC 2 do not apply to the instruments affected by the proposed amendments, because those requirements specifically relate to a transfer of members' shares in co-operatives between financial liabilities and equity that is caused by a change in the redemption prohibition. Consequently, staff recommend that the following paragraph 75A (based on paragraph 13 of IFRIC 2) be added to IAS 1, after paragraph 75, to require disclosure of the amount reclassified, and the timing and reason for the reclassification of the affected instruments.

75A If an entity has reclassified:

(a) a financial instrument puttable at fair value; or

(b) an instrument with an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation;

between financial liabilities and equity, it shall disclose the amount reclassified into and out of each category (financial liabilities or equity),and the timing and reason for that reclassification.

13. The recommended disclosure above would be useful also for *all* instruments reclassified between financial liabilities and equity (eg convertible debt that is reclassified from liabilities to equity upon exercise of the conversion option). If the Board wishes, the reclassification disclosure proposed above could be expanded to include all reclassifications of instruments between financial liabilities and equity.

14. Staff notes that on first-time application of the proposed amendments, entities that reclassify financial instruments puttable at fair value as equity are required by paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (shown below) to disclose information so that users are able to assess the impact of the change on the financial statements. This is consistent with the disclosure requirements for first-time application of all new standards and interpretations.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

Disclosure

28. When initial application of a Standard or an Interpretation has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

- ***(a) the title of the Standard or Interpretation;***
- ***(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;***
- ***(c) the nature of the change in accounting policy;***
- ***(d) when applicable, a description of the transitional provisions;***
- ***(e) when applicable, the transitional provisions that might have an effect on future periods;***
- ***(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:***
  - ***(i) for each financial statement line item affected; and***
  - ***(ii) If IAS 33* Earnings per Share *applies to the entity, for basic and diluted earnings per share;***
- ***(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and***
- ***(h) if retrospective application required by paragraph 19(a) or (b) is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.***

Financial statements of subsequent periods need not repeat these disclosures.

Capital Disclosures

15. IAS 1 requires various disclosures about capital as set out below.

IAS 1 *Presentation of Financial Statements*

Capital

124A An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

124B To comply with paragraph 124A, the entity discloses the following:

(a) qualitative information about its objectives, policies and processes for managing capital, including (but not limited to):

(i) a description of what it manages as capital;

(ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and

(iii) how it is meeting its objectives for managing capital.

(b) summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (eg some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (eg components arising from cash flow hedges).

(c) any changes in (a) and (b) from the previous period.

(d) whether during the period it complied with any externally imposed capital requirements to which it is subject.

(e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

These disclosures shall be based on the information provided internally to the entity's key management personnel.

124C An entity may manage capital in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities, and those entities may also operate in several jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity shall disclose separate information for each capital requirement to which the entity is subject.

16. Paragraphs 124A-124C of IAS 1 require an entity to disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing its capital. In the staff view, the affected instruments (financial instruments puttable at fair value and instruments with obligations arising on liquidation) most likely will be considered to be part of an entity's capital and, therefore, will be subject to the disclosure requirements of paragraphs 124A-124C of IAS 1. However, because this is not certain and because there may be risks (eg. liquidity risk) arising from the ability of the holder of a financial instrument puttable at fair value to put the instrument to the issuer at any time, the staff recommend that the following requirements, which are based on paragraphs 124A-124B, be added to IAS 1 (after paragraph 124C):

<u>**Financial Instruments Puttable at Fair value**</u>

<u>124D For financial instruments puttable at fair value classified as equity, an entity shall disclose (to the extent not disclosed elsewhere):</u>

(a) <u>summary quantitative data about the amount classified as equity;</u>

(b) <u>its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;</u>

(c) whether the instruments are included in what the entity manages as capital;

17. Staff do not recommend that the above disclosure include instruments with an obligation arising on liquidation classified as equity (affecting partnerships and limited life entities), because these obligations arise only on the issuer's liquidation and hence, do not affect liquidity.

Fair Value

18. IFRS 7 paragraph 25 requires an entity to disclose the fair value of each class of financial assets and financial liabilities in a way that allows it to be compared to its carrying value. It also requires disclosures about the methods used to arrive at the fair values of each class of financial assets and financial liabilities. Those disclosures are equally relevant for financial instruments puttable at fair value because these instruments' price on issue, redemption or repurchase is fair value. Moreover, fair value disclosures for financial instruments puttable at fair value allow users to fully assess the risks arising from these instruments. Consequently, staff recommend the following amendments to paragraph 124D (new text is underlined) as set out below:

124D For financial instruments puttable at fair value classified as equity, an entity shall disclose (to the extent not disclosed elsewhere):

(a) summary quantitative data about the amount classified as equity;

(b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

(c) whether any of these instruments are included in what the entity manages as capital;

(d) the fair value of that class of financial instruments in a way that permits it to be compared with its carrying amount; and

(e) information about how fair value was determined, consistent with the requirements of IFRS 7 *Financial Instruments: Disclosures* paragraphs 27(a)-27(c), to the extent applicable.

19. At its December 2005 meeting, the Board decided to permit a non-public entity to use a formula to estimate the fair value of financial instruments puttable at fair value, upon issuance, redemption or repurchase of the instruments, provided that the formula is intended to approximate fair value. Therefore, for non-public entities that use a formula to estimate fair value, staff recommend requiring disclosure of this fact. Also, staff recommend requiring the entity to use the formula, and disclose information about the formula, for the purposes of complying with the proposed sub-paragraphs 124D (d) and (e). The proposed disclosure is shown below as paragraph 124E:

124E If an entity uses a formula to determine the price received or paid by the entity upon issuance, redemption or repurchase of financial instruments puttable at fair value that are classified as equity (as permitted by paragraph AG14A of IAS 32), it shall:

(a) disclose that fact, and

(b) use that formula, and disclose information about the formula, for the purposes of complying with sub-paragraphs 124D(d) and (e).

20. Staff do not recommend any fair value disclosures for instruments with an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation (affecting limited life entities and partnerships); because their obligations are conditional on the liquidation of the entity and hence, do not affect liquidity.

21. Some may argue that the cost of compliance would outweigh the benefits of requiring, at every reporting date, the proposed fair value disclosures for financial instruments puttable at fair value; because, in the majority of cases, these instruments are not traded on an active market and/or are issued or repurchased on an infrequent basis. Moreover, there are no current requirements to disclose the fair values of equity instruments.

22. However, staff note that the cost of compliance would not *increase* for entities currently applying IFRSs because financial instruments puttable at fair value are classified as financial liabilities under IAS 32 at present, and therefore these entities are required to disclose information about fair value under IFRS 7. Consequently, it is only entities that are adopting IFRSs for the first time (and that are not disclosing the fair values of financial instruments puttable at fair value under local GAAP) that will be subject to an *increase* in compliance costs due to the recommended disclosures. Furthermore, the compliance costs of the recommended disclosures will be minimal for non-public entities that calculate the fair value of financial instruments puttable at fair value using a formula. However, given that fair value disclosures are not required for other types of equity instruments, the proposed disclosures will result in a *continuation* of compliance costs, which otherwise would have been reduced when the instruments are classified as equity under the proposed amendments.

Alternative fair value disclosures

23. If the Board concludes that the costs outweigh the benefits of the recommended disclosures, staff recommend, as a compromise, that *the most recent* fair value (last calculated on issuance, redemption or repurchase of a financial instrument puttable at fair value) be required to be disclosed instead of the fair value *at every balance date*. This

alternative could be applied to non-public (unlisted) entities only, or to all entities.[2] The most recent fair value (calculated on issuance, redemption or repurchase) of financial instruments puttable at fair value is readily available and would not marginally increase the cost of compliance for the entity.

24. If the Board agrees with this alternative recommendation, staff also recommend that entities be required to disclose the date of the most recent fair value determination. This information will allow users to be able to judge the relevancy of the fair value disclosures for financial instruments puttable at fair value.

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[2] In other words, the Board could require public (listed) entities to provide information about fair value calculated at each balance date, but permit non-public (unlisted) entities to provide information about the most recent fair value, calculated on the most recent issue, repurchase or redemption of a financial instrument puttable at fair value.