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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation (Agenda Paper 8)**

SWEEP ISSUES

Introduction

1. In February 2006, the Board considered a staff draft of proposed amendments to IAS 32 *Financial Instrument: Presentation* to require equity classification for 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 (affecting partnerships and limited life entities) ('obligations arising on liquidation'), subject to these instruments meeting specified criteria.

2. The paper considers sweep issues arising from the pre-ballot draft circulated in February. They are:

   (a) the formula to determine the fair value of financial instruments puttable at fair value issued by an entity that is not publicly accountable;

   (b) appropriate guidance for determining fair value;

   (c) the issue price of an ordinary share puttable at fair value issued upon conversion of a convertible bond; and

(d) the analysis of benefits and costs of the proposed amendments.

3. For the convenience of Board members, the paper includes relevant extracts from IFRSs and the proposed amendments.

Formula to determine fair value of financial instruments puttable at fair value

4. At its December 2005 meeting, the Board decided to permit an entity that is not publicly accountable 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.

5. A national standard-setter has requested clarification of whether an instrument's pro-rata share of net assets of the entity at book value (which are measured under IFRS) qualifies as a formula that is intended to approximate fair value and, therefore, can be used to determine the fair value of a financial instrument puttable at fair value for entities that are not publicly accountable.

6. Some argue that it should be acceptable to use a formula based on the book value of the entity's net assets as an approximation of fair value. Moreover, book value may be a good proxy for the fair value of the net assets of the entity when there are no material unrecognised assets (eg goodwill and other intangible assets) and liabilities, and the majority of recognised assets and liabilities of the entity are measured at fair value under IFRS.

7. Others argue that book value cannot be used to approximate the fair value of the net assets of the majority of entities because typically there are material unrecognised assets (eg intangibles), and often many recognised assets and liabilities are not measured at fair value under IFRSs. Instead, they interpret that a formula that is meant to approximate fair value means those formulas that are commonly used by industry to value entities (eg P/E multiples).

8. Staff understood, from the Board's deliberations at its December 2005 meeting, that using a pro rata share of net assets of the entity at book value is not considered to be a formula that approximates fair value, except in rare cases when the fair value of an entity's net assets is not materially different from its book value. Hence, as a result of the comment received from a national standard setter, staff recommend the

following amendment to paragraph AG14A of the proposed amendments (new text is underlined) to clarify this point:

Financial instruments puttable at fair value

AG14A For a financial instrument to be a financial instrument puttable at fair value, the issue price received, or the redemption or repurchase price paid, by the entity for the financial instrument is its fair value, determined in accordance with the requirements of IAS 39 paragraphs AG69-AG82. However, entities that

(a) have not filed, or are not in the process of filing, their financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or

(b) do not hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;

are permitted to use a formula to determine the fair value of financial instruments puttable at fair value on their issuance, redemption or repurchase, provided that the formula is intended to approximate the fair value of the financial instruments. In many cases, the instrument's pro rata share of the book value of the net assets of the entity would not be a formula that is intended to approximate the fair value of the instrument. Such a formula would approximate the fair value of the instrument only when there is no material difference between the book value and the fair value of the net assets of the entity. An entity may change the basis of determination of the fair value of financial instruments puttable at fair value if, and only if, the change results in an estimate that is more representative of the fair value of the financial instruments puttable at fair value in the circumstances.

Appropriate guidance for determining fair value

9. A national standard setter has requested that the following exception in sub-paragraph 46(c) of IAS 39 *Financial Instrument: Recognition and Measurement* be included in references to guidance on determining fair value in the first sentence of paragraph AG14A of the proposed amendments to IAS 32 (shown above). In essence, they are asking for an exemption that permits non-public entities that redeem or repurchase puttable instruments at the instrument's cost to classify these instruments as equity (assuming all other conditions are met).

46. After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

….

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89-102. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 58-70 and Appendix A paragraphs AG84-AG93.

10. Sub-paragraph 46(c) of IAS 39 is an exemption for the measurement of *financial assets* in the form of investments in equity instruments *in other entities* that are not listed or where their fair values cannot be reliably measured. The exemption was given as, in the majority of cases, an entity would not be able to get the information necessary to fair value an investment in *another* entity that is unlisted. However, that circumstance does not apply when the entity is estimating the fair value of its *own* equity instruments. Furthermore, if cost is used to determine the repurchase or redemption price of puttable instruments, these instruments are not entitled to a pro rata share of the net assets of the entity during its entire life, which is an essential characteristic of an ordinary share.

11. Consequently, the staff do not recommend that a reference to sub-paragraph 46(c) of IAS 39 be added to paragraph 14A of the proposed amendments to IAS 32. The exception in sub-paragraph 46(c) of IAS 39 is relevant only for the measurement of the equity instruments of *other* entities, and not for when an entity measures its *own* equity instruments.

The issue price of an ordinary share puttable at fair value converted from a convertible bond

12. At its December 2005 meeting, the Board decided that a condition for a financial instrument puttable at fair value to be classified as equity is that its issue price must be at fair value. A Board member has requested that staff consider the interaction of this condition with the classification of an ordinary share puttable at fair value that is issued upon conversion of a convertible debt instrument. The question is whether the price of shares issued upon conversion is considered to be at fair value. If not, the shares will not qualify for equity classification even if the shares meet all other specified conditions under the proposed amendments.

13. In considering this point, the following issues arise:

(a) the accounting treatment of the conversion option embedded in a convertible debt instrument;

(b) the meaning of the issue price of a financial instrument puttable at fair value; and

(c) application guidance required for (a) and (b) above.

(a) Accounting treatment of the conversion option

14. IAS 32 requires the option embedded in a convertible bond to be recognised separately from the host instrument (bond). Ordinarily, the option would be accounted for as an equity instrument and not remeasured. However, in the case of an option to convert into a financial instrument puttable at fair value, the conversion option is a derivative that meets the definition of a financial liability. (The Board had earlier decided that all derivatives on financial instruments puttable at fair value would continue to be classified as financial liabilities.) Therefore, the conversion option is measured at fair value at each balance sheet date and on the date of conversion.

(b) Meaning of issue price

15. When the Board agreed that a financial instrument puttable at fair value must be issued at fair value, as a condition to qualify for equity classification, the staff interpreted this to mean that the fair value of the consideration received upon issue of the puttable instruments must equal the fair value of those instruments. For example, if 100,000 financial instruments puttable at fair value are issued, and the fair value of each instrument is $4, then the instruments will be issued at fair value only if the fair value of the consideration received is $400,000.

16. In the case of a convertible bond, the fair value of the consideration received, when financial instruments puttable at fair value are issued upon conversion of the bond, is the fair value of the convertible bond. The fair value of the convertible bond will reflect both the fair value of the conversion option and the fair value of the bond. Therefore, the puttable instruments issued upon conversion are issued at fair value because the fair value of the consideration received (convertible bond) would equal the fair value of the puttable instruments issued, for the purposes of determining whether the financial instrument meets the definition of a financial instrument puttable at fair value.

17. In the staff view, this conclusion applies irrespective of the accounting entries required to recognise the conversion. If the bond is carried at amortised cost, then the carrying amount of the liabilities derecognised (the bond and the conversion option) is unlikely to be the same as the fair value of the puttable instruments. Nevertheless, in the staff view, those puttable instruments were issued at fair value because, in economic terms, the entity received consideration (the convertible bond) that had a fair value equal to the fair value of the puttable shares.

(c) Application guidance required

18. The staff asks the Board whether it wishes to provide any application guidance. If so, the staff asks what that guidance should address. For example, should the application guidance explain any or all of the following:

    (a) The conversion option is a derivative that meets the definition of a financial liability, and should be recognised separately from the bond.

    (b) Financial instruments puttable at fair value are issued at fair value only if the fair value of the consideration received equals the fair value of the instruments issued.

    (c) In the case of a convertible bond, the fair value of the consideration received is the fair value of the convertible bond tendered in exchange for the puttable instruments. The fair value of the convertible bond will reflect both the fair value of the conversion option and the fair value of the bond. Therefore, the puttable instruments issued upon conversion are issued at fair value for the purposes of determining whether the financial instrument meets the definition of a financial instrument puttable at fair value.

Analysis of benefits and costs

19. At its February 2006 meeting, the IASB decided to include an analysis of benefit and costs of the proposals in all forthcoming exposure drafts. Staff notes that the FASB currently includes a 'Benefit and Costs' section in the Basis for Conclusions accompanying its exposure drafts.

20. Staff has drafted paragraphs to include in the Basis for Conclusions based on the FASB's paragraphs and requests feedback on whether the approach taken reflects the Board's expectations. If it does not, the Board is requested to explain what it envisaged for the 'analysis of benefits and costs' section. Staff is not seeking detailed drafting comments at this stage.