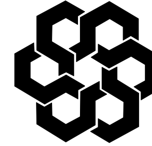

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **3 November 2006, London**

Project: **Financial Instruments puttable at an amount other than Fair Value (Agenda Paper 12(ii))**

RELEVANT STANDARDS

- IFRS 3 *Business Combinations*
- IAS 27 *Consolidated and Separate Financial Statements*
- IAS 32 *Financial Instruments: Presentation*
- IAS 39 *Financial Instruments: Recognition and Measurement*

BACKGROUND

1. The IFRIC received a request that relates to how a financial instrument should be accounted for in the financial statements of the holder, when the financial instrument is classified as a financial liability in the financial statements of the issuer.

2. For example:

- Entity A ('the issuer') issues puttable instruments. The holders have the right to put the instruments back to the issuer at any time at a predetermined variable amount that is not equal to the fair value.

- The issuer has not issued other instruments.

- If the holders do not put the instruments back to the issuer, the holders receive distributions at the discretion of the issuer and are entitled to other characteristics and risks similar to those of an equity instrument.

The formula for the variable amount at which the instrument is put back to the issuer may be based on the book value of net assets of the issuer determined under IFRSs or local generally accepted accounting principles.

3. The puttable instruments addressed in this agenda paper are not within the scope of the recent exposure draft, *Proposed Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Financial Instruments – Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation (the Exposure Draft),* because the instruments are not puttable at fair value. In addition, the exposure draft focuses on the accounting in the financial statements of the issuer, whereas one of the questions raised with the IFRIC is how the puttable instruments should be accounted for in the financial statements of the holders.

4. This agenda paper assumes that any derivatives identified in the contractual terms of the puttable instruments are not transferable independently (see IAS 39.10).

SUMMARY OF THE ISSUES

5. Two issues have been raised with the IFRIC.

1st issue

6. The puttable instruments meet the definition of a financial instrument. In the financial statements of the issuer, the issuer's contractual obligation to deliver cash results in the recognition of a financial liability in accordance with IAS 32.

7. Some suggest that, given that the issuer is required to recognise a financial liability in its financial statements, the instrument in the financial statements of the holder should be recognised as an investment in a debt instrument.

8. Therefore, the first issue relates to how the puttable instruments should be accounted for in the financial statements of the holders, in particular, whether the accounting for the instruments in the financial statements of the holders should be symmetrical to that in the financial statements of the issuer.

2nd issue

9. The second issue relates to whether an entity that has control over another entity (that has no equity instruments in issue) is required to present consolidated financial statements in accordance with IAS 27 (as well as to recognise goodwill in accordance with IFRS 3).

SUMMARY OF THE STAFF RECOMMENDATION

1st issue

10. The staff believes that current financial instruments' literature (i.e. IAS 32 and IAS 39) does not directly address whether the accounting for financial instruments in the financial statements of holders should be symmetrical to that in the financial statements of the issuer.

11. The issuer of a financial instrument is required to classify it in accordance with IAS 32, whereas the holder of the financial instrument is required to classify and account for it in accordance with IAS 39. In classifying a financial instrument, the first question IAS 32 asks is whether there is a contractual obligation to deliver cash or other financial assets. In contrast, the first question IAS 39 asks is whether there are one or more embedded derivatives (see paragraph 26 of this agenda paper).

12. IAS 39 provides guidance on whether the characteristics and risks of an embedded derivative are closely related to those of a host contract. However, whether or not the identified embedded derivative is closely related to the host contract depends on the nature of the host and embedded derivative – and it is not possible to ascertain the nature of one without simultaneously deciding the nature of the other.

13. Attempting to bifurcate one set of interdependent rights and obligations in any contract is always complex. IAS 39 acknowledges this difficulty and explicitly states that judgment is often required (see Guidance on Implementing IAS 39 - C.1). In addition, AG 33A of IAS 39 states that the requirements on the identification and separation of embedded derivatives can be more complex or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. As a result, IAS 39 permits the entire instrument to be designated as at fair value through profit or loss provided that certain criteria in paragraph 11A of IAS 39 are met.

14. Furthermore, IAS 39.12 states that, if an entity is required to separate an embedded derivative from its host contract but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it must designate the entire hybrid instrument as at fair value through profit or loss.

15. The staff believes that specifying how to account for a particular financial instrument in the financial statements of a holder would require development of implementation guidance (rather than a principle-based Interpretation). The staff believes that any Interpretation on how to separate an embedded derivative and identify the nature of the host contract will inevitably not be principled based.

16. Furthermore, since the terms of each hybrid financial instrument vary case-by-case, the staff does not believe that a principle-based consensus to deal with all cases can be reached on a timely basis.

17. For the above reasons, the staff recommends that the first issue should not be taken onto the agenda.

2nd issue

18. IAS 27 requires a parent to present consolidated financial statements unless all conditions set out in IAS 27.10 are met. IAS 27.22 – 36 set out consolidated procedures as to how a parent should consolidate a subsidiary.

19. IFRS 3.51 requires an entity that obtains control over the financial and operating policies of another entity (through a business combination within the scope of IFRS 3) to recognise and measure goodwill at the date of acquisition.

20. In the light of the above requirements, the staff recommends that the second issue should not be taken onto the agenda. Proposed ‘rejection’ wording is set out in the Appendix to this agenda paper.

QUESTIONS TO THE IFRIC:

21. Does the IFRIC agree with the staff recommendation?

22. Does the IFRIC have any comments on the ‘rejection’ wording (see the Appendix to this agenda paper)?

STAFF ANALYSIS

1st issue

23. IAS 32 requires the recognition of a financial liability when the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. A financial instrument is classified as equity in IAS 32 if it is not a financial liability. IAS 32.11 defines an equity instrument as a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

24. Similarly, for a compound financial instrument that contains both a financial liability and an equity component, IAS 32 requires that the financial liability component be identified and measured first on initial recognition of the financial instrument.

25. Holders of financial instruments are required to classify and account for the financial instruments in accordance with IAS 39 (not IAS 32).

26. IAS 39 first requires the identification of an embedded derivative. IAS 39.10 requires the identification of the effect of those cash flows of a hybrid instrument that vary in a way similar to a stand-alone derivative (also see BC 77(a) of IAS 39). After an embedded derivative is identified, the remaining non-derivative component is the host contract.

27. IAS 39 also requires the measurement of embedded derivatives first. AG 28 of IAS 39 states that the initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

28. The staff notes that AG 33A of IAS 39 states that:

> 'When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently.''

29. Therefore, in determining how to account for a hybrid instrument in the financial statements of the holders, the staff believes that holders of the financial instrument need to:

- Step 1: identify embedded derivatives;
- Step 2: determine whether the remaining (i.e. the host) is a debt or an equity instrument; and
- Step 3: determine whether the characteristics and risks of any identified embedded derivatives are closely related to those of its host contract.

Identifying embedded derivatives

30. Under IAS 39.10, an embedded derivative is a component of a hybrid (combined) instrument that includes a non-derivative host contract- with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

31. In the process of identifying embedded derivatives, the holders should bear in mind the following:

- any identified embedded derivatives should meet the definition of a derivative (see IAS 39.10 and IAS 39.11[1]);
- in the absence of implied or stated terms, judgement is required. However, a cash flow that does not exist in the terms of the hybrid instrument cannot be created (see C.1 of the Guidance on Implementing IAS 39);
- for any non-option embedded derivatives, the fair value on initial recognition of the hybrid instrument should have a fair value of zero. Otherwise, there will be an infinite number of embedded derivatives (see C.1 and C.2 of the Guidance on Implementing IAS 39); and
- for any option-based embedded derivatives, the fair value does not need to be equal to zero on initial recognition of the hybrid financial instrument.

32. In addition, AG 29 of IAS 39 states: 'Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. If an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.'

33. Based on the information available in the illustrative example, an option-style derivative (representing the holders' right to exchange equity interest in the issuer of the puttable instruments for a variable amount of cash) is embedded in the puttable instruments.

Determining whether the host is a debt or an equity instrument

34. After identifying embedded derivatives, the next step is to determine whether the remainder (i.e. the host) is a debt or an equity instrument. The host of a hybrid financial instrument should be of non-derivative nature (see IAS 39.10).

35. The classification of whether the host is a debt or an equity instrument is important because the accounting for a debt and an equity instrument may be different under IAS 39. For example, the accounting treatments for an available-for-sale debt investment and for an available-for-sale equity investment are

[1] A derivative is a financial instrument that contains the following three characteristics: (i) its value changes in response to an underlying; (ii) it requires no initial net investment; and (iii) it is settled at a future date.

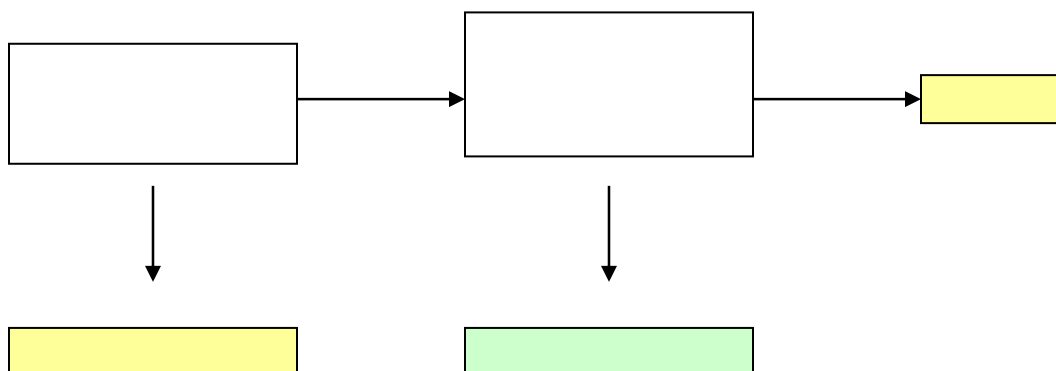
different in terms of (i) whether previously recognised impairment losses can be reversed[2]; and (ii) how transaction costs are accounted for[3].

36. IAS 39 provides some guidance on how to determine whether a host contract is a debt or an equity instrument, as follows:

- AG 27 of IAS 39 states: ‘If a host contract has no stated or predetermined maturity and represents residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.’

- C.5 of the Guidance on Implementing IAS 39 states: ‘The host contract is a debt instrument because the hybrid instrument has a stated maturity.’

37. Taken together, the guidance in AG 27 of IAS 39 and C.5 of the Guidance on Implementing IAS 39 can be shown as a decision-tree in determining whether the host contract is a debt or an equity instrument for the purposes of the preparation of the financial statements of a holder of a financial instrument, as follows:



[2] IAS 39.66 requires that, for unquoted equity instruments that are measured at cost less any impairment losses because their fair values cannot be measured reliably, previously recognised impairment losses cannot be reversed in subsequent periods.

[3] AG 67 of IAS 39 states that: ‘If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.’

38. An embedded option is identified in the illustrative example (see paragraph 33 of this agenda paper). The remaining contract, which represents a residual interest in the net assets of the issuer, is an equity instrument.

Determining whether any identified embedded derivatives are closely related to the host contract

39. IAS 39.11 states: 'An embedded derivative shall be separated from the host contract and accounted for as a derivative under IAS 39, if and only if: (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).'

40. Whether or not the host contract and an embedded derivative are closely related depends on the nature of the host contract and the embedded derivative.

41. IAS 39 provides two lists of examples describing circumstances where embedded derivatives are closely related to the host contract and circumstances where embedded derivatives are not closely related to the host contract (see AG 30 and AG 33 of IAS 39).

Alternative view – the host of the puttable instruments is a debt instrument

42. AG 31 of IAS 39 states that: "An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instruments as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 11 because the host contract is a debt instrument under paragraph AG 27 and the indexed principal payment is not closely related to a host debt contract under paragraph AG 30(a). Because the

principal payment can increase or decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable."

43. Some argue that, based on AG 31 of IAS 39, the host of the puttable instruments in the financial statements of the holder is a debt contract. Supporters of this view argue that the instruments are in economic substance equivalent to debt-host contracts with a guaranteed amount plus an option to exchange the variable amount for the residual interests in the issuer.

44. Proponents of this view argue that this approach is consistent with the principles in IAS 32, which require the identification and measurement of financial liabilities first on initial recognition of compound financial instruments. However, as mentioned above, holders of financial instruments should classify and account for the financial instruments in accordance with IAS 39 (not IAS 32).

45. In the staff's view, AG 31 of IAS 39 focuses on the financial statements of the issuer. Though AG 31 of IAS 39 refers readers to AG 27 of IAS 39, it does not provide any information as to whether the instrument has a stated or predetermined maturity. AG 27 of IAS 39 states that one of the factors in determining whether the host is a debt or an equity instrument is whether or not the host has a stated or predetermined maturity.

46. In addition, the staff notes that in the Exposure Draft, the Board considers that the puttable instruments in the financial statements of the issuer contain two components – an equity component and a written put option (see BC 9 of the Exposure Draft).

47. Furthermore, the staff believes that the analysis in AG 31 of IAS 39 focuses merely on the accounting for the contractual right to receive a variable amount of cash that is based on the change in an equity or commodity index.

48. However, for puttable instruments in the illustrated example, in addition to a contractual right to put the instruments to the issuer, the holders enjoy benefits which are the same as those enjoyed by an equity participant.

49. Moreover, based on the contractual terms of the puttable instruments in this agenda paper, the option embedded represents holders' rights to exchange their residual interest for a variable amount of cash (not rights to exchange the variable

amount of cash for the residual interests). The staff does not believe that one should identify derivatives that do not exist in the contractual terms.

50. Furthermore, for puttable instruments with a debt-host contract, the staff believes that holders have unconditional contractual rights to receive cash or other financial assets. However, for the puttable instruments in this agenda paper, holders are only entitled to receive cash if they surrender their residual interests in the net assets of the issuer.

B.22 of the Guidance on Implementing IAS 39

51. Some commentators suggest that B.22 of the Guidance on Implementing IAS 39 can be read as requiring that a financial asset be classified as a debt instrument if the counterparty (i.e. the issuer) classifies the financial instrument as a financial liability in accordance with IAS 32.

52. B.22 of the Guidance on Implementing IAS 39 states: 'If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holders, provided that the definition is otherwise met. IAS 32.15 – IAS 32.22 provide guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under IAS 32, it cannot be classified as within loans and receivables by the holder.'

53. The staff notes that the question raised in B.22 is whether an equity instrument, such as a preference share, with fixed or determinable payments can be classified within loans and receivables. In the staff's view, B.22 aims to emphasise two things: (i) holders of financial instruments can classify the financial assets within loans and receivables only when the financial assets meet the definition of loans and receivables in IAS 39; and (ii) equity instruments cannot be classified as loans and receivables.

2nd issue

54. IAS 27.4 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The fact that an entity does not have any equity instruments in issue does not prevent it from being controlled by another entity (its parent). This agenda paper is not to discuss

whether an entity has control over another entity. Indeed, the answer to that question is a matter of facts.

55. IAS 27.9 requires an entity (a parent) that controls another entity (its subsidiary) to present consolidated financial statements unless all conditions in IAS 27.10 are met.

56. IAS 27.12 states that consolidated financial statements should include all subsidiaries of the parent.

57. IAS 27.22 – 36 set out consolidated procedures as to how a parent should consolidate a subsidiary.

58. Based on the above IFRS requirements, the staff believes that an entity that has control over another entity (that has no equity instruments in issue) is still required to present consolidated financial statements, unless all conditions set out in IAS 27.10 are met. In addition, the staff believes that the entity should follow the principles in IAS 27 to prepare consolidated financial statements.

59. Furthermore, the staff notes that IFRS 3.51 requires an entity that obtains control over the financial and operating policies of another entity (through a business combination within the scope of IFRS 3) to recognise and measure goodwill at the date of acquisition.

60. In accordance with IFRS 3.51, goodwill is measured at its cost, which is the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree.

61. IFRS 3.44 states: 'The identifiable assets and liabilities that are recognised in accordance with IFRS 3.36 include all of the acquiree's assets and liabilities that the acquirer purchases or assumes, including all of its financial assets and financial liabilities.'

62. Combining the requirements of IFRS 3.44 and 3.51, goodwill is measured as the difference between the cost of the business combination and the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities that the acquirer purchases or assumes. Therefore, the staff believes that, in determining the amount of goodwill, the identifiable liabilities of

the acquiree should not include liabilities of the acquiree that reflect the acquirer's controlling interest in the acquiree.

APPENDIX: [OMITTED FROM OBSERVER NOTE]