30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*
*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

**INFORMATION FOR OBSERVERS**

**Board Meeting:** **17 April 2007, London**

**Project:** **Financial Instruments Puttable At Fair Value And Obligations Arising On Liquidation**

**Subject:** **Next steps (Agenda Paper 6)**

---

## BACKGROUND

1. The ED, *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation,* was issued for comment in June 2006 with a comment deadline of 23 October 2006. Analysis of the eighty-seven comment letters received was presented to the Board at the January 2007 meeting. The purpose of this paper is to inform the Board of the staff's intended next steps.

2. The objective of the project was to undertake a short-term, limited-scope project to address concerns about the classification of certain financial instruments. The Exposure Draft proposes to classify as equity some instruments puttable at fair value and some instruments within finite lived entities. The scope of the ED was kept deliberately narrow to limit structuring opportunities.

3. Eighty-seven comment letters were received with regard to this exposure draft and commentators broadly fell into three categories.

   a) Those who unconditionally support the ED.

   b) Those who support the ED but with certain scope extensions.

   c) Those who do not support the proposed change and believe the project should be discontinued.

4. As a result of comments received the staff proposes to separate the issues into two work streams. These are:

   a) Finalisation of the exposure draft. The staff is working to address issues raised in comment letters that would not require re-exposure of the proposed amendment. These issues are listed in paragraph 5 of this paper.

   b) Research on the issues raised in the comment letters that would require re-exposure of the proposed amendment. Some letters received suggest that the criteria for equity classification within the amendment are too restrictive. These letters cite a number of instruments that may create the same concerns for entities as financial instruments puttable at fair value, but whose classification as liabilities would not be affected by the proposed amendment. The staff intends to research the nature of these instruments, explore possible methods to address such instruments and then ask the Board whether additional exceptions to IAS 32 *Financial Instruments: Presentation* are justified.

5. As part of this second research stream we are discussing certain issues relating to partnerships and co-operatives with the German Accounting Standards Board (GASB). A meeting has been scheduled for April. It is expected that a representative of the Association of Partnerships, an accounting practitioner and a lawyer will attend that meeting as well as representatives from the IASB and GASB. Meetings with other parties in other jurisdictions are also likely to be necessary.

## FINALISATION OF THE EXPOSURE DRAFT

6. The issues raised by the comment letters that would need to be addressed prior to finalizing the proposed amendment are briefly discussed below. A fuller discussion of these issues can be found in Appendix 1:

   a) *Clarification of what is meant by reference to fair value in the equity classification criteria.*

      i) A number of comment letters queried whether fair value meant the fair value of the *instrument*, the fair value of the *net assets* of the entity or the fair value of the *entity*.

      ii) The staff needs to confirm with the Board the original intention, and then redraft the amendment to ensure the correct meaning is clearly communicated. The staff's understanding is that the requirement was meant to reflect the fair value of the residual interest in the entity. If that is indeed the case, then this needs to be clearly communicated. Also respondents' comments that the fair value of the instrument incorporates more into its valuation than just the residual interest in the entity need to be considered.

   b) *Clarification of "the most subordinated class" requirement.*

      i) The ED states that to be classified as equity one requirement to be met is that an instrument must be in the most subordinated class. An instrument that is not puttable is more subordinate to an instrument that is puttable. Therefore the presence of any non-puttable instruments would prevent any puttable instruments within that entity being classified as equity.

      ii) There are entities with a small number of instruments that do not have an embedded obligation, and the presence of these non-puttable instruments prevents instruments with the embedded obligation getting equity classification. Equally, an entity with puttable instruments classified as equity would need to reclassify those instruments if it subsequently issued non-puttable instruments.

      iii) Another issue with regards to the most subordinate requirements relates primarily to partnerships where there are both limited and general partners. In liquidation of an entity with net assets all partners would share in those net assets proportionately to their capital contribution. In the event of liquidation of an entity with net liabilities the limited partners have no further exposure, but the general partner is liable for all the losses in the entity. Many would say that the general partners are more subordinate to the limited partners.

iv) Within the exposure draft a variety of terms are used that suggest the Board were considering liquidation in a net asset position. However, the criteria for most subordinated uses the term 'residual interest', which has neither a positive or negative connotation. Some commentators have interpreted the ED to refer to subordination in a net asset position only, and therefore concluded that all partners were equally subordinate. The staff needs to confirm the Board's original intention.

c) *Whether the issue price of financial instruments puttable at fair value must be at fair value, and whether transitional guidance needs to be included as to what that means.*

i) Some commentators question the necessity for, and logic behind, the requirement for an instrument to be entered into at fair value in order to be classified as equity. Many looked to the Basis of Conclusions to understand the need for this requirement but there is no discussion there. This needs to be addressed.

ii) Also, some constituents do not believe that from a practical viewpoint they can ascertain whether the issue price of the puttable instrument was at fair value. There appears to be confusion between cash received and issue price and which one (if either) are relevant. This needs to be addressed.

iii) Additional transitional guidance may be necessary as many instruments have been in existence for a long time and hence ascertaining whether their issue price was at fair value could potentially be difficult.

d) *The disclosure of the fair values of financial instruments puttable at fair value.*

i) Many of the comment letters questioned why the additional disclosure was required for these instruments, given that such disclosures are not required for other equity instruments. Commentators question whether such disclosure requirements arise because these instruments are actually not equity.

e) *The effective date of amendments.*

   i) An effective date needs to be set.

7. The staff aim to bring a paper to the May board requesting decisions on issues raised in paragraph 6.

8. As stated in the introduction, the Board's objective for this project is that it be a short-term, limited-scope project to address concerns about the classification of certain financial instruments – namely the treatment of instruments puttable at fair value. The ED largely meets that objective (although further drafting to clarify certain issues is required).

9. However the staff considers that the issues raised by respondents in reference to instruments creating similar problems to those addressed in the proposed amendment should be given further consideration.

10. The staff also considers that the most expeditious way to finalise the proposed amendment is to separate the issues raised in comments letters into two work streams. This will avoid the need to possibly re-expose the proposed amendment.

**POSSIBLE ISSUES TO BE ADDRESSED OUTSIDE OF THE PROPOSED AMENDMENT**

11. The comment letters raised a number of areas in the proposed amendment that prevent that amendment being helpful to certain respondents. These areas include:

   a) The requirement to enter at fair value, share proportionately throughout and exit at fair value;

   b) The need to be the most subordinate instrument;

   c) The treatment and classification of puttable minority interests;

   d) The impact of mandatory dividends or partnership remuneration.

12. Specific examples of entities in which such issues arise include:

a) Partnership interests. In some situations partners do not enter at fair value. In many situations partners do not exit at fair value (depending on the interpretation of what is meant by fair value as discussed in paragraph 6a). Also, many partnership structures have both limited partners and general partners and it is debatable whether the limited partners could be considered to be in the most subordinate class (as discussed in paragraph 6b).

b) Co-operatives. A lot of co-operatives exit at the face value of their membership interests less any losses incurred to date, therefore they do not meet the requirement to exit at fair value. The value they obtain from their membership is through participation in the co-operative and other non-monetary rewards rather than financial appreciation of their interests *per se*.

c) Many development banks allow members to put their interests back to the bank, but the value of their exit is not known until a member does actually exercise their put. Therefore apart from failing to meet the exit at fair value criteria, development banks have the additional problem of not knowing how to value the resultant liability.

d) Many fund management structures have a small number of management shares that are not puttable. Therefore only the small number of management shares would be in the most subordinate class, leaving all other interests in the structure as liability. Also, the redemption value of many instruments are dictated by FSA rules and are formula based, therefore would be unlikely to meet the fair value definition as currently drafted.

13. Any potential exceptions to IAS 32 for any of the above instruments would need to contemplate the characteristics of those instruments, identify what is the critical characteristic that makes those interests equity, and try to incorporate that critical characteristic into a proposed amendment. As mentioned earlier there is currently a meeting planned with the GASB to discuss partnerships, and it may be necessary to organize meetings with other parties to develop the staff's understanding of the different entity structures discussed above.

*Next steps*

14. The first step of the ongoing work on these wider issues will be develop a clear understanding of :

    a) the instruments brought to our attention,

    b) the problems the current classification creates

    c) the critical characteristics of these instruments.

15. Once this understanding has been developed staff will then assess the various options open with regards to how to reconsider classification of these instruments. At this stage the staff sees threeoptions:

    a) Further amendments to IAS 32

    b) Focus on the long term project, and include the work done on these instruments in the long term project.

    c) A combination of the two, some instruments to be dealt with in other amendments and others to be considered within the long term project.

16. The staff aims to bring preliminary considerations on these issues to the board in June.

**Questions to the board:**

- **Does the board agree with the proposed approach?**
- **If the board does not agree with the proposed approach, how should the staff move forward?**