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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**14 December 2007, London**
Project:	**Puttable Financial Instruments and Obligations Arising on Liquidation**
Subject:	**Discussion of Remaining Issues and Drafting Changes (Agenda paper 12)**

OBJECTIVE OF THIS PAPER

1. In November, the board held two public roundtable discussions to consider a staff draft of the proposed amendments. The staff asked participants whether the approach set out in the draft met the objectives of the limited-scope project and were operational. Additionally, the staff asked whether any additional issues needed to be addressed.

2. Participants provided comments on the content and clarity of the staff draft and raised several issues related to the requirements therein. Having considered those comments and comments arising from other discussions with constituents, the staff has issued a preballot draft of the proposed amendments.

3. The objective of this paper is twofold—first, to discuss specific issues that the staff thinks require further board consideration and second, to summarise significant drafting changes made to the staff draft.

SECTION 1: ISSUES THAT REQUIRE FURTHER BOARD CONSIDERATION

4. The staff thinks that the following seven issues require discussion:

   A. financial instruments that include other contractual obligations

   B. an instrument holder in the role of owner and non-owner

   C. the meaning of ‘fixed’, ‘guaranteed’ or ‘restricted’ to describe an instrument’s return

   D. interaction of the proposed amendment and the requirements in IFRS 2 *Share-based Payment*

   E. the proposed disclosure requirements

   F. application of the proposed amendment’s requirements to specific mutual fund structures

   G. whether it is appropriate to analogise to the exception in the proposed amendment.

Issue A: Financial Instruments that Include Other Contractual Obligations

5. This issue can be divided into two sub-issues:

   A1: the difference between the proposed requirements for puttable instruments and the proposed requirements for instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity on liquidation

   A2: mandatory dividends and partnership remuneration

A1: Difference between the proposed requirements

6. A puttable financial instrument is classified as equity if it has all the features and meets the conditions in paragraphs 16A and 16B of the proposed amendment. An instrument that includes a contractual obligation for the issuing entity to deliver to the instrument holder a pro rata share of its net assets on liquidation is classified as

equity if it has all the features and meets the conditions in paragraphs 16C and 16D. Constituents questioned why paragraphs 16A and 16C were different in the staff draft of the proposed amendment.

7. Specifically, paragraph 16A(d) states that the instrument must not include any other contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are unfavourable to the entity. Paragraph 16C does not include that condition.

8. The reason for the difference between 16A and 16C is the timing of the possible settlement of the instruments' obligations (that is to say, <u>when</u> the issuing entity might be required to satisfy those obligations).

9. The holder of a puttable instrument can exercise the put before liquidation of the entity and exercise of the put does not trigger the liquidation of the entity. It is necessary to identify all contractual obligations that exist throughout the instrument's life to ensure that the instrument always represents the residual interest; if the instrument contains another obligation, this arguably results in the instrument not representing the most residual interest because the holder of the puttable instrument may have a claim to some of the net assets of the entity in preference to other instruments. As such, the proposed amendment focuses on the period from issuance to redemption and includes the condition that requires that the instrument has no contractual obligations other than the put.

10. An instrument that includes a contractual obligation to deliver a pro rata share of net assets on liquidation is different. The life of that instrument is the same as the life of the issuing entity; the extinguishment of the obligation only can occur at liquidation. Therefore, the amendment focuses only on the obligations that exist at liquidation. The instrument must be subordinate to all other classes of instruments and represent the residual interests only at that point in time. However, if the instrument contains any other contractual obligations, they may need to be separated out in accordance with the requirements of IAS 32 *Financial Instruments: Presentation*.

11. The staff thinks that the different conditions in paragraphs 16A and 16C are appropriate; thus, the staff did make any changes to those paragraphs in the preballot draft.

12. However, the staff changed the title of the section that includes paragraph 16C to include ‘components of instruments’ to clarify that such instruments can have other contractual obligations that would need to be separated. Additionally, the Basis for Conclusions (paragraph BC69 in the preballot draft) states that if the instrument has other contractual obligations then the issuing entity is required to separately account for them.

13. **Question for the Board:**

Does the board agree with the staff’s analysis and the wording in the proposed amendment? If not, what would the board suggest and why?

A2: Mandatory dividends and partnership remuneration

14. Constituents have asked whether mandatory dividends and partnership remuneration meet the definition of a ‘contractual obligation.’

15. As discussed above in Issue A1, the existence other contractual obligations affect the accounting treatment of the instruments that are within the scope of the proposed amendment. Specifically, a puttable instrument will not meet the condition in paragraph 16A(d) if the instrument includes other contractual obligations to the instrument holder in the role as owner. If an instrument that includes a contractual obligation for the issuing entity to deliver to the instrument holder a pro rata share of its net assets upon its liquidation includes other contractual obligations, those may need to be separated in accordance with the existing requirements of IAS 32. (Note: this section assumes the partnership remuneration is distributed to the instrument holders in their role as owners. If that remuneration is distributed to holders in their role as non-owners, Issue B applies.)

16. The staff draft of the amendment does not address explicitly the issue of mandatory dividends or partnership remuneration.

17. In September 2007, the board agreed that the proposed amendment should not address whether mandatory dividends (and partnership remuneration) meet the definition of a contractual obligation because answering that question would have broader implications.

18. However, if an issuing entity concludes that mandatory dividends or partnership remuneration do meet that definition, the staff thinks that the puttable instrument would fail to meet the condition in 16A(d) of the proposed amendment. Thus, the instrument would be classified as a financial liability. The proposed amendment is clear that the instrument cannot include any other contractual obligation to deliver cash or another financial asset.

19. As noted above, if an issuing entity concludes that there are contractual obligations in addition to those discussed in paragraph 16C, those obligations need to be analysed separately.

20. The staff thinks that additional guidance in the proposed amendment is unnecessary.

21. **Question for the Board:**

Does the board agree with the staff's analysis? If not, how do board members think mandatory dividends and partnership remuneration should be treated under the proposed amendment and why?

Issue B: An Instrument Holder in the Role of Owner and Non-Owner

22. The proposed amendment requires the issuing entity to consider all cash flows, conditions, and features related to the instrument. However, there are situations in which the instrument holder performs multiple roles within the issuing entity and may receive compensation related to those other roles. For example, the instrument holder also may be an employee or a provider of a guarantee.

23. Paragraphs 16A and 16C address the instrument holder <u>as an owner</u>. To determine whether an instrument meets the requirements in those paragraphs, the cash flows, conditions, and features relating to the instrument holder as an owner must be considered in isolation.

24. If an instrument holder also has a role as a non-owner, then the cash flows, conditions, and features of that arrangement must be considered separately to determine whether the arrangement violates the requirements in paragraphs 16B or 16D.

25. Arrangements with instrument holders as non-owners may be included in the terms and conditions of the instrument or, alternatively, in a separate contract.

26. For instance, in a partnership, the terms and conditions of a general partner's contract will be more extensive than those of a limited partner. However, those additional terms and conditions may not relate to the general partner as an owner; rather, they may relate to the general partner as either a managing director of the entity or as a provider of a guarantee.

27. The wording in the proposed amendment (paragraphs AG14E–AG14G and BC63 in the preballot draft) has been expanded to provide clarity about situations in which the instrument holder also has a role as a non-owner.

28. Constituents have asked specifically about scenarios where a cooperative distributes a significant part of its profits via rebates. Those rebates may not compensate the instrument holders in their roles as owners, but rather in their roles as suppliers to the cooperative. Whether a specific scenario has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D will be based on the facts and circumstances.

29. **Question for the Board:**

    Does the board agree with the staff's analysis and the revised wording in the proposed amendment? If not, what would the board suggest and why?

Issue C: Returns That Are 'Fixed', 'Guaranteed' or 'Restricted'

30. The original Exposure Draft (ED) stated that '…the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, to any extent, before or at liquidation' (paragraph 11).

31. The staff draft separately discusses the puttable financial instrument (paragraph 16A(e)) and other financial instruments or contracts of the issuing entity (paragraph 16B). Moreover, the staff draft used different terminology. It stated

that the residual return of the puttable financial instrument must be neither ‘fixed’ nor ‘guaranteed’ (paragraph 16A(e)) and that other financial instruments and contracts must neither ‘restrict’ nor ‘fix’ the residual return of the puttable instrument (paragraph 16B). That change caused confusion because constituents were unsure about the distinction among the terms.

32. Those changes were meant to provide clearer guidance. The staff’s objective was to communicate the principle that to have all the features and meet the conditions in paragraph 16A and 16B, the puttable financial instrument always must be subordinate to all other classes of instruments and always represents the residual interest.

33. However, the change caused confusion. As a result, in the preballot draft, the staff has removed the last sentence of paragraph 16A(e) because it is unnecessary; it was included simply as an example of an instrument that would not meet the conditions therein. Furthermore, language in the Application Guidance (paragraphs AG14B–AG14D and AG14H) and the Basis for Conclusions (paragraphs BC61 and BC62) in the preballot draft discuss the objectives of paragraphs 16A and 16B.

34. One constituent at the roundtable discussions described a specific scenario related to this issue. In that scenario, instrument holders are able to put their instruments back to the issuing entity before liquidation at the lower of paid-in capital or their share of net assets. Those terms discourage the exercise of the put and, therefore, encourage instrument holders to remain until liquidation. The staff thinks the specific facts and circumstances of that scenario need to be analysed to determine whether it has all the features and meets the conditions of paragraphs 16A and 16B (for example, whether the puttable instruments are subordinate to all other classes of instruments and whether profits are distributed during the life of the puttable instrument).

35. **Question for the Board:**

Does the board agree with the staff’s analysis and the revised wording in the proposed amendment? If not, what would the board suggest and why?

Issue D: Interaction of the Proposed Amendment and the Requirements of IFRS 2 *Share-based Payment*

36. Constituents have asked about the interaction between the proposed amendment and IFRS 2.

37. Under existing requirements, the puttable financial instrument is a financial liability; therefore, the executory contract is outside the scope of IFRS 2 (and probably is not recognised).

38. However, the proposed amendment makes an exception to IAS 32 and requires entities effectively to ignore the put obligation and to classify the puttable financial instrument as equity if it has all the features and meets the conditions in paragraphs 16A and 16B. That raises the question whether puttable financial instruments that have all those features and meet those conditions should be considered equity for the purposes of identifying a 'share-based payment transaction' in IFRS 2. (The same applies to instruments that impose an obligation on the entity to deliver to another party a pro rata share of its net assets on liquidation.)

39. IFRS 2 defines an 'equity-settled share-based payment transaction' as a transaction in which the entity receives goods or services as consideration for equity instruments of the entity. It defines a 'cash-settled share-based payment transaction' as a transaction in which the entity acquires goods or services by incurring a liability to the supplier of those goods and services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity.

40. IAS 32 and IFRS 2 both define an equity instrument as 'a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.' However, the definition in IFRS 2 includes a footnote that references the definition of a 'liability' from the *Framework*.

41. Currently, the definition of a 'liability' in IFRS 2 and the definition of 'financial liability' in IAS 32 are not consistent. As a result, any contract that will or may be settled in the issuer's own equity instruments is only classified as an equity instrument itself in IAS 32 if the 'fixed for fixed' rules are met, whereas all such

contracts are considered as equity instruments for the purposes of applying IFRS 2.

42. The proposed amendment will create another inconsistency between the two standards. For example, some puttable instruments will be classified as equity in IAS 32 but will not be considered as an equity instrument in IFRS 2 (because they meet the definition of a liability in the *Framework*).

43. Despite this, the staff thinks that such instruments should not be considered equity for the purposes of applying the requirements of IFRS 2. This is consistent with the proposed amendments being a limited scope exception and with the previous decision of the board regarding the classification of contracts that may or will be settled with puttable instruments or with instruments that impose an obligation on the entity to deliver to another party a pro rata share of its net assets on liquidation.

44. In the Basis for Conclusions in the preballot draft (paragraph BC65), it states that the classification of financial instruments as equity under the proposed amendment should be limited to those IFRS requirements that use the term 'financial liability' as defined in IAS 32 (for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*). Such an instrument shall not be considered an equity instrument under other guidance, for example IFRS 2.

45. **Question for the Board:**

Does the board agree with the staff's analysis and the revised wording in the proposed amendment? If not, what would the board suggest and why?

Issue E: The Proposed Amendment's Disclosures

46. The ED included disclosure requirements for financial instruments puttable at fair value and classified as equity. Among those requirements, entities had to disclose, '…the fair value of that class of financial instruments in a way that permits it to be compared with its carrying amount and information about how fair value was determined…' (paragraph 124D of the proposed amendment to IAS 1).

47. The staff draft includes disclosure requirements for puttable financial instruments classified as equity. Those requirements include '…the expected cash outflow on

redemption or repurchase of that class of financial instruments and information about how the expected cash outflow on redemption or repurchase was determined…' (paragraph 136A of the proposed amendments to IAS 1).

48. That difference in disclosure requirements reflects the board's modified approach for identifying whether puttable financial instruments are the residual interest in an entity. The modified approach in the staff draft assesses whether the class of puttable instruments is the residual interest in the entity. Consideration of the class as a whole eliminates the need for the condition in the exposure draft that each puttable instrument should be issued and redeemed at the fair value of the pro-rata share of the net assets of the entity.

49. Some constituents argue that the disclosure requirements in the staff draft do not result in useful information, especially if the instrument holder is prohibited from exercising the put for a significant period of time or if exercise of the put will cause liquidation and is unlikely in the near-term. Those constituents suggest that the disclosure only include a qualitative analysis of the terms and conditions of the puttable instruments.

50. Some staff agree with those constituents. Those staff argue that the ED disclosure requirement was based on the notion that entities would be disclosing information that was already available. With the expansion of the exception, that conclusion no longer applies. They support the idea of qualitative disclosure, unless the entity must stand ready to honour puts within 12 months or is otherwise required by the terms of the instrument to compute the put amount at the balance sheet date. If those conditions obtain, then quantitative disclosure is consistent with the principles of IFRS 7. If not, they fail to see the benefit that would be gained.

51. Other staff think that the disclosures proposed in the staff draft are more consistent with the principles of IFRS 7 than only disclosing the instrument's terms and conditions. The required quantitative information allows users to evaluate the liquidity risk associated with the put obligation. Moreover, the required disclosures are consistent with the guidance in IAS 1 *Presentation of Financial Statements* that the financial statements should provide information about the reporting entity that is useful to a wide range of users and assists those users in

predicting the entity's future cash flows, including their timing and uncertainty. While the staff acknowledges that the required information may be less useful if the put cannot be exercised in the near-term, the staff thinks that the requirement that an entity disclose how the expected cash outflow has been determined will address this issue. Thus, the staff has maintained those requirements in the preballot draft.

52. **Question for the Board:**

Does the board agree with the staff's analysis and the disclosure requirements in the proposed amendment? If not, what would the board suggest and why?

Issue F: Application of the Requirements to Specific Mutual Fund Structures

53. Some constituents have asked whether a class of financial instruments in a mutual fund has all the features and meets the conditions in the proposed amendment. The staff thinks that it will depend on the facts and circumstances of the specific fund structure.

54. However, based on the illustrative examples provided by constituents at the roundtable discussions, the staff thinks that it is unlikely that the proposed amendments will result in equity classification for puttable instruments issued by some mutual funds. Reasons may include that puttable instruments may include a contractual obligation in addition to the put feature (because the fund is contractually bound to distribute annually the mutual fund's net income to instrument holders).

55. **Question for the Board:**

Does the board have additional questions related to the application of the amendment to mutual funds? If so, what additional analysis would board members like to see?

Issue G: Possible Analogy to the Amendment

56. The proposed amendment is an exception to IAS 32. The scope is very limited and the board deliberated the requirements in that limited context.

57. For that reason, the staff would like to state explicitly in the proposed amendment that no analogy can made to the exception.

58. Alternatively, the board could amend IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to clarify that entities should never analogise to exceptions.

59. **Question for the Board:**

    Does the board agree that the proposed amendment should state that it is inappropriate to analogise to the exception therein? If so, where in the document should that guidance be inserted?

SECTION 2: SIGNIFICANT DRAFTING CHANGES FROM THE STAFF DRAFT

60. Below is a discussion of significant drafting changes that staff would like to bring to the board's attention:

The Exception to the Definition of a Liability

61. The proposed amendment provides an exception to the definition of a *liability* in IAS 32. In the ED, the staff included that exception in paragraph 11 and effectively changed the definition. However, respondents to the ED said that the revised definition of a liability was confusing and unclear.

62. Therefore, both the staff draft and the preballot draft of the amendment move the exception from paragraph 11 to paragraphs 16A—16D. It is clear that the amendment is not changing the definition of a liability; it is making an exception to it.

63. However, the staff draft of the amendment did not link the exception in paragraphs 16A—16D to the definition in paragraph 11. The preballot draft clearly links them.

Paragraph 16A(e)

64. This paragraph was discussed at length at the roundtables. Participants thought the paragraph was confusing for a number of reasons:

    a. The meaning of *substantially* was unclear.

    b. Participants were uncertain whether 'net assets' only referred to recognised assets and liabilities or also included unrecognised assets and liabilities. As a result, it was unclear whether an instrument whose return is based on the fair value of the entity would meet the condition in this paragraph.

    c. This paragraph used the terms 'fixed' and 'guaranteed' while paragraph 16B used the terms 'fixing' and 'restricting.' Participants were uncertain about the distinction. (Refer to Issue C of this paper).

65. Staff clarified paragraph 16A(e) as follows:

    a. explicitly included instruments whose returns are based on the change in the fair value of the recognised and unrecognised net assets of the entity,

    b. removed the terms 'fixed' and 'guaranteed' (as discussed in Issue C).

    c. included discussion of the objective of the paragraph 16A in the Application Guidance and the Basis for Conclusions (as discussed in Issue C)

IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments*

66. Roundtable participants were confused about the interaction between the proposed amendment and IFRIC 2. That is because paragraph 96A of the staff draft referred to a consequential amendment to IFRIC 2 but did not discuss the nature of that consequential amendment.

67. That was a drafting oversight. The ED included the consequential amendment to IFRIC 2 (paragraph 2 of the Appendix–Amendments to other IFRSs) but the staff draft did not.

68. The consequential amendment to IFRIC 2 clarifies that members' shares in a cooperative are classified as equity if those financial instruments have all the features and meet the conditions in paragraph 16A and 16B or paragraphs 16C and 16D of the proposed amendment.

69. The consequential amendment is included in the preballot draft.

Other Drafting Changes

70. Below is a list of other drafting changes that the staff would like to bring to the board's attention:

   a. <u>Introduction</u>: added a section 'Reasons for Amending IAS 32 in 2008' to specifically address the proposed requirements rather than amending the existing section.

   b. <u>Paragraph 16A(a) and paragraph 16C(a)</u>: clarified the calculation of a *pro rata share*

   c. <u>Paragraphs 16A(b)(i) and 16C(b)(i):</u> removed the phrase '…in either the calculation of the amount due on liquidation or the timing of payment of that amount' because it was unnecessary and caused confusion

   d. <u>Paragraph 16A:</u> changed 'its own shares' to 'that instrument' because the financial instrument may not be in the legal form of shares

   e. <u>Paragraph 22A</u>: changed 'derivative' to 'contract' to include agreements that do not meet the definition of a *derivative*

   f. <u>Paragraph AG14B and AG14C</u>: removed these paragraphs because they were redundant; the information is included in paragraph 11, paragraph 16A, and 16C

   g. <u>Terminology</u>: changed *net profit* to *profit* throughout the amendment

   h. <u>Consequential Amendments</u>: as noted in paragraphs 66-69 of this paper, the staff draft did not include the consequential amendments. In addition to the amendment to IFRIC 2 discussed above, there is a minor amendment to the scope of IAS 39 that clarifies that paragraph 2(d) of that standard includes financial instruments that have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of the proposed amendment. That consequential amendment has been added to the preballot draft.

i. Basis for Conclusions: has been added to the preballot draft

71. **Question for the Board:**

Does the board agree with the staff's drafting changes in the proposed amendment?