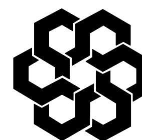

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International Accounting Standards Board

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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: **25 January 2007, London**

Project: **Financial Instruments Puttable at Fair Value**

Subject: **Analysis of Comment Letters on the Exposure Draft (Agenda paper 8)**

Introduction

1. The Board published its Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements: *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* (ED) on 22 June 2006. The comment period ended on 23 October 2006. Eighty-seven comment letters were received.

2. The purpose of this paper is to provide an analysis of the responses received to the ED for the Board's information only. The staff is not requesting that the Board make any decisions at this meeting.

Question 1: Financial Instruments Puttable at Fair Value

3. The ED proposes the following conditions for classifying as equity a financial instrument puttable at fair value:

(a) the instrument entitles the holder to require the entity to repurchase or redeem the instrument for the fair value of a pro rata share of the net assets of the entity and would, but for this entitlement, have met the definition of an equity instrument;

(b) the instrument entitles the holder to a pro rata share of the net assets of the entity in the event of the entity's liquidation;

(c) the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, either before or at liquidation;

(d) the instrument is in the most subordinated class of instruments with a claim to the entity's net assets;

(e) the instrument's issue price is the fair value of a pro rata share of the net assets of the entity at the time of issue; and

(f) the instruments in the most subordinated class are all financial instruments puttable at fair value.

Under the proposed amendments, minority interests puttable at fair value and warrants (and other derivatives) to be settled by the issue of financial instruments puttable at fair value would not qualify for equity classification and would continue to be classified as financial liabilities.

4. The majority of respondents agree with equity classification for financial instruments puttable at fair value. These respondents can be grouped into three sub-categories:

(a) those who fully support the criteria for classifying as equity financial instruments puttable at fair value;

(b) those who support equity classification for financial instruments puttable at fair value but believe that this should be accomplished in the long-term project; and

(c) those who support equity classification for financial instruments puttable at fair value but recommend amending the criteria for equity classification or the approach used to achieve this.

5. Some respondents agree, without qualification, with the proposals to classify financial instruments puttable at fair value. The respondents argue that financial instruments puttable at fair value should be classified as equity because:

(a) this reflects the economic substance of the arrangements, which is evidenced by the behaviour of the parties involved and capital market participants (eg CL1);

(b) this is consistent with IAS 32's current departure from the Framework (ie IAS 32 classifies an instrument as a liability when it does not meet the Framework's definition of a liability because, in substance, it is akin to a liability) (eg CL7);

(c) current information reported under IAS 32 does not meet the requirements of the Framework for relevance and understandability (eg CL11) and does not appropriately reflect the financial position of the entities (eg CL44). For example:

   (i) On an ongoing basis, the liability is recognised at not less than the amount payable on demand (ie the instrument's fair value). This results in the entire market capitalisation of the entity being recognised as a liability because the instruments are the equivalent of the entity's ordinary shares.

   (ii) The changes in the fair value of the liability are recognised in profit or loss. When the entity performs well and the fair value of the liabilities increases, a loss is recognised. When the entity performs poorly and the fair value of the liability decreases, a gain is recognised.

   (iii) It is likely that the entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

   (iv) The issuing entity's balance sheet portrays the entity as wholly, or mostly, debt funded.

   (v) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that net income is a function of the distribution policy, not performance.

(d) the additional information produced to reconcile the information produced under IAS 32 and to reflect a 'true and fair view' is a significant compliance burden for the affected entities (eg CL30) and does not resolve all the issues arising from the IAS 32's current treatment of these instruments (eg CL7). For example, a constituent argues that "the current disclosure in circumstances where an investment company has no equity is confusing and unhelpful to all parties. A 'one sided' balance sheet or a balance sheet that stops at the 'net assets attributable' line is difficult for users to understand, particularly when details of share capital is still shown in the notes" (CL42); and

(e) current information reported under IAS 32 is not comparable to non-IFRS requirements for unit trusts (eg US GAAP) (eg CL30, CL80).

Some constituents argue that the concerns arising from the current IAS 32 treatment of these instruments are such that a short-term amendment is warranted especially because the long-term project on liability and equity is unlikely to be completed before 2010 (eg CL7).

6. A few respondents agree with equity classification for financial instruments puttable at fair value but believe that the appropriate place to consider this is in the long-term project on liabilities and equities. These constituents object to the approach proposed in the ED because it is not principle-based, is inconsistent with the Framework and would create complex exceptions to the definition of a financial liability (eg CL4). Another constituent did not want a short-term change that might be reversed once the long-term project has been completed (CL24).

7. Around half of the respondents agree with the proposal to classify as equity financial instruments puttable at fair value but recommend that the scope of the proposals be widened to classify as equity the following instruments:

(a) financial instruments puttable at no more that its fair value (for example, financial instruments puttable at book value and co-operative capital);

(b) minority interests puttable at fair value;

(c) financial instruments puttable at fair value that are not in the most subordinated class but are subordinated to creditors, or financial instruments puttable at fair value that are in the most subordinated class but there exists another class of shares in the most subordinated class without the right to put;

(d) warrants (and other derivatives) to be settled by the issue of financial instruments puttable at fair value; and

(e) financial instruments puttable at fair value with the right to mandatory dividend distribution or partnership remuneration.

Some respondents, while agreeing with the proposal, request that the proposals be implemented as an interpretation (eg CL56) or by amending the equity definition instead (eg CL77).

8. Some respondents disagree with the proposal to classify as equity financial instruments puttable at fair value. The respondents who disagree with the proposal to classify as equity financial instruments puttable at fair value argue that:

(a) the instruments meet the definition of a liability under the current framework (eg CL13, CL8);

(b) the exception is not based on a clear principle but instead comprises detailed rules put together to achieve a preset accounting result (eg CL13, CL67);

(c) the proposals give rise to inconsistencies where very similar instruments are treated differently (eg CL13, CL21). For example, while the instruments are economically similar to an entity issuing a 'plain vanilla' ordinary share and, at the same time, issuing the holder of that share a separate derivative contract allowing the holder to put the shares back to the entity at any time at fair value, their treatments would not be comparable (eg CL19);

(d) there will be circumstances in which the amendments could expand the structuring opportunities aimed at obtaining a desired accounting result which bears little relation to the substance of the transaction or the underlying reason for the proposed amendments (eg CL10, CL21);

(e) the reclassification of these instruments as equity appears to be driven by the investors' point of view (the share in the residual net assets) rather than that of a lender who might view these as subordinated liabilities (eg CL29);

(f) it is likely that there will be further changes in the classification of instruments of this kind after the completion of the IASB's debt/equity project (eg CL13);

(g) the constituents' concerns could be temporarily addressed through additional disclosure (eg CL27); and

(h) the proposals have limited application (eg does not solve issue of the classification of partnership interests) when there are many other genuine concerns regarding IAS 32 (eg CL23).

Question 2: Obligations to Deliver to Another Entity a Pro Rata Share of the Net Assets of the Entity upon its Liquidation

9. The ED proposes the following conditions for classifying as equity an instrument that imposes an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation:

   (a) the instrument entitles the holder to a pro rata share of the net assets of the entity in the event of the entity's liquidation where liquidation is certain (affects limited life entities) or at the option of the holder (affects partnerships);

   (b) the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, either before or at liquidation;

   (c) the instrument is in the most subordinated class of instruments with a claim to the entity's net assets; and

   (d) the instruments (or components of the instruments) in the most subordinated class are all instruments that impose an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation.

   Under the proposed amendments, minority interests with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation and warrants (and other derivatives) to be settled by the issue of instruments that impose an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation would not qualify for equity classification and would continue to be classified as financial liabilities.

10. Some of the respondents did not comment on the classification of instruments with obligations 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). Of the respondents who did comment on this question, the majority of respondents agree with equity classification of instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation. These respondents can be grouped into three sub-categories:

    (a) those who fully support the criteria for equity classification of these types of instruments;

    (b) those who support equity classification of these types of instruments but believe that this should be accomplished in the long-term project; and

(c) those who support equity classification of these types of instruments but recommend amending the criteria for equity classification or the approach used to achieve this.

11. Some respondents support, without qualification, equity classification of instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation. Their reasons for supporting equity classification of these instruments are similar to those raised for financial instruments puttable at fair value. Moreover, some respondents believe that there is a stronger case for equity classification of instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation. They argue:

    (a) "…Before liquidation there will be no contractual outflow of resources. In liquidation the liquidator's task is simply to liquidate the assets and return them to shareholders in accordance with their established rights…. highlighting the fact that there is an expected 'outflow of resources' in respect of shares, when these only arise on liquidation, is of little value to users of the accounts, as the entire 'resources' of the company will be distributed in one way or another on liquidation" (CL42); and

    (b) "that these instruments more closely align with common stock, as redemption occurs only when the entity ceases to exist. As such, unlike investments in puttable instruments, holders of instruments that impose an obligation upon liquidation are unable to 'walk away from the risk' during the life of the entity. The fact that termination is pre-defined should not make any difference in the classification of the residual interests" (CL27).

12. Some respondents agree with equity classification of instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation but request that the scope of the amendments be widened to classify as equity:

    (a) minority interests with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation;

    (b) warrants (and other derivatives) on instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation;

    (c) financial instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation that are not in the most subordinated class but are subordinated to creditors, or when liquidation can

occur at the option of the holder but there exists another class of shares without the option to liquidate the entity;

(d) financial instruments with obligations for a pro rata share of the net assets of the entity upon its liquidation with the right to mandatory dividend distribution or partnership remuneration; and

(e) all financial instruments with obligations arising only on liquidation for limited life entities (ie amend the requirements for contingent settlement provisions).

The recommendations to widen the scope of the proposed amendments raised above are similar to those raised for financial instruments puttable at fair value except for the recommendation in sub-paragraph (e) above.

13. The respondents who agree that instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation should be classified as equity but believe that this should be accomplished in the long-term project did so for the same reasons as they believed financial instruments puttable at fair value should be classified as equity but only in the long-term project.

14. Similarly, respondents that disagree with the proposals to classify as equity instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation did so for the same reasons as they opposed the proposals to classify as equity financial instruments puttable at fair value.

Question 3: Disclosures – Annual Disclosure of the Fair Values of the Financial Instruments Puttable at Fair Value

15. The ED proposed requiring additional disclosures about financial instruments puttable at fair value classified as equity, including the annual disclosures of their fair values.

16. The majority of respondents agree with the proposal to require additional disclosures about financial instruments puttable at fair value classified as equity including the annual disclosures of their fair values. The respondents who agree with this proposal reason that:

(a) "as stated in BC21, it is unusual for holders of equity instruments to have an entitlement to put these instruments to the issuer at anytime, and therefore, their fair values, which represent the amounts at which these instruments could be

redeemed, is necessary information to help all users of financial statements in their assessment of risks that may arise from such action" (eg CL73); or

(b) "the cost of providing this information should not create an undue burden on entities that need to comply with them" (eg CL17).

17. Some respondents disagree with this proposal. They argue that this disclosure:

(a) is inconsistent with equity classification of these instruments as other equity instruments do not have to disclose their fair values (eg CL49);

(b) discriminates against partnerships (and other entities with these instruments) based on the legal form of the entity (eg CL49);

(c) would provide competitors with commercially sensitive information (eg CL49), especially for unlisted entities (eg CL87);

(d) does not provide useful information because the event is unlikely to occur. In practice, it is uncommon to put back these instruments. The additional disclosures present the probable cash outflows in the worst case scenario, when all holders of financial instruments puttable at fair value have put back their instruments to the entity. In this most unlikely case, the entity would be liquidated and hence, the amount returned to the instrument holders, their share of the residual amount, is unlikely to be the fair values of these instruments (eg CL71); and

(e) the cost of the disclosures is onerous (eg CL87). For example:

  (i) The concession for non-listed entities for the calculation of the redemption price of financial instruments puttable at fair value is deemed to be ineffective and therefore, the cost for this disclosure is prohibitive for these entities (eg CL71).

  (ii) The additional cost for this disclosure for first-time adopters would outweigh the benefits of IFRS adoption and would deter voluntary adoption by entities with financial instruments puttable at fair value (eg CL54).

18. One constituent (CL71) suggests, as an alternative disclosure, the disclosure of the probability of cash outflow resulting from an instrument puttable at fair value. These disclosures might comprise information on contracted cancellation periods, already known cancellations, and statistics on cancellations of financial instruments puttable at fair value.

Another constituent (CL26) recommends that the Board consider further concessions for small and medium entities from the requirement to disclose the fair values of financial instruments puttable at fair value annually and that this issue may be better addressed in the project for Small and Medium-sized entities.

Question 3: Disclosures – Reclassification

19. The majority of respondents support the disclosure of information about reclassification of financial instruments puttable at fair value and instruments with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation between financial liabilities and equity. An example of the reasons given supporting this disclosure is:

    > "This disclosure will highlight the impact of the change in classification which will enable the user to better appreciate the measurement issues associated with the change in classification" (CL17).

20. No respondents disagree with the proposed disclosure of reclassification of the affected instruments and the rest of respondents did not comment on this proposal.

Question 4: Effective date and transition

21. The exposure draft proposed that the changes would be required to be applied retrospectively, from a date to be determined by the Board after exposure (with one exception permitted relating to compound instruments). Earlier application would be encouraged.

22. The majority of the respondents agree with the proposed effective date and transitional requirements. The reasons for supporting the proposals are that they are appropriate (eg CL26, CL28), retrospective application will always be possible (eg CL21, CL73) and it will enhance comparability over time (eg CL40, CL85).

23. A few respondents agree with the proposed effective date and transitional requirements but request that the Board consider:

    (a) whether consequential amendments are needed to IFRS 1 (eg CL25);

    (b) prospective application of the proposed amendments because of the costs retrospective amendments (eg CL76);

(c) whether the amendments will be effective before 2009 or be subject to the IASB's policy that new major standards or amendments to standards will be effective from 1 January 2009 (eg CL33);

(d) additional guidance on the treatment of instruments that are reclassified between equity and liabilities (eg CL87); and

(e) transitional provisions for when an entity is unable to determine the issue price of a financial instruments puttable at fair value (eg CL34).

24. A few respondents did not agree with the proposed effective date and transitional requirements because:

(a) they did not agree with the proposals of the ED (eg CL81); or

(b) the costs outweigh the benefits of retrospective application. Retrospective application will impose a heavy and unnecessary burden on preparers and introduce confusion among users of financial information (eg CL64).

Next steps

25. The staff will prepare an analysis of the following major issues for the Board's consideration:

(a) the scope of the proposed amendments, in particular:

(i) whether the scope should be extended to classify as equity financial instruments puttable at no more than fair value; and

(ii) whether the scope should be extended, to classify as equity, minority interests puttable at fair value and minority interests with obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation;

(b) the criteria for equity classification, in particular:

(i) the issue price of financial instruments puttable at fair value must be at fair value;

(ii) the instrument must be in the most subordinated class of instruments and all instruments in that class must have the same obligation; and

(iii) the classification of instruments with the right to mandatory dividends or partnership remuneration;

(c) the disclosure of the fair values of financial instruments puttable at fair value;

(d) concessions for small and medium-sized entities;

(i) the calculation of the issue and redemption price of a financial instrument puttable at fair value; and

(ii) the disclosure of the fair values of financial instruments puttable at fair value;

(e) whether additional transitional provisions are needed; and

(f) the effective date of the amendments.