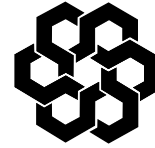

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International Accounting Standards Board

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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:	**18 May 2007, London**
Project:	**Financial Instruments Puttable at Fair Value and Obligations arising on Liquidation (ED)**
Subject:	**Board re-deliberations (Agenda paper 9)**

BACKGROUND

1. In January 2007 the board discussed an analysis of comment letters received from respondents to the ED. At the April meeting the Board agreed to consider issues associated with the original scope of the ED, and to separately explore the requests made by some respondents consider other instruments.
2. Since the April Board meeting a number of Board members and staff have met with some constituents to discuss partnership structures that are prevalent in Germany. Some of that discussion is incorporated into this paper. Meetings with other constituents are already, or will be, set up.
3. For the convenience of Board members appendix one contains the ED.

APPROACH TAKEN BY THIS PAPER

4. Many respondents found the ED both complex and confusing. The Board and staff need to consider how the proposed amendment can be more clearly articulated. This paper attempts to do that by identifying the underlying principles of the ED.

The paper then goes on to analyse the issues raised by respondents in the context of those underlying principles.

5. This paper focuses on instruments puttable at fair value, primarily because that was the main source of confusion for respondents.

SECTION 1

PRINCIPLES UNDERLYING THE ED

Staff recommendation 1. The proposed amendment should be redrafted based on the principles underlying the ED. Such redrafting is not intended to change the requirements of the ED, other than those changes the Board agrees to, but rather to make the proposed amendment less complex to understand.

6. The exception to IAS 32 *Financial Instruments: Presentation* proposed by the ED was based on the assertion that certain instruments that contain certain types of obligations also have characteristics that are similar to ordinary shares. The ED uses ordinary shares as a proxy for 'equity'. The ED states that requiring equity classification for such instruments is an improvement in financial reporting.

7. Paragraph BC 6 of the ED states that "…financial instruments puttable at fair value have characteristics similar to ordinary shares, in that the instruments give the holder a residual interest in the net assets of the entity".

8. The first characteristic, or maybe 'principle', of equity cited in the ED is therefore the residual nature of the instrument.

9. Paragraph BC12 explains why the criteria set out in the ED are required for equity classification. One of the reasons given is "…to ensure that the affected instruments are *equivalent* to ordinary shares, except for the right to put at fair value…". [Emphasis added]

10. Paragraph BC 12, when taken together with some of the criteria for equity classification that focus on the *return* to the holder (as set out in BC11 and in the rest of the ED) highlight an additional theme - the return to the instrument holder. In fact, consideration of the detailed criteria suggest that an instrument, as well as being the most residual, must also fully participate in the performance of the entity during the time that instrument is outstanding.

11. In summary, the two characteristics (principles) underlying the ED are that the instrument:

    a) Has a residual interest in that entity throughout the life of the instrument, and

    b) Participates fully in the performance of the entity throughout the life of the instrument.

12. It is worth noting that these two principles are consistent with the models being developed by the FASB in the long term project. The staff considers it important that decisions within this short term project are at least directionally consistent with the work done to date on the long term project.

13. The following sections explore these two principles further.

RESIDUAL INTEREST

Background

14. Residual interest is a fundamental principle of equity both in the ED and in IAS 32.

15. An instrument can be residual without partially or fully participating in the performance of an entity. Such instruments are fairly unusual and normally only exist for statutory or regulatory reasons. An example might be a management share in a unit trust or similar investment vehicle.

16. Whilst an instrument can be residual without participating, participation in the performance of an entity is inextricably linked to the principle of a residual interest in the entity. Before you can assess whether an instrument is participating you need to identify *what* they are participating in, and that would be the residual value of the entity. Hence, the residual interest identifies the ‘performance’ of the entity that participation is then judged against.

The criteria in the ED relating to most residual

17. The ED contains 3 criteria that directly illustrate the principle of most residual:

    a) The instrument is in the most subordinated class of instrument, and all instruments in that class are puttable

    b) The instrument contains no other contractual obligation other than the embedded put and the claim to a pro-rata share of the net assets on liquidation

c) The instrument has no preferential rights on liquidation

18. The main criteria relating to the residual nature of the instrument is the requirement for the instrument to be in the most subordinated class. The other criteria simply illustrate the underlying principle.

19. The restrictive nature of this requirement ensures that only the instruments that really are the most residual interest in the entity get an exception to the principle of IAS 32.

Link with long-term project

20. The FASB models definition of a Direct Ownership Instrument uses the term "no priority on liquidation". This is less restrictive than the ED. Such a term would allow both puttable and non-puttable instruments within the same entity to meet the criteria. It would treat instruments consistently across different entities but would widen the scope of the proposed amendment. Therefore using the most subordinate as a criterion is directionally consistent with, but more restrictive than, the long-term project. The proposed amendment would not allow equity classification for instruments that might then be reversed as a result of the long term project, based on the work performed to date.

PARTICIPATION IN THE PERFORMANCE OF THE ENTITY

21. The second principle underlying the ED is full participation in the performance of the entity throughout the life of the instrument. As noted above, identification of the performance of an entity relies on the most residual interest principle.

22. The table below lists the criteria in the ED that illustrate the principle of participation.

Criteria	Reason for inclusion
Issuance at fair value	Ensures equal participation with other instrument holders. Ensures full participation in the entity performance.
Puttable at fair value	Ensures equal participation with other instrument holders. Ensures full participation in the entity performance.
Entitled to a pro-rata share of net assets on liquidation	Return linked to residual of the entity at liquidation.
Return is neither limited nor guaranteed	Entire return linked to the performance of the entity throughout life.

23. Questions from respondents concentrated on the requirement to issue and put the instrument at fair value. Respondents were confused as to:

    a) why the requirements were necessary, and

    b) what 'fair value' is being referred to.

    The second question is addressed later in the document. The question of why the requirements are necessary is more fundamental to understanding the principle of participation, and is therefore discussed below.

Why the requirements are necessary

24. Issuance and exit at fair value ensures full and equal participation by all instruments in the most residual category in the performance of the entity throughout the life of the instrument. If one investor can invest at a discount and leave at fair value then their return is greater than another investor who invests and leaves at the same times but at fair value.

25. It may not always be necessary for an instrument to be issued and put at fair value, but simply that the calculation basis used ensures full pro-rata participation in the performance of the entity during the period of investment. This idea is already partially included within the ED with the allowed use of formula as a proxy for fair value in certain situations. However, use of the formula is included in the ED

as an allowed relaxation of the criteria in limited situations rather than based on a principle of full participation in the performance of an entity

26. The approach of requiring issue and exit at fair value is consistent with a principle of full participation in the performance of the entity. However, in entities such as partnerships where things other than cash may form part of the issue or exit price, such an approach does create difficulties. This issue is discussed later in this paper.

27. **Question for the Board: Do you agree with the staff recommendation?**

SECTION 2

ISSUES RAISED BY RESPONDENTS

28. This section addresses issues raised by respondents to the ED, and discusses them in the context of the two principles suggested in the previous section.

29. The issues to be addressed are summarised below.

Issue no.	Description of issue	Residual interest principle	Participation in performance principle
1	**Partnership interests**	Subordination amongst partners, and personal guarantees	In/out at fair value & contribution of non-cash assets
2	**Non-puttable shares**	Presence of non-puttable or more residual instruments (eg. management shares, perpetuals in partnerships).	
3	**Minority interests**	Puttable minority interests in consolidated financial statements	
4	**What 'fair value' refers to**		Participation in performance Use of formula Recognition of non-cash contributions (see partnership issue above)
5	**Identification of issue price for old instruments**		Transition issue

Issue 1: Partnership interests

Personal guarantees

Staff recommendation 2: Personal guarantees by partners (either general or limited) should be disregarded for classification purposes. Such personal guarantees can be considered to be separate contractual arrangements between the entity and another party. Such guarantees also do not change the ranking among the holders of the most residual class of instrument (who also fully participate in the performance of the entity).

30. There are two basic partnership structures:

    a) General partnerships – 11 partners all with the same unlimited liability. The partners all share equally in both the gains and losses. Therefore they are equally subordinate. The most subordinate class requirement is not an issue for this type of partnership.

    b) Limited partnership – 10 limited partners and 1 general partner. The partners share the gains and losses equally, distributed in proportion to their capital contribution. The only time the general partner has a liability in excess of the limited partners is if the partnership liquidates in a net liability position. In such a situation the general partner is *personally* liable for the entire net liability.

31. Within the limited partnership structure the participation and role of the general partner can vary. Often the general partner does not contribute any capital into the partnership, therefore does not participate in the ongoing profits and losses of the partnership. Also the general partner may be compensated on a fee type basis for bearing the unlimited risk. If the general partner does contribute capital he may share in the profits and losses proportionally to the total capital contributed by all partners, or the partnership agreement may contain special profit-sharing arrangements.

32. Quite often the general partner is a limited liability company, contributes no capital and therefore does not participate in profits or losses based on capital, and receive a fee for being general partner. In the event of liquidation in a net liability position the general partner has unlimited liability. However as it has no assets to

settle those liabilities, effectively it offers limited guarantee to the external creditors.

33. Considering the general partner as the most subordinate reflects the legalistic nature of the relationship. However, we could also describe the general partner relationship as a limited partner interest and a separate contractual guarantee between the entity and another party. The General Partner may or may not be separately compensated for the guarantee. Such an approach would also prevent structuring opportunities:

    - 11 Limited partners (all contributing equally) and one separate guarantee – all 11 partners would be equally subordinate. (In many jurisdictions, a limited partnership must have at least one general partner. We make the point here for comparison.)
    - 10 Limited partners and one General partner (all contributing equally, including the general partner) – the general partner would be most subordinate.

34. A similar situation can be found in many loans made to small businesses. In order to qualify, or to obtain special government-sponsored terms, the loans require a personal guarantee from one or more of the partners/shareholders of that business. Such a personal guarantee is arguably separate from the entity itself and does not change the order of subordination amongst the partners/shareholders of that entity. The claim against the personal assets of a particular partner or shareholder also does not change the relative claims to the residual value of the entity among the partners or shareholders as a group.

35. **Question for the board: Does the board agree with the staff recommendation?**

Participation in the performance of an entity

Staff recommendation 3: Participation in the performance of an entity should include consideration of all types of contributions made by a partner.

36. A separate but related issue is created by participation in the performance of the entity by partners within a partnership.

37. The requirement of the ED that both entry and exit is at fair value reflects full participation in an entity where the investors are at arms length to the business itself. However, in the situation that an investor is also employed in the business, applying a principle of full participation is more difficult.

38. Take a partnership. Two partners may join the same firm in the same year for the same stake in the partnership, but one may contribute significantly less cash than the other. The partnership would not agree to this discount on entry unless that partner contributing less cash is also contributing something else. This something else might be a client list.

39. The 'economic' double entry for such a contribution could be:

    Dr Cash X

    Dr Client list Y

    Cr Equity X+Y = FV of the investment

40. For accounting purposes that client list is not recognised. However, the fair value of the contribution made by both partners in this example is the same.

41. Assuming that the exit price for the partner is also not adjusted for such items, then the partner will have participated fully in the performance of the entity during the period that they were a partner. Such a partner will have participated equally with the partner who joined at the same time, did not bring an existing client list, but had to pay more cash to obtain the same ownership interest.

42. **Question for the Board: Does the board agree with the staff recommendation?**

Issue 2: Presence of non-puttable instruments

Staff recommendation 4: The criteria set out in the ED relating to the presence of non-puttable instruments should not be changed. Doing so would create an exception to one of the principles on which the ED is based. The staff will continue to explore this issue in the long-term project.

43. One feature of being most residual is that if an instrument is puttable at fair value, then all other instruments in that class must also be puttable.

44. Respondents have raised concerns over this criteria for a number of reasons, including:

    a) The criteria will mean that similar instruments will be treated inconsistently in different entities depending on what other instruments those entities have issued.

    b) Instruments may be treated inconsistently within one entity in different accounting periods if the entity, subsequently to issuing puttable instruments, issues non-puttable instruments.

    c) Finally, there are a number of types of entity with a minimal number of non-puttable instruments whilst most of the financing will be contributed via puttable shares. Such structures include fund structures when the fund has some permanent management shares but the majority of the units in the fund are puttable to ensure the unit holders have an established exit route. These funds would still show minimal equity because the presence of those management shares will prevent equity treatment of the main fund financing.

45. This criteria also means that a partnership that issues perpetual instruments would immediately cause all the partnership interests (that must be puttable by law) to be classified as liabilities. Some consider some perpetual instruments to have fewer equity 'characteristics' than the partnership interests, but perpetuals are more subordinate because they are perpetual.

46. One possible approach to these concerns is to create an exception to the most residual principle.

47. Such an exception could be that, if the instruments within the most subordinate class do not represent 'substantial' (or some similar word – that of course would result in need for further guidance!) equity, then the next class up should be considered so long as the instruments in the second class have no priority on liquidation.

48. Such an approach would represent a 'half-way house' between the restrictive requirements of the ED and the broader principle of the FASB's Direct Ownership Instrument as discussed in paragraph 20.

49. **Question for the board. Does the board agree with the staff recommendation?**

Issue 3: Minority Interests (MI)

Staff recommendation 5: The required reclassification of MI from equity to liability at the consolidated level (when the MI is puttable at fair value or shares in a limited life entity) should remain if those instruments are less residual than other instruments at a consolidated level.

50. Instruments puttable at fair value are classified as a liability under IAS 32 at the subsidiary level and at the consolidated group level. At the subsidiary level this classification would change to equity under the ED. However, such instruments should still be classified as a liability in the consolidated group as they are less residual than other instruments (see paragraph AG 29A of the ED).

51. Many respondents commented that this is inconsistent with all other situations in IAS 32 when the equity classification at the subsidiary level is maintained at the consolidated level unless other contractual terms exist between another group entity and a third-party that change that classification. Such respondents argued that the nature of the instrument and the contractual terms of the instrument have not changed, and so its classification should not change.

52. The reasoning in the ED for the change of classification from equity at the subsidiary level to liability at the group level is that at the group level those interests are no longer considered to be in the group's most subordinate class of instruments. Paragraph AG29A states that *"If the group were to liquidate, the claims of minority interest holders to the net assets of the subsidiary would have to be satisfied before the parent's share of the net assets of the subsidiary can be distributed to claimants to the assets of the parents."*

53. Respondents have questioned whether the above assumption is always the case in all jurisdictions. Some respondents also stated that it is unclear whether the ED meant that the subsidiary claimants get satisfied before the parent entity claimants, or whether minority interests get satisfied in advance of majority interests in the subsidiary.

54. The same issue also exists for instruments in a limited (or finite) life entity. The ED concluded that, because of the participation in the entity and residual nature, such instruments should be equity in the financial statements of the limited life

entity. The ED also concluded that the classification at the consolidated level should be changed to a liability.

55. One possible approach is to eliminate the requirement to reclassify the minority interest to a liability in the consolidated financial statements. This would result in consistent treatment of other equity instruments within the consolidated group. Reclassification from equity to liability might only be required if there are other terms and conditions that exist at the group level that do not exist at the subsidiary level.

56. However, this would arguably be an exception to the principle of most residual (although, as mentioned above, not all respondents agreed with the conclusion of the ED on this point). It would also represent a change to the ED and *may* necessitate re-exposure.

57. **Question for the board: Does the board agree with the staff recommendation?**

Issue 4: What fair value is being referenced to in the ED?

Staff recommendation 6: Any references to fair value in the proposed amendment should be in the context of a pro-rata share of the fair value of the entity.

58. What *fair value* was being referenced to by the ED (in the context of both the value that the instrument is issued at and the value that the instrument is put) was unclear to many respondents.

59. Some relevant references in the ED are as follows [Italics added]:

    a) Paragraph 11 – repurchase or redeem the instrument for the fair value of a *pro rata share of the net assets of the entity*.

    b) Paragraph AG14A – the redemption or repurchase price paid by the entity for the financial instrument is *its fair value*, determined in accordance with the requirements of IAS39 paragraph 48a and paragraphs AG69 – AG82.

    c) Paragraph BC13 - normally determine the fair value in accordance with IAS 39.

60. The implication of paragraphs AG14A and BC13 is that *fair value* referred to the fair value of the instrument. However the references in the introduction and the body of the standard refer to a share of the net assets of the entity.

Pro-rata share of the net assets

61. The use of a pro-rata share of net assets clearly describes the return of the residual interest on liquidation of an entity.

62. However, outside of liquidation of an entity the use of the term 'pro-rata share of net assets' raises a number of questions:

    a) What do we mean by net assets?

    b) Do we mean all assets and liabilities of the entity including internally generated goodwill?

    c) Or just recognised assets and liabilities but re-measured to fair value?

63. The context (other than on liquidation) clearly shows it was meant as short hand for the pro-rata share of the fair value of the entity. However, the term has caused confusion. The staff suggest removing references to net assets and instead label this requirement as being the 'pro-rata share of the fair value of the entity'.

Fair value of the instrument

64. The obligation that the ED is addressing is the embedded obligation in the instrument. In situations when this obligation reflects full participation in the performance of the entity (alongside the other criteria), the ED justifies an exception to IAS 32.

65. In many situations the fair value of the instrument and the fair value of a pro-rata share of the entity will be the same. The references in the ED to the fair value of the instrument are short-hand in such situations for the value of the actual obligation itself.

66. As discussed, the criterion exists to identify participation in the performance of the entity. A pro-rata share of the fair value of the entity would do that, and in many situations the fair value of the instrument would also do that. But in situations when the fair value of the instrument is not equal to the pro-rata share of the fair value of the entity the criteria looses the link between the value of the instrument and the entity.

67. **Question for the board: Does the board agree with the staff recommendation?**

Does entry and exit have to be at fair value (and associated issues)?

Staff recommendation 7: The requirement for issue and exit price to be at fair value should be redrafted in the context of a principle of full participation in the performance of the entity (consistent with the previous discussion of partnerships).

68. The ED permits the use of a formula as proxy for fair value in limited circumstances. One requirement of use is that it can be demonstrated that the formula is not materially different to the fair value (presumably pro-rata share of the fair value of the entity). Respondents have commented that this requirement prevents the use of a formula from providing any relief from the burden of calculating fair value.

69. However, use of a formula is consistent with comments made earlier regarding the requirement to fully participate in the performance of the entity throughout the life. Use of fair value on issue and exist reflects such participation. However, to the extent that other formula based approaches also reflect such participation, they should be considered consistent with a principle of full participation in the performance of an entity.

70. **Question for the board: Does the board agree with the staff recommendation?**

Issue 5: Identification of issue price for old instruments.

Staff recommendation 8: There should be specific transition guidance to address situations in which instruments were issued a significant time ago. We will address this and other transition related issues in more detail in June.

71. A specific transition issue that arose with regard to issuance at fair value is that many instruments were issued decades ago. Identifying whether those instruments were issued at fair value would be difficult if not impossible. As such the staff would suggest either including specific transition guidance to deal with this situation or requiring that this criterion be prospectively applied.

72. **Question for the board: Does the board agree with the staff recommendation?**

SECTION 3

ANCILLARY ISSUES

Disclosure requirements

Staff recommendation 9: To retain the existing disclosure requirements, emphasizing that it is the prospective cash out flow rather than the current fair value of the instrument that is required.

73. Many commentators did not like the requirement to disclose the fair values of financial instruments puttable at fair value. Comment letters questioned why additional disclosure was required for these instruments given that such disclosures are not required for other equity instruments.

74. Commentators are correct in their observation that these disclosures are not required for existing equity instruments. However, existing equity instruments do not contain obligations. Therefore these disclosures recognise that this category of 'equity' is different to other equity; there is a potential outflow of cash or other financial assets that is out of the control of the entity, and the users of the financial statements should be made aware of this. The disclosure requirements are less burdensome and more relevant if they reflect the expected cash outflow rather than the fair value of the instrument.

75. **Question for the board: Does the board agree with the staff recommendation?**

Other issues

76. Below are other questions and issues raised in comment letters. Staff would like to know whether or not the Board considers further work is required on these issues.

77. *Mandatory dividend distributions and partnership remuneration.* Seven respondents commented that they would like such instruments to be included within the scope of the ED. These respondents tend to come from the property trust market and have entities where distributions are required to maintain the

property trust status of the entity. Discussions are being organised with respondents in this area to develop staff understanding of the issues.

78. **Question for the board: should staff continue to look into this issue with a view to inclusion of these issues in the current ED? Alternatively, should staff research this situation under the parallel work stream?**

79. *Most subordinate class requirement*. Respondents asked whether there could be more than one class of most subordinate instrument, if both classes were equally subordinate and the class difference related to voting rights etc. The staff considers that if differences between the classes do not affect subordination, and the two classes were indeed equally subordinate, then more than one class of subordinate instrument could, theoretically, exist.

80. **Question for the board: Do the Board agree with the analysis of this question?**