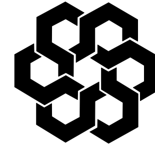

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This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on 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:	**21 September 2007, London**
Project:	**Financial Instruments Puttable at Fair Value and Obligations arising on Liquidation (ED)**
Subject:	**Board re-deliberations (Agenda paper 4)**

PURPOSE OF THIS PAPER

1. Some respondents to the ED highlighted that many puttable instruments that would not be classified as equity under the ED are actually the residual interest in the issuing entity, and that any amendment should reflect this fact.

2. This paper therefore re-examines the characteristics that result in puttable financial instruments being labelled as the residual interest in an entity, and classified as equity under the proposed amendment.

3. In considering those characteristics, this paper also considers a number of flaws inherent in the ED, and how they might be addressed in a final amendment.

4. In conclusion, this paper asks the Board how they would like to proceed.

5. This paper does not address the issue of re-exposure, or whether other due process steps need to be taken if the Board decides to proceed with an amendment based on an approach that is different from that set out in the ED. However, that is an important judgement the Board will need to make.

BACKGROUND

Approach of the ED

6. The ED identifies the residual interest in the net assets of an entity by requiring all individual puttable instruments:

   a) to be in the most subordinate class of instrument,

   b) to be issued and puttable at the fair value of the pro-rata share of the net assets of the entity, and

   c) to have neither a limited nor guaranteed return.

7. Characteristic (a) is essential to all approaches, but insufficient by itself. This paper therefore re-examines characteristics (b) and (c).

Characteristic (b) - Issued and puttable at the fair value of the pro-rata share of the net assets of the entity

8. Under the ED, each ***individual*** instrument in the puttable class has to be a ***residual interest*** in the net assets of the entity. The ED achieves this by requiring each instrument to be issued and puttable at the fair value of the pro-rata share of the net assets of the entity. Redemption of an instrument at something other than fair value of the pro-rata share of the net assets would fail the criteria because the holder of that instrument would not take their pro-rata share of the residual of the entity when they left. The investor (or investors) last in line would therefore receive a different return than all the other investors. Another way of saying this is that the ED does not permit a "tontine[1]".

9. Eliminating characteristic (b) – or replacing it with some other characteristic – provides the mechanism for labelling more puttable instruments as the residual interest in an entity (and therefore being classified as equity) than is the case in the ED.

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[1] An investment plan in which participants buy shares in a common fund and receive an annuity that increases every time a participant dies, with the entire fund going to the final survivor or to those who survive after a specified time. (American Heritage Dictionary)

Characteristic (c) – No limited or guaranteed return

10. Characteristic (c) is labelled as an 'anti-abuse' criterion in the ED, and seeks to ensure the most subordinate class is also the residual interest in the issuing entity.

11. This characteristic – and how it might be modified – is discussed in greater detail below. It is important to note that in some situations, characteristic (c) plays a vital role in the ED in determining whether puttable instruments are labelled as the residual interest.

The flaws in the ED

12. It is possible that other (less subordinated) items on the entity's balance sheet (or that are unrecognised for accounting purposes) may absorb all of the variability in the return (performance) of the entity, leaving only a pre-determined return for the class of puttable instruments.

13. Characteristic (c) prevents any such pre-determined return being limited(fixed) or guaranteed. However, in such situations, as long as there is *some* variability in the return of the puttable instruments then under the ED those instruments would be labelled as the residual interest in the entity and classified as equity. That variability could be insignificant and unrelated in any meaningful way with the entity.

14. The ED does not therefore prevent other items in the balance sheet (or indeed, unrecognised items) from absorbing *almost all* of the residual interest in the entity. An example would be an issued note with a return of 99.9% of the performance of the entity, leaving 0.1% of the performance to the (most subordinated) puttable shares. Arguably those other items are more residual than the puttable instruments, yet under the ED the puttable shares would be labelled as the residual interest as long as there was *some* variability in the return (and the other criteria of the ED were also met). That could be seen as a flaw.

15. In summary, the ED actually only identified some situations when a puttable instrument (that is most subordinated) is *not* a residual interest i.e. when the return is limited or guaranteed.

REVISED APPROACH

16. As noted previously, the ED requires ***each individual instrument*** to be a residual interest in the entity. It does this by requiring *all* the puttable instruments in the

most subordinated class to be issued and puttable at the fair value of the pro-rata share of the net assets of the entity.

17. The revised approach discussed in the following paragraphs instead seeks to identify whether ***the class of*** puttable instruments as a whole are the residual interest in the entity. It does this by eliminating the requirement that the puttable instruments be issued and puttable at a pro-rata share of the fair value of the net assets of the entity. Therefore, under the revised approach, any possible tontine is not relevant for classification of the class of puttable instruments as long as the class *as a whole* represents the residual interest in the entity.

18. However, this revised approach does require all instruments in the most subordinated class to be equal in all other respects – for example, the methodology for calculating exit price.

19. This ensures that no instrument could be put at *mor*e than the pro-rata share of the fair value of the net assets of the entity; for the instruments to be equal it must be possible for them all to be put at the same point in time (and clearly it would not be possible to distribute more net assets than an entity has).

20. In all other respects the criteria of approach 1 are the same as those in the ED.

21. However, by eliminating characteristic (b) the revised approach relies heavily upon characteristic (c) – that the return of the puttable instruments is neither limited nor guaranteed.

22. This reliance on characteristic (c) to determine whether a class of puttable instruments is the residual interest in an entity has exactly the same flaws as the ED in some situations (as discussed previously).

23. Both the ED and the revised approach are trying to ensure that equity treatment is only given to a residual interest, but identifying the residual interest is always going to be somewhat arbitrary for any entity that has anything other than the simplest of balance sheets. Simply concluding that a class of puttable instruments that are (a) the most subordinated class of instruments in the entity, and (b) that have neither a limited nor guaranteed return arguably does not go far enough.

24. That is, instead of simply saying what type of return is *not* a characteristic of equity, we should at least attempt to describe what type of return *is* a characteristic of equity.

DETERMINING THE TYPE OF RETURN THAT IS A CHARACTERISTIC OF EQUITY

25. While the criterion in the ED required that the return on the instrument was neither limited nor guaranteed, we could amend that as follows:

    The total return of the puttable instrument is based substantially on the net earnings or the change in net assets of the entity (excluding any possible effect the puttable instrument may have on net earnings or net assets). An example of a puttable instrument with a return that is not based substantially on the net earnings or the change in net assets of the entity is a puttable instrument that has a fixed or guaranteed total return to any extent, before or at liquidation.

26. This would ensure that the return on the puttable instrument is substantially linked to how well (or otherwise) an entity performs; for example, if the entity does well the return to the puttable instrument holders increases more or less in line with that performance (on a pro-rata basis).

27. Another way of saying this is that a characteristic of equity (for the purposes of the proposed amendment) is that the total return of the puttable instruments must move in the same direction as, and be substantially affected by, how well (or otherwise) the entity performs. If the return is fixed or guaranteed, this would not be the case.

28. This addresses the return on the instrument and links it to the return generated by the entity. However, it does not address the issue that there might be another (less subordinated) item that is absorbing most of the variability in the performance of the entity and leaving only a predetermined (but slightly variable) amount of net earnings (or net assets) for the class of puttable instruments.

IS THERE ANOTHER ITEM ABSORBING MOST OF THE VARIABILITY IN PERFORMANCE?

29. The only way to ensure that the net earnings or net assets of the entity are truly the residual interest in the entity at any time before liquidation is by reference to the other items on the balance sheet (or that are unrecognised for accounting purposes). The question we are seeking to address is whether there is some other item that results in the net earnings or the net assets of the entity essentially being pre-determined – and therefore creates a substantially fixed return for the class of

puttable instruments. If there is such an item, then arguably that item is more residual-like than the class of puttable instruments.

30. One possible approach could be the following criterion.

    The variability of the total return to the class of puttable instruments is not substantially absorbed by another contract or financial instrument, or some combination thereof. If a determination cannot be made that these conditions are met, the puttable instruments are classified as liabilities.

31. However such an approach raises a number of issues. For example, this criterion could be difficult to implement; it uses the terms *substantially* and *variability* the meaning of which is ambiguous. For example, it might be argued that applying such a criterion would require a FIN46R type calculation to prove that other items do not absorb a substantial amount of the variability of the entity.

32. This approach could be said to be based on a presumption of guilt rather than innocence. That is, until an entity can prove that there are no other items that substantially absorb the variability arising from the performance of the entity, then the class of puttable instruments cannot be proved to be the most residual interest in an entity.

33. A modification to the wording in paragraph 30 that could be made to create a presumption of innocence rather than guilt might be:

    Ordinary commercial contracts, like leases, mortgages, and franchise and license agreements may include provisions based on elements of the entity's performance (for example, a percentage of gross revenue). Contracts entered into on normal commercial terms with unrelated parties are unlikely to fall within the meaning of this test. For example, if commercial practice for lessors is to base rentals in part on a percentage of gross sales, and the percentage in the entity's lease is consistent with amounts charged in the are area, then the lease should not be considered to absorb substantial variability in net earnings or net assets.

34. Such wording would make it clear an entity is not required to assess ordinary commercial contracts entered into in the normal course of business. This would reduce (although not eliminate) the possible difficulties of application associated with the criterion in paragraph 30.

35. We have asked some interested constituents how they would implement this criterion and are currently awaiting their feedback.

ANOTHER APPROACH

36. At the last Board meeting it was suggested that a complete rethink on the approach to this issue may actually be a more expeditious way to address the problem. The alternative approach suggested was to separate the embedded put option from the equity host instrument and record the components as separate instruments.

37. This approach was discussed in the initial deliberations of this project and rejected on the basis that *further research into an approach that splits a puttable share into an equity component and a written put option component (financial liability) would duplicate efforts of the Board's longer term project on liabilities and equity.* The Board's opinion may have changed.

38. However the first question that would need to be addressed is the scope; that is, what instruments would we consider separating into their components? This is primarily the issue we are addressing in this paper. In the approaches discussed in this paper we are trying to decide in which situations a contractual obligation should be disregarded for classification purposes. Under any other approach we would also need to decide the instruments that should be in the scope of the approach – for example, the instruments that should be separated into the equity host and the embedded option. Therefore the issues being addressed in this paper would still need to be considered under that "something else" approach.

39. The staff also considers that any other approach would inevitably require re-exposure.

NEXT STEPS

Revised approach

40. If the revised approach has the required support of the Board the staff envisages this being the last Board meeting on the topic (beyond any possible sweep issues arising from the balloting process). A proposed amendment based on the revised approach has already been drafted. This document will be amended to incorporate the decisions of this Board meeting and could then be distributed as a pre-ballot

draft (obviously subject to any decision on re-exposure or other due process steps that may be required).

Finalising the amendment based on the ED

41. If the revised approach does not obtain the required Board support the default position is to consider issuing the approach set out in the ED. However, as discussed in this paper, that approach has some flaws.

STAFF RECOMMENDATION

42. The number of situations addressed by the ED is narrow; that is consistent with a narrow scope exception to IAS 32. However, the comment letters raised legitimate concerns regarding the classification of other instruments that, in many ways, are similar to those that would be classified as equity under the ED. The staff also considers that the ED has some flaws, as discussed previously. Therefore the staff supports the revised approach.

43. However, the elimination of the characteristic of entry and exit at fair value also removes any requirement for the return on the instrument to be linked in anyway to the performance of the entity. The suggested amendment to the *no fixed or guaranteed return* criterion, as drafted in paragraph 25 re-establishes the link between the issuing entity's performance and the return from the instrument. Therefore the staff recommends adopting that change.

44. The staff believes that the suggested criterion in paragraph 30 (regarding other items on the balance sheet absorbing most of the variability in the performance of the entity) to be problematic in terms of application; it will inevitably result in requests for additional guidance. Staffs concerns about implementation would be considerably allayed by the additional inclusion of paragraph 33. While it is clear that without this criterion there is a possibility that other instruments could be the true residual interest in the entity, that is the case today for entities with non-puttable equity.

45. **Questions for the Board: Do the Board wish to:**

    a) **Accept the staff recommendations in paragraph 42 and 43? If so:**

        i) **Does the Board also wish to add the criterion set out in paragraphs 30 and 33 and discussed in paragraph 44 (regarding other items on the**

balance sheet absorbing most of the variability in the performance of the entity)?

ii) **What, if any, additional due process steps are required?**

OR

b) **Do something else? If so, what?**