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International Accounting Standards Board

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 4A)**

BACKGROUND

1. This paper considers the other issues the Board needs to re-deliberate before the chosen approach (as discussed in paper 4) can be finalised.

   a) Mandatory dividends and partnership remuneration

   b) Derivatives on puttable instruments and limited life obligations

   c) Reclassification of instruments

   d) Mandatory redemption

   e) Implications of the re-deliberations to obligations arising on liquidation of limited life entities

   f) Transition requirements

   g) Effective date

MANDATORY DIVIDENDS AND PARTNERSHIP REMUNERATION

2. The ED required that the put or the obligation arising on liquidation be the only contractual obligation in an instrument for that instrument to be in the scope of the amendment.

   Other than the contractual obligation arising from the entitlement to require the entity to redeem the instrument or on liquidation of the entity the instrument does not contain any 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 potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a liability.

3. Some respondents to the ED questioned whether mandatory dividends and partnership remuneration are a contractual obligation. A number of entities (such as limited life property investment vehicles) have issued puttable shares that require a percentage of profits to be distributed annually.

4. It can be argued that because such dividends are dependent on the level of profits in the entity, then until profits are recognised no contractual obligation exists; that is, the entity can avoid paying any dividends or other remuneration by not making profits.

5. The Board and the IFRIC have discussed a similar issue in relation to contracts (possibly 'derivative' contracts) with payouts linked to EBITDA or revenue. The implication of those discussions was that a liability existed, but that the measurement of that liability was uncertain. That discussion had a different focus, it was primarily concerned with whether the contract met the definition of a derivative - the existence of a contractual obligation was assumed. However, a logical extension of that discussion would suggest a dividend that is required to be paid by the contractual terms of an instrument (although the actual amount may be uncertain) is a contractual obligation.

6. It can also be argued that an obligation to deliver a share of the profit is economically similar to a put at fair value. Both (arguably) are contractual obligations (the dividends being a strip of puts); the only difference is *when* the residual interest is distributed to the holder. Taking such an approach would raise the question of why one obligation should be disregarded for classification purposes, but the other is not.

7. However, this project specifically addresses puttable instruments and obligations arising on liquidation, not whether a mandatory dividend is a contractual obligation. Answering the question of whether mandatory dividends are a contractual obligation would have implications for other situations and projects (for example, leasing). Therefore, the staff considers that this amendment should not provide guidance as to whether a mandatory dividend is a contractual obligation.

8. **Question for the Board: Do you agree with the staff recommendation in paragraph 7? If not, what alternative approach would you support?**

DERIVATIVES ON PUTTABLE INSTRUMENTS AND OBLIGATIONS ARISING ON LIQUIDATION OF LIMITED LIFE ENTITIES

9. The ED makes it clear that derivatives on puttable instruments or limited life entity shares are not equity.

10. A number of respondents commented that this treatment is inconsistent with some derivatives on other equity instruments and asked that the scope of the exception be extended so that such derivatives were regarded as equity instruments. For completeness of re-deliberations this comment has been brought to the Board.

11. Not permitting such derivative instruments to be classified as equity is consistent with a narrow scope exception to IAS 32.

12. The equity instruments identified by the proposed amendment are different to other equity instruments (in that they contain a contractual obligation). Such a difference is important and in the view of the staff justifies what might be considered as inconsistent treatment with some derivatives on other equity instruments. The staff recommends retaining the proposals set out in the ED.

13. **Question for the Board: Does the Board agree with the staff recommendation in paragraph 12? If not, why not?**

RECLASSIFICATION OF INSTRUMENTS

14. All three approaches might require reassessment of instruments in certain circumstances. For example, if puttable instruments are no longer the most

subordinated class of instrument (because of the issuance of other instruments) then equity classification would no longer be applicable. Another situation would be the repurchase of non-puttable instruments (that then result in puttable instruments qualifying as equity).

15. A number of respondents noted that the ED did not contain guidance as to the accounting on reclassification.

16. There are two categories of reclassifications - from liability to equity and from equity to liability.

17. The first situation (liability to equity) is relatively straight forward. The liability will be carried at the discounted future[1] settlement amount due to the requirements of IAS 32 and IAS 39 (paragraph AG8). Therefore the staff recommends that on reclassification the instrument is classified as equity with a carrying value equal to its previous carrying value. There would be no gain or loss.

18. The second situation (from equity to liability) is slightly more complicated. The equity instrument will be carried at cost. IAS 39 requires initial recognition of a liability to be at fair value (paragraph 43). Therefore there may be a difference. There are three alternatives:

    a) To recognise the difference in profit or loss immediately,

    b) To recognise the difference in equity, or

    c) To recognise the liability at the equity carrying value, hence creating no gain or loss on reclassification. The gain would eventually be recorded in profit or loss.

19. Arguments for recognising the difference in profit or loss include increased visibility to the users of the financial statements. There has been a reclassification, and recording the impact of that reclassification in profit or loss highlights this point to the users. However, taking any difference to profit or loss is treating that instrument as if it had always been classified as a liability. That is not the case – the reclassification arose because of a change in circumstances.

[1] The put amount is not discounted to the expected payment date, but to the first date that the instrument could be put.

20. The difference arising on reclassification from equity to liability arose during the period in which the instrument was classified as an equity instrument. IAS 32 requires that interest, dividends, losses and gains on equity instruments are recorded directly in equity and not the income statement. Movements on equity instruments do not go to the income statement.

21. Re-classifying the instrument and recognising a financial liability at the equity carrying value rather than at the fair value of the financial liability would be inconsistent with the requirements of IAS 39 (see previous comments). This issue was discussed by the IFRIC in the context of a change in the terms of an equity instrument to allow cash settlement. In that situation the IFRIC agreed that the new liability should be recognised as fair value and any difference between the carrying value and the fair value should be recognised in equity.

22. The staff therefore recommends that differences arising on reclassification of an instrument from equity to liability should be recognised on reclassification and consistently with that original classification. That is, any difference between carrying value of the equity instrument and fair value of the newly recognised financial liability should be recognised in equity.

23. **Questions for the Board:**

    a) **Does the Board agree that guidance on how to reclassify an instrument under this amendment should be included?**

    b) **Does the Board agree with the staff recommendation in paragraph 17 and paragraph 22? If not, what alternative method of reclassification would the Board prefer, and why?**

MANDATORY REDEMPTION

24. If the embedded put option in an instrument is *certain* to be exercised in certain situations then the instrument is mandatorily redeemable. For example, a puttable instrument that on death of the partner must be redeemed by the entity. Death is certain, and neither the holder nor the issuing entity control redemption of the instrument on the death of the partner. The issue is therefore how such instruments should be treated under any amendment.

25. Paragraph 25 of IAS 32 is somewhat related to the issue of mandatorily redeemable instruments. However, paragraph 25 of IAS 32 discusses classification of instruments in the context of *uncertain* future events that are controlled by neither the holder nor the issuer.

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability , in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in the stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

26. The issue was discussed at the December 2005 Board paper and relevant extracts from that paper are included below:

Definition of 'puttable instruments'

1. Feedback has indicated that there is some confusion over whether 'puttable instruments' include puttable instruments with a fixed term. IAS 32.18(b) suggests that a 'puttable instrument' does not include an instrument mandatorily redeemable on a fixed date, which contrasts with IAS 32.BC7.

2. IAS 32.BC7 argues that it makes no difference whether an instrument is puttable on only one date or on a variety of dates for deciding its classification as a financial liability. This is a view we support. There are many examples of fixed period activities where the equity holders are *sharing the residual risk of the activity. In the present case allowing for a fixed date redemption should not increase the risk of financial engineering because the redemption event must be the same for all of the instruments.*

3. *In our view a consequential amendment to the definition of 'puttable instruments' in IAS 32.18(b) would clarify that the term 'puttable instrument' includes puttable instruments that have a fixed term such as those mandatorily redeemable with a fixed term.*

27. However the ED did not explicitly address this issue.

28. The criteria in the proposed amendment would not prohibit an instrument in which the embedded put is automatically exercised on the occurrence of specific events – either certain or uncertain - (such as death or retirement) from being classified as equity.

29. Paragraph BC16 of the ED references obligations *arising on liquidation* in two distinct situations commenting that the amendment applies to both situations:

    a) Certain to occur and outside the control of the entity (affects limited life entities); or

    b) Uncertain to occur and liquidation is at the option of the holder (affects partnership interests).

    There is no such distinction with regards to puttable instruments.

30. The staff believes that the proposed amendment should explicitly address the classification of a class of puttable instruments that are the residual interest in an entity but that are mandatorily redeemable as a result of a certain event (other than liquidation).

31. IAS 32 is clear that if an entity cannot avoid an outflow of cash or another financial asset as settlement of a contractual obligation, a financial liability exists. The proposed amendment is an exception to this principle.

32. The revised approach discussed in paper 4 considers the class of puttable instruments *as a whole.* Despite the instruments in that class containing a contractual obligation for the issuer to settle in cash or another financial instruments, the revised approach in paper 4 would classify all of the puttable instruments in that class as equity if the class is the residual interest in the entity.

33. It would be consistent with such an approach to also classify a class of puttable instruments that are the residual interest in an entity as equity (that is, they have the characteristics of a residual interest as discussed in paper 4), even if the instruments include a mandatory redemption clause.

34. As noted above, the staff believes it important that the Board and any proposed amendment is clear with respect to such instruments.

35. **Question for the Board: Does the Board agree with the staff recommendation in paragraph 34 that any proposed amendment explicitly addresses the classification of a class of mandatorily redeemable puttable instruments with the characteristics of a residual interest in the entity? If so, how does the Board consider that such instruments should be classified, and why?**

LIMITED LIFE ENTITIES

36. So far re-deliberations have primarily focussed on puttable instruments. The ED also addressed obligations arising on liquidation of a limited life entity. Hence we need to consider the impact of the re-deliberations on the requirements for this second category of obligation.

37. Respondents had fewer concerns about obligations arising on liquidation than for financial instruments puttable at fair value. The exception for limited life entities is concerned only with liquidation rather than the price of exit before liquidation. (The price of exit before liquidation has been the significant cause of re-deliberations regarding to puttable instruments). Therefore the staff proposes retaining the criteria per the ED.

38. Some of the confusion respondents had with the ED arose from trying to identify what criteria relate to which type of obligation. To overcome these problems the staff intends to separate the criteria for the two different obligations in drafting the proposed amendment and provide separate guidance for each. Although the criteria for limited life entities are a subset of those puttable instruments the staff believe that while consistency of criteria between the different types of obligations is important, separation of the criteria will reduce complexity in understanding the amendment.

39. The criteria to be met for limited life entities are that:

a) The instrument must be in the most subordinated class of instrument with a claim to the assets of the entity. To be in such a class the instrument must also meet the following criteria:

    i) The claims have no priority over other claims to the assets of the entity, in terms of amount or timing of the payment made on exercise of the put or on liquidation.

    ii) It must not need to be converted into another instrument before it is in the most subordinated class of financial instruments.

    iii) All financial instruments with a claim to the net assets of the entity are puttable at fair value.

b) The instrument entitles the holder to a proportionate share in the residual interest in the assets of the entity on liquidation that remains after deducting all other claims to the assets of the entity. A proportionate share is one that is determined by:

    i) Dividing the amount of the residual interest in the assets of the entity in to units of equal amount; and

    ii) Multiplying that unit amount by the ratio of the number of units held by the financial instrument holder to the total number of units.

c) The financial instruments 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, through the terms and conditions of either (i) the instrument, (ii) another financial instrument issued by the entity (to either the instrument holder or another party), or (iii) a related contract between entity and the instrument holder.

40. Question for the Board: Does the Board agree with the staff recommendation? If not, what approach would the Board prefer?

EFFECTIVE DATE

41. The IASB has committed to having no new effective dates prior to 1 January 2009. Therefore the staff proposes an effective date for the proposed amendment of 1 January 2009 with early adoption encouraged.

42. **Question for the Board: Does the Board agree with the staff recommendation? If not, what effective date would you prefer?**

TRANSITION GUIDANCE

43. The ED proposed retrospective application of this amendment with one exception; compound instruments in which the liability component is no longer outstanding.

    Question for the Board: Does the Board agree with retrospective application (including the exception to retrospective application for compound instruments where the liability is no longer outstanding), as proposed in the ED? If not, what would the Board prefer?