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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2009, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement:* Financial Instruments with Participating Rights (Agenda Paper 5E)**

BACKGROUND

1. In November 2008 the IFRIC received a request for guidance on how an issuer should account for financial liabilities that contain participation rights through which the holders share in the net income and losses of the issuer. Portions of the original submission are included as Appendix A.

2. According to the submission, the primary features of such financial liabilities are as follows:

   a. The holders receive a fixed annual interest payment.

   b. The holders receive a percentage of the issuer's net income (subject to a stated "ceiling").

c. The holders are allocated a proportional share of the issuer's losses, which is applied to the nominal value (repayment amount) of the instrument. The nominal value is repaid upon maturity. Losses can be offset by subsequent profits of the issuer.

3. For the purposes of this paper, these instruments are called "participating financial instruments."

4. The participating financial instruments described in the submission are measured at amortized cost. The submission asks how the issuer should account for such instruments in periods in which the issuer records a loss and allocates a portion of that loss to the participating financial instruments.

5. The submission deals only with financial liabilities that:

   a. are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*

   b. do not meet the definition of a derivative in their entirety

   c. do not contain an embedded derivative

   d. are measured at amortized cost using the effective interest rate method (EIRM)

   e. are not considered *floating rate* financial liabilities in accordance with AG7 of IAS 39

SUMMARY OF ALTERNATIVES OUTLINED IN THE SUBMISSION

6. The submission contains two alternatives:

   Alternative A – The requirements in paragraph AG8 of IAS 39 related to the EIRM do **not** apply. The portion of the current period loss that is allocated to the participating financial instruments should be recognized immediately as a gain (with an offsetting reduction in the carrying amount of the instrument).

Alternative B – The requirements in paragraph AG8 apply. Current period losses are one factor that the issuer would consider when it evaluates whether it needs to revise its estimated future cash flows and adjust the carrying amount of the participating financial instrument.

Alternative A

7. Proponents of Alternative A think that paragraph AG8 of IAS 39 does not apply to reductions in the repayment amount of the instrument that are due to loss participation. Rather, such a reduction is more analogous to the derecognition of the financial liability. Therefore the requirements for derecognition should be applied and a gain equal to the allocated loss should be recognized in the current period.

Alternative B

8. Proponents of Alternative B note that the participating financial instruments described in the submission are measured at amortized cost. Therefore, issuers must apply the application guidance in AG6-AG8 to such instruments.

9. Consistent with those requirements, the issuer most likely will consider current period losses when it evaluates whether it needs to revise its estimated future cash flows (i.e., the amount that it ultimately will pay to the holder) and adjust the carrying amount of the participating financial instrument.

STAFF ANALYSIS AND RECOMMENDATION

10. The staff recommends that IFRIC not add the issue to its agenda. The staff thinks that the question in the submission relates to the measurement of the participating financial instruments and can be resolved by applying the existing requirements in IAS 39. Paragraphs AG6–AG8 of IAS 39 provide the relevant guidance for applying the EIRM to financial liabilities.

11. The staff thinks that it is inappropriate to analogize to the derecognition guidance in IAS 39 because the liabilities have not been extinguished (discharged, cancelled or expired). As mentioned above, the question in the submission relates to the **measurement** of the participating financial instruments–not their **derecognition**.

12. Wording for the proposed tentative agenda decision is set out in Appendix B (the staff welcomes drafting changes after the meeting):

QUESTION FOR THE IFRIC

13. Does the IFRIC agree that the issue should not be added to the agenda? If not, on what basis should it be added?

APPENDIX A

IFRIC Potential Agenda Item Request

The issue is related to the Issuer's accounting treatment for a financial instrument with participating rights through which the instrument holders must share in the losses of the Issuer.

Description of the issue

The Issuer issued participating rights on the stock exchange with the following features:

- The holders receive a fixed annual interest payment of 5% of the nominal amount.
- The holders receive 25% of the Issuer's net income calculated based on local GAAP yet limited to a maximum of 10 % of the nominal amount of the participating right, including the fixed interest.
- The holders participate in the proportional share of the Issuer's losses based on the separate financial statements compiled in accordance with local GAAP. The proportional losses are applied to the nominal value of the instrument. The nominal value is to be repaid upon maturity. (The fixed annual interest payment is still calculated based on the original nominal amount.) Current losses attributed to the instrument holders can be compensated, however, by future profits of the Issuer.
- The participating rights mature on 31 December 2020; there are no early cancellation rights.

In 200X the loss based on the separate financial statements amounted to CU10.0 million, of which CU2.5 million was allocated to the participating rights.

The participating rights are listed on the stock exchange. Their market price at the balance sheet date and one year later is above the nominal value. The Issuer offered to redeem the participating rights for an amount above the nominal value shortly after the financial statements were authorized for issue.

The Issuer expects to be profitable in the future so that at least part of the losses allocated to the participating rights will be reversed. Positive results were achieved in the separate financial statements for the last three years.

The participating rights are classified as financial liabilities, carried at amortised cost.

Alternatives

Alternative A: Do not apply paragraph AG8 of IAS 39 and thereby recognize profit immediately

Proponents of immediate gain recognition in this case believe that IAS 39 Application Guidance 8 does not apply to the case at hand. In applying the effective interest method, fees, points paid, transaction costs and other premiums and discounts should be considered (IAS 39 AG6). However, a reduction in the nominal amount of the debt instrument payable upon maturity due to loss participation is significantly different from fees and the like which are paid upon inception of the financial debt instrument. Effectively, reductions in the nominal value do not fulfil the wording of the derecognition requirements nor are they similar to the examples given relating to the effective interest method. In substance, however, the reduction of the ultimate nominal value (repayment amount) has more similarities with the derecognition of the financial liability. Therefore, the proponents of immediate gain recognition believe that the change in the nominal value at the balance sheet date should be reflected as a gain in the current financial period.

Alternative B: Apply paragraph AG8 of IAS 39 and thereby not recognize a gain totaling the entire amount of the reduction of the financial liabilities:

Financial liabilities are measured at amortized cost using the effective interest method unless they are valued at fair value through the profit and loss (IAS 39 paragraph 47). In this particular case, the financial liabilities were measured at amortized cost. Thus, the application guidance to the effective interest rate method in IAS 39 AG 5–8 is applicable.

It is not probable that the repayment amount would be reduced by the total amount of losses assigned to the participating rights at the balance sheet date since:

- according to the Issuer's forecasts, the Issuer expects to be profitable in the future;
- the participating rights cannot be cancelled until 2020;
- the market price of the participating rights at the balance sheet date and thereafter was above the nominal value; and,
- the amount of the Issuer's redemption offer made immediately after year end was above the nominal value.

Supporters of this view believe that it is not justified to reduce the carrying amount of the financial liability and recognise a gain amounting to CU2.5 million, the full amount of the loss participation in the current year.

Even if it were probable that the repayment amount would be partially reduced due to the 200X loss participation, the entire impact would be expected to be less than CU2.5

million. Under this scenario, revised estimates would be expected to reflect only a partial reduction of the financial liabilities and lead to a gain less than CU2.5 million.

Additionally, it could be argued that at the balance sheet date too much uncertainty exists concerning the estimated repayment amount of the participating rights since the maturity date is 14 years in the future (31 December 2020). A gain should only be recognised once the repayment amount can be reliably estimated.