STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity research project**		
Paper topic	Exception in Paragraphs 16A – 16D of IAS 32		
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Introduction

1. IAS 32 *Financial Instruments: Presentation* includes an exception that a financial instrument which meets the definition of liability is treated as equity, if it has all the features and meets the conditions in paragraphs 16A and 16B [or 16C and 16D] (reproduced in full in Appendix A).

2. The objective of this paper is to consider whether the exception as set out in paragraphs 16A and 16B [or 16C and 16D] of IAS 32 ('the puttables exception') is still needed given the classification and presentation requirements of the Gamma approach.

3. This paper is structured as follows:

   (a) The origin of the puttables exception in IAS 32 (paragraphs 4-8)

   (b) Treatment of instruments that meet the puttables exception under the Gamma approach (paragraphs 9-16)

   (c) Does the Gamma approach address the concerns that lead to the exception? (paragraphs 17-24)

   (d) Exception in Paragraphs 16C and 16D of IAS 32(paragraphs 25-27)

   (e) Summary and staff recommendation(paragraphs 28-29)

   (f) Appendix A: Relevant text of IAS 32

The origin of the puttables exception in IAS 32

4. When revising IAS 32 in 2003, the Board initially concluded that all financial instruments that are puttable to the entity for cash or other financial assets (puttable instruments) should be classified as liabilities, as they meet the definition of a financial liability. However, it reconsidered its conclusion with regards to some puttable instruments that represent the most residual claim to the net assets of the entity. At that time, the following concerns were raised about classifying such instruments as a liability [paragraph BC50]:

   (a) On an ongoing basis, the liability is recognised at no less than the amount payable on demand. This can result in the entire market capitalisation of the entity being recognised as liability;

   (b) Changes in the carrying value of the liability are recognised in profit or loss. This results in counter-intuitive accounting because when an entity performs well, the carrying amount of the liability increases; when an entity performs poorly, the carrying amount of the liability decreases;

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

   (d) The entity would be depicted as wholly, or mostly, debt funded.

   (e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not performance.

   Similar issues also apply to some financial instruments that create an obligation only on liquidation.

5. As a result, the Board made a limited-scope amendment to IAS 32 in February 2008. The main result is the insertion of paragraphs 16A, 16B, 16C and 16D to clarify circumstances in which some puttable instruments, and by extension, some instruments that impose on the entity an obligation to deliver to another entity a pro rata share of its net assets only on liquidation, are classified as equity instead of liability.

6. Reasons for the amendments to IAS 32 include [paragraph BC56]:

   (a) to ensure that the puttable instruments, as a class, represent the residual interest in the net assets of the entity;

   (b) to ensure that the proposed amendments are consistent with a limited scope exception to the definition of a financial liability; and

   (c) to reduce structuring opportunities that might arise as a result of the amendments.

7. The Board also intended that financial instruments that are largely equivalent to ordinary shares would be classified consistently across different entity structures[1] (eg. some partnerships, limited life entities and co-operatives).

8. The Board rejected the following alternative approaches to improving financial reporting for instruments that represent a residual interest in the net assets of the entity:

   (a) To classify those instruments as financial liabilities, but amend their measurement so that changes in their fair value would not be recognised. The Board rejected this approach because it would introduce a new category of financial liabilities to IAS 39 *Financial Instruments: Recognition and Measurement*, and retain the disadvantage that entities whose instruments are all puttable would have no equity instruments.

   (b) To require separation of all puttable instruments into a put option and a host instrument. The Board rejected this approach because it decided not to proceed with considering whether a puttable share should be split into an equity component and a written put option component, which would duplicate effort of the Board's then project on liabilities and equity.

[1] Paragraph BC70

Treatment of instruments that meet the puttables exception under the Gamma approach

9. A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. Under IAS 32, if such instrument has all the features as set out in paragraphs 16A and 16B, it will be treated as equity. If not, it would be treated as a liability because of the obligation to transfer cash or another financial asset.

10. Approach Gamma focuses the distinction between liabilities and equity on both:

    (a) the **timing** of required settlement—which is relevant to assessing the extent to which the entity is expected to have the economic resources required when it is required to transfer them; and

    (b) the **amount** of economic resources required to settle the claim—which is relevant to assessing the extent to which the entity has:

        (i) sufficient economic resources to satisfy the total claims against it if they were all to be settled at a point in time; and

        (ii) produced a sufficient return on its economic resources to satisfy the promised return on claims against it.

11. To provide information to help users make those assessments, approach Gamma will classify as liabilities obligations:

    (a) to transfer economic resources at particular points in time **other than at liquidation**; or

    (b) for an **amount** that is not solely dependent on the **residual amount**.

12. Under the Gamma approach, a puttable instrument would meet the definition of liability. This is because it can be put back to the issuing entity for economic resources at any point in time before liquidation (ie. redemption obligation).

13. If a puttable instrument has all of the features as set out in paragraphs 16A and 16B of IAS 32, it would still meet the definition of liability under the Gamma approach, due to its redemption obligation. Such instruments, however, are treated as equity under IAS 32.

14. Paragraphs 16A and 16B of IAS 32 describe such instruments as having all of the following features[2]:

    (a) It entitles the holder to a pro rata share of the entity's net assets in the event of liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets;

    (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. It has no priority over other claims on liquidation, and does not need to be converted into another instrument to be most subordinate;

    (c) All financial instruments in the most subordinate class have identical features;

    (d) The instrument does not include any contractual obligation other than the redemption obligation. It cannot be settled in the entity's own equity instruments;

    (e) The total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the unrecognised net assets over the life of the instrument;

    (f) The issuing entity has no other financial instrument or contract as described in (e) with the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

    Paragraph BC61 in the Basis for Conclusion for IAS 32 states that the criterion in paragraph 14 (f) above is included to ensure that there is no other financial instrument or contract that is more residual and holders of the puttable instruments represent the residual interest in the entity's net assets[3].

15. As per the condition outlined in paragraph 14(e), the total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the

[2] The full text of paragraphs 16A and 16B of IAS 32 is reproduced in Appendix A.

[3] Paragraph BC61

unrecognised net assets over the life of the instrument. Hence, before liquidation, the total cash flows attributable to such instruments substantially depend on the key drivers of the residual amount.

16. We note that because the feature in paragraph 14(e) only requires the settlement amount of such instruments to have a substantial dependency on the key drivers of residual amount, such instruments may not qualify for the separate presentation requirements under Gamma, which requires sole dependence on the residual amount. However, we think the objective of the separate presentation requirements for specific types of liabilities also apply to puttable instruments as defined in paragraphs 16A and 16B of IAS 32, for the two reasons as outlined below:

    (a) Applying separate presentation requirements to such instruments would allow the change in fair value to be separately presented, thus addressing the concerns about counter-intuitive effects on profit or loss, as identified in paragraph 4(b);

    (b) The puttable instruments subject to the exception in paragraphs 16A and 16B of IAS 32 are narrowly defined. Applying the separate presentation requirements to such instruments would be a limited-scope extension, which does not leave much room for inappropriate separate presentation of instruments with amounts that are independent of the residual.

Does the Gamma approach address the concerns that lead to the exception?

17. We think applying the Gamma approach to instruments that meet the conditions of the exception, along with the separate presentation requirements, would address the following concerns identified in paragraph 4 about classifying such instruments as a liability:

    (a) Changes in the carrying amounts of such instruments would be presented separately under Gamma approach, hence avoiding the counter-intuitive effects on profit or loss.

(b) Distributions of profits to holders of such instruments would not affect profit or loss.

18. In addition, classifying such instruments as liability allows direct measurement at fair value, as opposed to being a fixed measurement under equity classification. This would provide useful information for users to predict the potential for future cash outflows arising from such claims. Currently, this information is only partially provided through disclosure.

19. However, classification and presentation under the Gamma approach does not address the challenge that comes when all of the entity's claims meet the definition of liability and there is no claim that can be classified as equity. This would lead to the previous concerns identified in paragraph 4(a) and 4(d), as well as raising questions as to what the difference between the assets and liabilities would represent and how that difference should be reported. Having said that, this problem would arise in entities with very specific capital structures (eg. entirely debt-funded entities), even if there is an exception to classify puttable instruments as equity. This issue arises as a result of an entity's capital structure.

Retaining the exception in paragraphs 16A and 16B of IAS 32

20. If we retain the puttables exception in IAS 32, it would address all of the previous concerns as identified in paragraph 4 and paragraph 19. However, being equity classified, puttable instruments which meet the conditions in paragraphs 16A and 16B would not be directly measured at fair value, as would be the case under liability classification. As a result, users would not have sufficient information to estimate the potential cash outflows from these claims.

21. However, the problem as described in paragraph 20 is mitigated by the current disclosure requirements in IAS 1 *Presentation of Financial Statements* in relation to puttable instruments, which provide some information on the redemption obligations for users to estimate the potential cash outflows from these claims.

22. Specifically, paragraph 136A of IAS 1 *Presentation of Financial Statements* requires the following disclosures:

For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):

(a) summary quantitative data about the amount classified as equity;

(b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

(c) the expected cash outflow on redemption or repurchase of that class of financial instruments; and

(d) information about how the expected cash outflow on redemption or repurchase was determined.

23. The above disclosures are intended to allow users to assess any effect on the issuing entity's liquidity arising from the holder's ability to put the instruments to the issuer (paragraph BC100B). The Board concluded that additional disclosures are needed as financial instruments treated as equity usually do not include any obligation to deliver cash or financial assets. We think these disclosures are sufficient to indicate the existence of redemption obligations for puttable instruments classified as equity, and to show any related effect on cash flows.

24. Hence, if the puttable exception is kept under the Gamma approach we suggest keeping the related disclosure requirements in paragraph 136A of IAS 1, which to some extent mitigate the concerns as identified in paragraph 20.

Exception in Paragraphs 16C and 16D of IAS 32

25. By extension, the Board provided similar exceptions for instruments (or components thereof) that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. Those conditions are set out in paragraphs 16C and 16D of IAS 32 (full text reproduced in Appendix A).

26. The instruments described in paragraphs 16C and 16D of IAS 32 are liabilities under the Gamma approach. Although such instruments do not require the issuing entity to transfer economic resources prior to liquidation, they give rise to contractual obligation at *particular point in time.* This is because the exception

described in paragraphs 16C and 16D is applicable to the cases where the liquidation is certain to occur and outside the control of the entity or is at the option of the instrument holder.

27. We think the same analysis of paragraphs 16A and 16B also applies here[4].

Summary and staff recommendation

28. In the staff's view, there are two alternatives:

(a) apply the Gamma approach to financial instruments with all of the characteristics in paragraphs 16A and 16B [or 16C and 16D], and not provide an exception for such instruments; or

(b) retain the exception under IAS 32 for financial instruments as described in paragraphs 16A and 16B [or 16C and 16D]. In addition, retain the disclosure requirements in relation to puttable instruments in paragraph 136 of IAS 1 and extend the same disclosure requirements to financial instruments as described in paragraphs 16C and 16D.

29. In addition, the staff is not aware of any issues regarding the exception as outlined in paragraphs 16A – 16D of IAS 32 that we need to address nor are we aware of how prevalent the application of the exception is. As part of the consultation period of the Discussion Paper, we think the Board could seek further input on these matters.

Question
1. Does the Board have a preference for either of the two alternatives in relation to the classification of financial instruments as described in paragraphs 16A and 16B [or 16C and 16D] of IAS 32? 2. If the Board decides to retain the exception under IAS 32, does the Board agree to extend the same disclosure requirements which apply to puttable instruments (paragraph 136 of IAS 1) to financial instruments as described in

[4] We note that currently, the puttable instrument disclosures in IAS 1 do not apply to the instruments as described in paragraphs 16C and 16D.

paragraphs 16C and 16D?

3. If the Board does not have a preference for either of the two alternatives, does the Board agree to include a discussion for both alternatives in the future Discussion Paper?

4. Does the Board agree to include a question in the future Discussion Paper inquiring about the prevalence of the application of the exception as outlined in paragraphs 16A-16D of IAS 32?

Appendix A

A1. Paragraph 16A:

A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

(i) dividing the entity's net assets on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation, and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include 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 financial liability.

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

A2. Paragraph 16B:

For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

A3. Paragraph 16C:

Some financial instruments include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation.

The obligation arises because liquidation either is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain to occur but is at the option of the instrument holder. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the A1. event of the entity's liquidation. The entity's net assets are those assets. that remain after deducting all other claims on its assets. A pro rata share is determined by:

 (i) dividing the net assets of the entity on liquidation into units of equal amount; and

 (ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

 (i) has no priority over other claims to the assets of the entity on liquidation, and

 (ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual (i) obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.

A4. Paragraph 16D:

For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised A1. and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16C that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the instrument as an equity instrument.