# IFRIC POTENTIAL AGENDA ITEM REQUEST

## I. The issue

**Amendments to IAS 32 Financial Instruments:**
**Presentation and IAS 1 Presentation of Financial Statements**
**Puttable Financial Instruments and**
**Obligations Arising on Liquidation**

(in the following referred to as "IAS 32 (amend)")

### Perpetual instruments classified as equity and puttable instruments

Suppose that an entity has correctly classified perpetual instruments, i.e. non-puttable instruments, as equity instruments under IAS 32's principle, i.e. the perpetual instruments that do not impose a contractual settlement obligation during the entity's lifetime. In light of the 2008 amendments to IAS 32 the question is whether the entity can, at the same time, also classify puttable instruments as equity instruments under IAS 32 (rev. 2008) if they meet the relevant criteria of the standard. In particular, the question is whether the puttable instruments can meet the criterion in IAS 32.16A(c) in this situation, as the perpetual instruments and the puttable instruments differ at least in the respect that not all the instruments are puttable. Thus, the 'identical features'-condition in IAS 32.16A(c) might not be met.

**View A:** Perpetual instruments classified as equity do not prohibit the entity from (additionally) classifying puttable instruments as equity instruments, provided all criteria in IAS 32.16A and B are met. This includes the criterion in IAS 32.16A(c).

Proponents of view A give the following reasons:

(1)

Proponents of view A emphasise the principles laid down in the definitions in IAS 32.11. Herein liabilities are defined and if a financial instrument does not meet the definition of a liability it represents an equity instrument: "An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities".

In light of the discussions regarding IAS 32 (amend) it is important to note that IAS 32.11 does not contain any notion regarding "subordination" or "most subordinated" respectively. It does neither refer to "**the** residual interest" or even "**the** residual **instrument**" but to "**a** residual interest". Accordingly, under IAS 32 it is obvious that different types of instruments can represent equity instruments and, using IAS 32 (amend) terminology, different equity classes can exist.

There is no indication in the standards that the above principles of IAS 32 are changed by IAS 32 (amend). In contrast para 16A outlines in the second sentence: "**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 of the following features: […]"

As a result the amendments are directed to a special equity accounting treatment for puttables **in addition** to the general principles of IAS 32. The possibility of different equity classes is retained and the only difference is that under IAS 32 (amend) puttables can now qualify as equity if the related criteria are met in addition to those instruments classified as equity under the general principle.

The history of the development of IAS 32 (amend), in particular why the project was put on the Board's agenda, supports this view.

(2)

Referring specifically to IAS 32 (amend) proponents of view A argue that the wording in IAS 32.16A (c) refers to instruments in the class of instruments that is "subordinate to all other classes of instruments that have identical features"; in other words and with reference to IAS 32.16A (b): "the most subordinated class upon liquidation". Again, this implies that there can be more than one class of equity instruments and that only **those** instruments in the **most subordinated** class upon liquidation are subject to the 'identical features'-test. Consequently, if the perpetual instruments classified as equity instruments **are less subordinated** (i.e. the puttable instruments' claims upon liquidation were subordinated to the claims in relation to the perpetual instrument), the puttable instruments can be classified as equity, since the 'identical features'-test is limited to the most subordinated class of instruments and the perpetual instruments are not within that class.

Accordingly, the criterion established via IAS 32.16A needs to be met **only** by the most subordinated class of puttables in reference to all puttables issued; different classes of equity (such as perpetuals) continue to fall under the unamended general principles of IAS 32, i.e. an "equity instrument" is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. In terms of terminology, both classes represent residual interests. No flaw can be seen that there are different classes of residual instruments because required note disclosures provide for the required transparency.

(3)

IAS 32 (amend) para. 136A (a) and (c) respectively also support the view that different equity classes of residual instruments can exist when referring to " […] for puttable financial instruments classified as equity instruments […]: (a) summary quantitative data about the amount classified as equity" and "[…]; c) the expected cash outflow on redemption or repurchase of that class of financial instruments; […]". If it were the intention of the IASB to allow for just one class of equity instruments why such a wording of "amount classified as equity" or ".that class of […]"?

(4)

If the above views will not hold true, the proponents of View A argue that the scope of IAS 32 (amend) would be limited to those entities which do not have equity instruments other than puttables qualifying under IAS 32 (amend). This would mean that identical puttables would be treated differently subject to whether the entity has other equity instruments in line with IAS 32 or not. The underlying principle is not apparent.

(5)

In addition, the significant consequences are by no means appropriately clarified in IAS 32 (amend), neither in the standard, the Basis for Conclusions nor the Illustrative Examples. The BoC reference cited in this context by proponents of View B is not clear and, at least, does not remove the argument, that both puttables and other equity instruments can represent residual interests.

As a matter of principle, proponents of View A also do not believe that discussions during a Board meeting – as raised by proponents of View B – and which for example may have changed in subsequent meetings - replace understandable and clear standards. Constituents are not committed to follow Board meetings in order to understand IFRS. Referring more specifically to the cited Board discussion it is not clear whether the response to comments received considers a case, as mentioned above, where the non-puttable instruments are less subordinated to the puttables.

Based on the above, the Proponents of View A believe that the understanding outlined above is an appropriate answer to the issue under discussion. It results in a more appropriate presentation of equity for those entities with puttables irrespective whether there are other equity instruments or not.

**View B:** If an entity has classified perpetual instruments as equity instruments (= residual instruments), this prohibits puttable instruments to be classified as equity at the same time, since the criterion in IAS 32.16A (c) is violated. Since perpetual instruments and puttable instruments are both residual instruments, but differ at least in respect of being puttable / perpetual, the puttable instruments fail to qualify for equity treatment. Another way of saying this is that perpetual instruments are always more subordinated to puttable instrument because they are perpetual.

Proponents of view B give the following reasons:

(1)

Although IAS 32.16A (c) uses the term „most subordinated“, it is unclear if and how this differs from the term „residual“. They refer to parts of the Basis for Conclusions (such as IAS 32.BC51) that seem to use both terms interchangeably. Moreover, it is not totally clear what the difference between a “residual claim” and a “subordinated claim” upon liquidation is supposed to be: Both terms describe a claim that is settled after some other claims (i.e. liabilities) are settled. Any perpetual instrument classified as equity must, by definition, meet the definition of an equity instrument in IAS 32.11, meaning that it must be a residual instrument.

(2)

Proponents of view B acknowledge that different classes of equity instruments (potentially with different levels of subordination) can exist under the general principle of IAS 32. This is because any equity instruments under IAS 32's principle do not impose any obligations onto the entity during the entity's lifetime. Thus, under IAS 32's principle, a situation in which there are puttable and perpetual equity instruments at the same time can never occur. This situation would indeed give rise to the question of which equity instruments are more "subordinated" or "residual".

If, however, an entity has issued puttable residual instruments, the question becomes relevant. If an instrument is puttable by the holder during the entity's lifetime (and thus gives rise to an obligation of the entity during the lifetime) and, at the same time, the entity has perpetual residual instruments, only the latter class of instruments can truly be considered "residual" upon liquidation.

The only situation in which a puttable residual interest is deemed to have equity characteristics and may be classifiable as equity is when the residual class of instruments itself is puttable and there are no other residual instruments. This is the situation that the amendment addresses. In this situation, the criterion in IAS 32.16A (c) ensures that the class of residual instruments has identical features, i.e. the instruments are all puttable and it is ex ante unclear which of the instruments will be outstanding until liquidation and which will be put prior to liquidation.

(3)

With regard to arguments (1) and (2) put forward under view A, proponents of view B argue that it was the IASB's intention to address those situations in which **the** residual interests in an entity are not classified as equity instruments because they are puttable and thus, the entity appears as debt-funded (see IAS 32.BC50). In this situation, the amendment permits the entity to classify their residual interests as equity instruments, by way of an exception. They note that this intention of the criteria in IAS 32.16A, including (c), is evidenced by IAS 32.BC56:

> *"The Board decided on those conditions for the following reasons:*
>
> *(a) to ensure that the puttable instruments, as a class,* ***represent the residual interest*** *in the net assets of the entity; […]"*

In particular with regard to argument (1), proponents of view B acknowledge that in the definition of an equity instrument as cited there, the IASB used the word "**a** residual". However, they point to the fact that, in par.56 Basis for Conclusions to IAS 32amend (see above), the word "**the** residual" was used. Thus, while under the general principle of IAS 32 different classes of equity instruments can exist, under the amended standard, in the case of puttable instruments classified as equity, the puttable instruments represent the residual interest.

Proponents of view B also refer to the discussion during the IASB board meeting in May 2008 (see Agenda Paper 9, par 44 ff.):

> *"Respondents have raised concerns over this criteria for a number of reasons, including: [...]*
>
> *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. […]*

> ***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.***
>
> *One possible approach to these concerns is to create an exception to the most residual principle."*

Note that the IASB did not agree to an exception to the most residual principle.

(4)

Proponents of view B also point to the fact that view A implicitly assumes (at least) two classes of residual instruments, one of which is puttable and one is not. View A could potentially lead to a number of different classes of different residual instruments, one of which is puttable, the others not. They note that the criterion in IAS 32.16A (c) largely becomes superfluous if one can define different classes within the residual instruments that can be heterogeneous between classes, while only the puttable class must be homogenous (i.e. must have identical features).

(5)

With regard to the arguments put forward under (3) in relation to view A, proponents of view B note that the note disclosures are intended to compensate the fact that, under IAS 32's general principle, equity instruments do not embody an obligation. That piece of information is relevant regardless of whether other instruments are classifiable as equity (view A) or not (view B). Even under view B, an entity may present other amounts other than puttable financial instruments as equity, such as currency translation adjustments, cash flow hedging reserves, revaluation reserves. These amounts do not meet the definition of a contractual financial instrument. Thus, information on the class of puttable financial instruments classified as equity as a subgroup of total equity is relevant also under view B. Accordingly, proponents of view B do not see why the note disclosure supports view A.

## II. Current practice: diversity in practice

Since IAS 32 (amend) has not yet been endorsed by the EU, it needs to be stated that no current practice has yet developed.

However, since there is a widespread discussion in literature on IAS 32 (amend) amongst constituents, the IFRIC should address the issue as lined out above so that there is an official interpretation (either by an IFRIC or at least by an agenda decision) how to properly apply IAS 32.16A.

## III. Reasons for the IFRIC to address the issue:

**a) Is the issue widespread and practical?**

As mentioned above, IAS 32 (amend) has not yet been endorsed by the EU. However, based on the current discussion it is envisaged that the issue will be widespread. In Germany alone, there are a few thousand commercial partnerships, some of which are currently considering switching to IFRS. For these companies it will be important to know how to deal with this issue.

**b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?**

As outlined above – there are currently the two views A and B, which would lead to fundamentally different treatments.

**c) Would financial reporting be improved through elimination of the diversity?**

Financial reporting would be improved greatly by clarifying this issue since the accounting for equity instruments based on an appropriate interpretation of the IFRIC would enhance comparability among companies' financial reportings.

**d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and *Framework for the Preparation and Presentation of Financial Statements*, but not so narrow that it is inefficient to apply the interpretation process?**

We are of the opinion that the issue is sufficiently narrow in order to be addressed by an interpretation of the IFRIC.

**e) If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process).**

N.A.

# IFRIC POTENTIAL AGENDA ITEM REQUEST

## Submitted by:



| | |
|---|---|
| **Name:** | **Prof. Dr. Manfred Bolin** |
| **Organisation:** | **AIC (Accounting Interpretations Committee e.V.) / Germany** |
| **Address:** | **Zimmerstrasse 30** |
| | **10969 Berlin** |
| | **Germany** |
| **Telephone:** | **+49 30 2064 12 13** |
| **Email:** | **bolin@drsc.de** |