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1049 Brussels

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Dear Mr Holmquist

The Amendment to IAS 32 and IAS 1 “Puttable Financial Instruments and Obligations Arising on Liquidation”

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements* “Puttable Financial Instruments and Obligations Arising on Liquidation” (referred to hereafter as ‘the amendment’). It was issued as an exposure draft first and EFRAG commented on it.

The amendment changes the classification of certain instruments that are similar to an ordinary share except for an obligation to redeem (referred to in the amendment as puttable instruments or instruments 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); they would be classified as equity if they meet certain criteria.

The amendment becomes effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

EFRAG has carried out an evaluation of the amendment. As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG’s evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the amendment and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the ‘true and fair principle’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG's Endorsement Advice on the Amendment to IAS 32 and IAS 1

For the reasons given above, EFRAG believes that it is in the European interest to adopt the amendment and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix Basis for Conclusions

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendment to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements "Puttable Financial Instruments and Obligations Arising on Liquidation".

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

- 1 When evaluating the amendment to IAS 32 and IAS 1 *Puttable Financial Instruments and Obligations Arising on Liquidation*—henceforth "the amendment"—in light of the endorsement criteria, EFRAG considered the following key questions:
 - (a) Is there an issue that needs to be addressed?
 - (b) Is the amendment consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the Framework)?
 - (c) Would the implementation of the amendment result in an improvement in accounting?
 - (d) Does the accounting that results from the application of the amendment meet the criteria for EU endorsement?
- 2 Having formed tentative views on the issues and prepared a draft evaluation, EFRAG issued that draft evaluation for comment on 26 March 2008 and asked for comments on it by 28 April 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

Is there an issue that needs to be addressed?

- 3 Under the version of IAS 32 that is currently endorsed ("current IAS 32") shares that are identical to ordinary shares except that the holder has the right to require the issuer to redeem the shares meet the definition of a financial liability because they embody a contractual obligation to deliver cash or another financial asset. However, classification of such instruments as liabilities raises the following concerns in practice:
 - (a) As liabilities, the instruments would be required under current IFRS to be measured on an ongoing basis at not less than the amount payable on demand. This would have the following implications:
 - (i) the entire market capitalisation of the entity may be recognised as a liability;

- (ii) when the entity performs well and as a result the value of the instruments increases, a loss would be recognised. Similarly, when the entity performs poorly and the value of the instruments decreases, a gain is recognised; and
 - (iii) the entity is likely to have negative net assets, because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities is not at fair value.
- (b) An entity's balance sheet might appear to be wholly, or mostly, debt funded.
- (c) Distributions of profits to shareholders are recognised as expenses. As a result, net income is a function of the distribution policy, not performance.
- 4 Current IAS 32 suggests alternative income statement and balance sheet formats that can be used by entities that do not have equity as defined in IAS 32. However, those alternative presentation possibilities do not address some of the above concerns and have not fully resolved those they do address.
- 5 EFRAG agrees that, when the entity has issued instruments that are identical to ordinary shares except for a put obligation, the issues highlighted in paragraph 3 result in anomalies and those anomalies need to be addressed.
- 6 EFRAG has noted that the IASB is currently addressing the issue of the definition of equity and liabilities in a broader context at two levels: at the conceptual level as part of its project on the Framework, and at the standards level through a research project that is considering ways to improve and simplify the equity/financial liabilities classification approach in current IAS 32. One way of addressing the anomalies mentioned above would be to wait for new concepts and new IFRSs resulting from these projects to be finalised. However, that is likely to take some years and, in the mean time, the anomalies would remain. The IASB therefore decided to amend IAS 32 to provide a limited exception to the existing requirements as a short-term solution pending the outcome of its longer-term projects. EFRAG believes that such an approach is reasonable in the circumstances.

Is the amendment consistent with the Framework?

- 7 EFRAG has considered whether the amendment is consistent with the Framework. In EFRAG's view, the aspects of the Framework that are most relevant for this purpose are the qualitative characteristics of relevance, reliability, comparability and understandability and the material dealing with the elements of financial statements (in particular the definitions of liabilities and equity). As the amendment will be judged against the qualitative characteristics later in this appendix, the focus in this section is on the extent to which the amendment is consistent with what the Framework says about liabilities and equity.
- 8 According to paragraph 49 of the Framework, a liability is "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits". Equity is "the residual interest in the assets of the entity after deducting all its liabilities."
- 9 The contractual provisions attached to puttable instruments that the amendment would require to be classified as equity give the holders the right to put the instruments to the entity and demand cash or other resources. Thus, there is a present obligation of the entity arising from a past event, the settlement of which is expected to result in an

outflow of resources of the entity. In other words, the puttable instruments that the amendment would require to be classified as equity meet the definition of a liability.

10 However, things are not as simple as that. Although the Framework's approach to distinguishing between liabilities and equity has been implemented in IFRS for liabilities that are *not* financial instruments, current IAS 32 apply a different approach in the case of financial instruments. In particular, as the IASB's recently issued Discussion Paper *Financial Instruments with Characteristics of Equity* explains:

30 The definitions of a financial asset and financial liability in IAS 32 are inconsistent with the definitions of an asset and liability in the IASB's *Framework for the Preparation and Presentation of Financial Statements*. As a result, some derivative financial instruments that are settled with the issuer's own equity instruments would be classified in accordance with the *Framework's* guidance differently from their classification in accordance with IAS 32.

31 For example, some financial instruments that are settled with the issuer's own equity instruments meet the definition of a financial liability in IAS 32 (paragraphs 19 and 20 above). However, such instruments do not always meet the definition of a liability in the *Framework*. That is because the instrument may not result in the sacrifice of an asset (eg cash); rather it involves the delivery of the entity's own equity instruments. For example, a written call option for a variable number of the issuer's ordinary shares would meet the definition of a financial liability in IAS 32 but would not meet the definition of a liability in the *Framework*.

32 Another example of the differences between IAS 32 and the *Framework* is some purchased options that are settled with the issuer's own equity instruments. Such instruments meet the definition of an asset in the *Framework* because they have the potential to contribute to the entity's cash inflows. However, some of those instruments do not meet the definition of a financial asset in IAS 32 (and are classified as equity) because they meet the 'fixed for fixed' principle.

11 In other words, current IAS 32 already introduces some exceptions to the Framework definitions of equity and liabilities in order to try to keep up with the increasing sophistication of the financing instruments available to companies. And, although EFRAG believes it is preferable for standards to be consistent with the Framework, those exceptions to the Framework did not stop EFRAG from concluding that current IAS 32 met the criteria for endorsement. Bearing all this in mind, EFRAG has concluded that the fact that this amendment is not consistent with the Framework tells us nothing about its quality.

Would the implementation of the amendment result in an improvement in accounting?

Understandability

12 As already explained, the current approach to the classification of financial instruments between equity and liability is resulting in anomalies when the reporting entity has issued financial instruments that are largely equivalent to ordinary shares except for an obligation to redeem at the request of their holders or on liquidation that is outside the control of the entity (henceforth for simplicity 'puttable ordinary shares'). Those anomalies are affecting the understandability of the information provided by financial statements.

13 The amendment requires puttable ordinary shares to be classified as equity if they meet criteria designed primarily to ensure that the class of financial instruments involved represent a residual interest in the entity.

- 14 EFRAG's view is that classifying puttable ordinary shares that meet the criteria set out in the amendment as equity will resolve the anomalous reporting for such instruments. This will therefore result in an improvement in accounting as long as it does not at the same time result in other, new anomalies.
- 15 EFRAG notes that puttable ordinary shares that meet the criteria set out in the amendment are not the only instruments in respect of which the anomalies mentioned earlier arise. There are other instruments that will continue to be classified as liabilities and therefore in respect of which anomalies will continue to arise. This suggests that the amendment might give rise to comparability issues that could represent new anomalies. EFRAG has evaluated these concerns, and that evaluation is discussed in the next section.
- 16 The fact that puttable ordinary shares have a put option attached to them is significant to users, particularly when they are considering future cash outflows, liquidity etc. If classifying some puttable ordinary shares as equity rather than liabilities obscures the effect that such put options can have on the entity, the amendment will create new problems. EFRAG has therefore evaluated the additional disclosures that the amendment requires with this in mind. This is discussed later in this appendix.

Comparability

- 17 Some commentators argue that the existing classification approach gives rise to comparability concerns because instruments that they see as economically very similar (ordinary shares and at least certain types of puttable ordinary shares) are classified very differently. In their eyes, classifying them in the same way would enhance the comparability of the information provided.
- 18 This argument is of course based on the view that ordinary shares and certain types of puttable ordinary shares are economically very similar. There is no doubt that the existence of the put option is economically significant for a number of reasons, but the issue that needs to be considered in order to decide whether they are economically similar for accounting purposes is which attribute of the instruments is the most relevant one to present in the financial statements, and which attributes are less relevant. The view taken in the amendment is that more relevant information would be provided by the financial statements were they to focus on residual nature of the instrument holders' interest in the assets and other liabilities of the entity, rather than on the obligation that the put option represents. Judged from this perspective, the puttable ordinary shares that meet the criteria set out in the amendment are economically similar to ordinary shares and comparability is improved by classifying them in the same way.
- 19 On the other hand, it could be argued that there will be entities who have issued instruments that will continue to be classified as financial liabilities even though in substance they might be very similar to ordinary shares and/or to puttable ordinary shares that meet the criteria asset out in the amendment. For example, two entities might classify an identical type of puttable ordinary shares differently because it is a residual instrument of one entity but not the other. More generally, puttable ordinary shares that meet the criteria set out in the amendment will be classified differently from puttable ordinary shares that do not meet the criteria, even though those shares are economically similar.
- 20 EFRAG's view is that puttable ordinary shares that meet the criteria set out in the amendment are *not* economically similar to puttable ordinary shares that do not meet the criteria, so it is not a concern if such instruments are classified differently.

- 21 That is because EFRAG believes that at the heart of the criteria for determining which puttable instruments should be classified as equity and which should not there is a difference of substance. Although the detailed provisions of the amendment are rather rule-based, they *do* focus on identifying whether the puttable instruments, as a class, represent a residual interest; only those instruments that meet those criteria are classified as equity.
- 22 EFRAG has therefore concluded that the amendment does not give rise to any new comparability or consistency anomalies.

Puttable ordinary shares held by minority shareholders

- 23 Another issue that EFRAG has considered to determine whether it represents a “new anomaly” is how the amendment would apply to puttable ordinary shares held by minority shareholders.
- 24 Assume that an entity’s equity comprises puttable ordinary shares that meet the criteria set out in the amendment, and the majority of those instruments are held by one entity (the parent) and a minority by a second entity (the minority shareholder). In the separate financial statements of the issuer those shares meet all the criteria under the amendment and will therefore be classified in those financial statements as equity; however, in the consolidated financial statements the instruments will continue to be classified as financial liabilities.
- 25 In paragraph BC68 of the basis for conclusions, the IASB explains that such instruments would be classified as financial liabilities in the consolidated financial statements because such instruments were not the residual interest in the consolidated financial statements.
- 26 At the same time, the way the IASB explained this decision in its recently issued Discussion Paper *Financial Instruments with Characteristics of Equity* suggests it was more an arbitrary decision:

IAS 32 provides some guidance on how to classify non-controlling interests and refers to the guidance in IAS 1 *Presentation of Financial Statements* and IAS 27 *Consolidated and Separate Financial Statements*. IAS 32 requires an entity to consider all the terms and conditions agreed between members of the group and the instrument holders in assessing whether the consolidated group has an obligation that would result in liability classification of the instrument. In effect, the instrument would retain equity classification unless something else within the group affects the substance of that instrument. However, as an exception, some puttable instruments and some instruments that impose an obligation only on liquidation of the entity meet the definition of a financial liability but are required to be classified as equity in the entity’s separate financial statements. That exception does not extend to the consolidated financial statements of the group.

- 27 These different ways of explaining the amendment’s treatment of puttable ordinary shares held by minority shareholders is mirrored in the comments that commentators make about the treatment.
- (a) Some see the treatment as simply the application of the central principle in the amendment, which is that puttable ordinary shares that represent the residual interest should be classified as equity and other puttable ordinary shares should be classified as liabilities. In their view puttable ordinary shares held by minority shareholders are not a residual interest in the consolidated financial statements because, unless certain guarantees have been put in place, they are not affected

by profits and losses of the parent, or indeed any member of the group other than the entity that issued them.

- (b) Some believe that the required treatment is as an arbitrary rule. In their view the notions of 'most subordinated class of shares' and 'residual interest' are legal notions that work only when the reporting entity is a legal entity. In the case of consolidated financial statements, the reporting entity (the group) is an economic entity (rather than a legal entity). In a group, unless certain types of guarantees are involved, none of the financing of the entity acts as a residual interest, absorbing without limit the losses incurred by the entity and benefiting, again without limit, from the profits. In effect, all the financing that is classified as equity in the separate financial statements of the legal entities making up the group is in the nature of 'project finance'. These commentators argue that, faced with this, the IASB had no choice but to take an arbitrary decision about the treatment of puttable ordinary shares held by minority shareholders, and the IASB chose to require them to continue to be classified as financial liabilities.
- 28 Although the comments in BC68 (referred to above) seem to suggest that the IASB takes the view described in (a), EFRAG's view is closer to (b): the central principle in the amendment needs to be supplemented by a rule in order to be able to work in consolidated financial statements.
- 29 EFRAG considered whether this rule is a reasonable one in the circumstances.
- (a) One EFRAG member believes that the rule is not reasonable. In that member's view, puttable ordinary shares held by minority shareholders should be classified as equity in the consolidated financial statements and requiring them to be classified as liabilities is an arbitrary decision that is without reasonable foundation.
 - (b) EFRAG concluded however that the rule is reasonable.
 - (i) As already explained in paragraph 6 above, the amendment is intended as a short-term solution to some anomalies that currently exist. The anomalies are of greatest concern in the separate financial statements of the issuer of the puttable ordinary shares, and the amendment seeks to address those concerns. The concerns that arise from the anomalies in the context of consolidated financial statements are of a different level, and the IASB has chosen not to address those concerns in this project. EFRAG accepts that it is in the nature of 'quick fix' projects that they are scoped as narrowly as possible.
 - (ii) EFRAG understands that a key factor in the IASB's consideration of this issue was that this is the area where the opportunities to structure instruments that are liabilities in substance in a way that would result in them being classified as equity are the largest. For example, if all projects were arranged so that they were carried out in separate legal entities, it would not be difficult to structure the financing of each of those projects so that they would be classified under this amendment as equity of those entities and—had a different decision about puttable ordinary shares held by minority shareholders been taken—as equity in the consolidated financial statements even though it is exposed only to the gains and losses arising on a single, perhaps quite narrow, project. EFRAG did not believe this would be appropriate.

- (iii) Some see this treatment of puttable ordinary shares held by the minority shareholders as a contradiction of the consolidation principles of IAS 27 *Consolidated and Separate Financial Statements* in accordance with which minority interest (or 'non-controlling interest' as it is now generally called) is classified as equity. One respondent to EFRAG's consultations was concerned that, because the amendment does not change the treatment in consolidated financial statements of puttable instruments issued by a subsidiary and held by the minority interest holders, the amendment would affect the transparency of the information provided. EFRAG accepts that there may be a contradiction of IAS 27's consolidation principles but, because of the reasons given in (a) and (b), it still believes that the rule chosen is reasonable.

Disclosures

- 30 As mentioned above, the difference between ordinary shares and puttable ordinary shares is the put option. Although the view has been taken in the amendment that, if certain criteria are met, the put option should not affect the way in which the instrument is classified on the balance sheet, the existence of the put option could inflict a strain on liquidity and financial viability of the entity that will not be the case for ordinary shares without the put option. For that reason, it is important that the existence and potential impact of the put option is not obscured through the classification of certain puttable ordinary shares as equity; disclosures are required that provide sufficient information for users of financial statements to understand the nature of the instruments and enables them to evaluate the potential effects of the instruments on the entity. EFRAG has considered the disclosure requirements set out in the amendment against this benchmark.
- 31 Under current IAS 32, these puttable instruments are shown as liabilities and the disclosures required by IFRS 7 *Financial Instruments: Disclosures* are provided. One of the disclosures required is a maturity analysis by reference to contractual maturity dates of financial liabilities. Under the amendment, the puttable instruments would not be included in the maturity analysis; instead the existence and amount of the puttable instruments within equity would be disclosed, along with an estimate of the expected cash outflow arising from redemptions. In addition, entities would be required to provide summary quantitative data about the amount of puttable instruments classified as equity and the entity's objectives, policies and process of managing the obligation to repurchase. EFRAG has considered whether the new disclosures are sufficient to support the amended classification system and whether there is any loss of information.
 - (a) Expected future redemptions can be difficult to estimate because redemption rates and the price at which the redemptions take place are subject to inherent uncertainties. These difficulties increase the longer the redemption period involved, and some redemption periods are 10, 20 or even 30 years. Some respondents to EFRAG's consultations suggested that in such cases disclosure of expected cash outflows might be burdensome and might not provide meaningful information. However, EFRAG noted that under current IAS 32 these instruments are financial liabilities and entities are already required to provide an analysis by maturity of the contractual undiscounted cash outflows arising from financial liabilities in accordance with IFRS 7 *Financial Instruments: Disclosures*. Furthermore, EFRAG believes that this disclosure will shed light on the put option's potential implications for the entity, while the requirement to disclose information about how the expected cash flow on redemption has been

determined will enable users to understand the degree of uncertainty involved in the reported amounts.

- (b) Some commentators argue that a requirement to disclose quantitative information about cash outflows arising from redemptions without a similar requirement to disclose cash inflows from the re-issue of the shares show users an incomplete picture of the financial position. EFRAG noted however that under existing IFRS there is also no requirement to disclose information about cash inflows from re-issues.

- 32 Overall EFRAG's assessment is that the disclosures required are sufficient for their purpose and in some respects require the disclosure of useful additional information not provided under existing IFRS.

Conclusion

- 33 To summarise the foregoing discussion, the current approach to the classification of equity and liability causes:

- (a) anomalies. The amendment addresses those anomalies and thus improves the understandability of the financial information provided.
- (b) a lack of consistency in the treatment of instruments that are economically very similar. The amendment improves that consistency, and hence the comparability of the information provided.

- 34 For those reasons, EFRAG has concluded that the amendment is likely to result in an improvement in accounting.

Does the accounting that results from the application of the revised standard meet the criteria for EU endorsement?

- 35 EFRAG has considered whether it believes that the amendment meets the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that the amendment:

- (a) is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- (b) meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG has also considered whether it is in the European interest to adopt the amendment.

- 36 As already mentioned, EFRAG has concluded that the amendment improves the understandability and comparability of the financial information provided, relative to that provided under IAS 32, a standard that EFRAG has previously concluded meets the criteria set out above.

- 37 EFRAG has also considered whether the relevance criterion is met. Earlier it was explained that a key issue in evaluating the accounting treatment required by the amendment was which attribute of the instruments under consideration is the most relevant one to present in the financial statements. It was noted that the IASB has taken the view in the amendment that more relevant information would be provided by

the financial statements were they to focus on residual nature of the instrument holders' interest in the assets and other liabilities of the entity, rather than on the obligation that the put option represents. EFRAG agrees that is a relevant attribute for accounting purposes.

- 38 Finally, EFRAG has considered the reliability of the information that will result from the application of the amendment. In EFRAG's view, the key issues here are whether the revised accounting treatment enables a faithful representation to be given of the transactions involved, and whether it has enabled those transactions to be accounted for in accordance with their substance and not merely their legal form. For the reasons set out earlier, EFRAG believes that it does.
- 39 EFRAG has also concluded that there was no reason to believe that the information resulting from the application of the amendment would be contrary to the true and fair view principle.

Conclusion

- 40 For the reasons set out above, EFRAG has concluded that the amendment satisfies the criteria for EU endorsement and that EFRAG should recommend its endorsement.