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Basis for Conclusions on IFRIC Interpretation 2

This Basis for Conclusions accompanies, but is not part of, IFRIC 2.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC’s considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 In September 2001, the Standing Interpretations Committee instituted by the former International Accounting Standards Committee (IASC) published Draft Interpretation SIC D-34 *Financial Instruments—Instruments or Rights Redeemable by the Holder*. The Draft Interpretation stated: ‘The issuer of a Puttable Instrument should classify the entire instrument as a liability.’

BC3 In 2001 the International Accounting Standards Board (IASB) began operations in succession to IASC. The IASB’s initial agenda included a project to make limited amendments to the financial instruments standards issued by IASC. The IASB decided to incorporate the consensus from Draft Interpretation D-34 as part of those amendments. In June 2002 the IASB published an exposure draft of amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* that incorporated the proposed consensus from Draft Interpretation D-34.

BC4 In their responses to the Exposure Draft and in their participation in public round-table discussions held in March 2003, representatives of co-operative banks raised questions about the application of the principles in IAS 32 to members’ shares. This was followed by a series of meetings between IASB members and staff and representatives of the European Association of Co-operative Banks. After considering questions raised by the bank group, the IASB concluded that the principles articulated in IAS 32 should not be modified, but that there were questions about the application of those principles to co-operative entities that should be considered by the IFRIC.

BC5 In considering the application of IAS 32 to co-operative entities, the IFRIC recognised that a variety of entities operate as co-operatives and these entities have a variety of capital structures. The IFRIC decided that its proposed Interpretation should address some features that exist in a number of co-operatives. However, the IFRIC noted that its conclusions and the examples in the Interpretation are not limited to the specific characteristics of members’ shares in European co-operative banks.

Basis for consensus

BC6 Paragraph 15 of IAS 32 states:

The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the *substance of the contractual arrangement* and the definitions of a financial liability, a financial asset and an equity instrument. [Emphasis added]

BC7 In many jurisdictions, local law or regulations state that members’ shares are equity of the entity. However, paragraph 17 of IAS 32 states:

With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a critical feature in differentiating a financial liability from an equity instrument is *the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer*. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party. [Emphasis added]

BC8 Paragraphs cited in the examples in the Appendix and in the paragraphs above show that, under IAS 32, the terms of the contractual agreement govern the classification of a financial instrument as a financial liability or equity. If the terms of an instrument create an unconditional obligation to transfer cash or another financial asset, circumstances that might restrict an entity’s ability to make the transfer when due do not alter the classification as a financial liability. If the terms of the instrument give the entity an unconditional right to avoid delivering cash or another financial asset, the instrument is classified as equity. This is true even if other factors make it likely that the entity will continue to distribute dividends or make or other payments. In view

of those principles, the IFRIC decided to focus on circumstances that would indicate that the entity has the unconditional right to avoid making payments to a member who has requested that his or her shares be redeemed.

- BC9 The IFRIC identified two situations in which a co-operative entity has an unconditional right to avoid the transfer of cash or another financial asset. The IFRIC acknowledges that there may be other situations that may raise questions about the application of IAS 32 to members' shares. However, it understands that the two situations are often present in the contractual and other conditions surrounding members' shares and that interpretation of those two situations would eliminate many of the questions that may arise in practice.
- BC10 The IFRIC also noted that an entity assesses whether it has an unconditional right to avoid the transfer of cash or another financial asset on the basis of local laws, regulations and its governing charter in effect at the date of classification. This is because it is local laws, regulations and the governing charter in effect at the classification date, together with the terms contained in the instrument's documentation that constitute the terms and conditions of the instrument at that date. Accordingly, an entity does not take into account expected future amendments to local law, regulation or its governing charter.

The right to refuse redemption (paragraph 7)

- BC11 An entity may have the unconditional right to refuse redemption of a member's shares. If such a right exists, the entity does not have the obligation to transfer cash or another financial asset that IAS 32 identifies as a critical characteristic of a financial liability.
- BC12 The IFRIC considered whether the entity's history of making redemptions should be considered in deciding whether the entity's right to refuse requests is, in fact, unconditional. The IFRIC observed that a history of making redemptions may create a reasonable expectation that all future requests will be honoured. However, holders of many equity instruments have a reasonable expectation that an entity will continue a past practice of making payments. For example, an entity may have made dividend payments on preference shares for decades. Failure to make those payments would expose the entity to significant economic costs, including damage to the value of its ordinary shares. Nevertheless, as outlined in IAS 32 paragraph AG26 (cited in paragraph A3), a holder's expectations about dividends do not cause a preferred share to be classified as a financial liability.

Prohibitions against redemption (paragraphs 8 and 9)

- BC13 An entity may be prohibited by law or its governing charter from redeeming members' shares if doing so would cause the number of members' shares, or the amount of paid-in capital from members' shares, to fall below a specified level. While each individual share might be puttable, a portion of the total shares outstanding is not.
- BC14 The IFRIC concluded that conditions limiting an entity's ability to redeem members' shares must be evaluated sequentially. Unconditional prohibitions like those noted in paragraph 8 of the consensus prevent the entity from *incurring a liability* for redemption of all or some of the members' shares, regardless of whether it would otherwise be able to satisfy that financial liability. This contrasts with conditional prohibitions that prevent payments being made only if specified conditions—such as liquidity constraints—are met. Unconditional prohibitions prevent a liability from coming into existence, whereas the conditional prohibitions may only defer the payment of a liability already incurred. Following this analysis, an unconditional prohibition affects classification when an instrument subject to the prohibition is issued or when the prohibition is enacted or added to the entity's governing charter. In contrast, conditional restrictions such as those described in paragraphs 19 and AG25 of IAS 32 do not result in equity classification.
- BC15 The IFRIC discussed whether the requirements in IAS 32 can be applied to the classification of members' shares as a whole subject to a partial redemption prohibition. IAS 32 refers to 'a financial instrument', 'a financial liability' and 'an equity instrument'. It does not refer to groups or portfolios of instruments. In view of this the IFRIC considered whether it could apply the requirements in IAS 32 to the classification of members' shares subject to partial redemption prohibitions. The application of IAS 32 to a prohibition against redeeming some portion of members' shares (eg 500,000 shares of an entity with 1,000,000 shares outstanding) is unclear.
- BC16 The IFRIC noted that classifying a group of members' shares using the individual instrument approach could lead to misapplication of the principle of 'substance of the contract' in IAS 32. The IFRIC also noted that paragraph 23 of IAS 32 requires an entity that has entered into an agreement to purchase its own equity instruments to recognise a financial liability for the present value of the redemption amount (eg for the present value of the forward repurchase price, option exercise price or other redemption amount) even though the shares subject to the repurchase agreement are not individually identified. Accordingly, the IFRIC decided

that for purposes of classification there are instances when IAS 32 does not require the individual instrument approach.

- BC17 In many situations, looking at either individual instruments or all of the instruments governed by a particular contract would result in the same classification as financial liability or equity under IAS 32. Thus, if an entity is prohibited from redeeming any of its members' shares, the shares are not puttable and are equity. On the other hand, if there is no prohibition on redemption and no other conditions apply, members' shares are puttable and the shares are financial liabilities. However, in the case of partial prohibitions against redemption, the classification of members' shares governed by the same charter will differ, depending on whether such a classification is based on individual members' shares or the group of members' shares as a whole. For example, consider an entity with a partial prohibition that prevents it from redeeming 99 per cent of the highest number of members' shares ever outstanding. The classification based on individual shares considers each share to be potentially puttable and therefore a financial liability. This is different from the classification based on all of the members' shares. While each member's share may be redeemable individually, 99 per cent of the highest number of shares ever outstanding is not redeemable in any circumstances other than liquidation of the entity and therefore is equity.

Measurement on initial recognition (paragraph 10)

- BC18 The IFRIC noted that when the financial liability for the redemption of members' shares that are redeemable on demand is initially recognised, the financial liability is measured at fair value in accordance with paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement*.¹ Paragraph 49 states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid'. Accordingly, the IFRIC decided that the fair value of the financial liability for redemption of members' shares redeemable on demand is the maximum amount payable under the redemption provisions of its governing charter or applicable law. The IFRIC also considered situations in which the number of members' shares or the amount of paid-in capital subject to prohibition against redemption may change. The IFRIC concluded that a change in the level of a prohibition against redemption should lead to a transfer between financial liabilities and equity.

Subsequent measurement

- BC19 Some respondents requested additional guidance on subsequent measurement of the liability for redemption of members' shares. The IFRIC noted that the focus of this Interpretation was on clarifying the classification of financial instruments rather than their subsequent measurement. Also, the IASB has on its agenda a project to address the accounting for financial instruments (including members' shares) that are redeemable at a pro rata share of the fair value of the residual interest in the entity issuing the financial instrument. The IASB will consider certain measurement issues in this project. The IFRIC was also informed that the majority of members' shares in co-operative entities are not redeemable at a pro rata share of the fair value of the residual interest in the co-operative entity thereby obviating the more complex measurement issues. In view of the above, the IFRIC decided not to provide additional guidance on measurement in the Interpretation.

Presentation

- BC20 The IFRIC noted that entities whose members' shares are not equity could use the presentation formats included in paragraphs IE32 and IE33 of the Illustrative Examples with IAS 32.

Alternatives considered

- BC21 The IFRIC considered suggestions that:
- (a) members' shares should be classified as equity until a member has requested redemption. That member's share would then be classified as a financial liability and this treatment would be consistent with local laws. Some commentators believe this is a more straightforward approach to classification.
 - (b) the classification of members' shares should incorporate the probability that members will request redemption. Those who suggest this view observe that experience shows this probability to be small, usually within 1–5 per cent, for some types of co-operative. They see no basis for classifying 100 per cent of the members' shares as liabilities on the basis of the behaviour of 1 per cent.
- BC22 The IFRIC did not accept those views. Under IAS 32, the classification of an instrument as financial liability or equity is based on the 'substance of the contractual arrangement and the definitions of a financial liability,

¹ IFRS 9 *Financial Instruments* replaced IAS 39. Paragraph 49 of IAS 39 was ultimately relocated to paragraph 47 of IFRS 13 *Fair Value Measurement*. Paragraph BC18 refers to matters relevant when IFRIC 2 was issued.

a financial asset and an equity instrument.’ In paragraph BC7 of the Basis for Conclusions on IAS 32, the IASB observed:

Although the legal form of such financial instruments often includes a right to the residual interest in the assets of an entity available to holders of such instruments, the inclusion of an option for the holder to put the instrument back to the entity for cash or another financial asset means that the instrument meets the definition of a financial liability. The classification as a financial liability is independent of considerations such as when the right is exercisable, how the amount payable or receivable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity.

- BC23 The IFRIC also observed that an approach similar to that in paragraph BC21(a) is advocated in the Dissenting Opinion of one Board member on IAS 32. As the IASB did not adopt that approach its adoption here would require an amendment to IAS 32.

Transition and effective date (paragraph 14)

- BC24 The IFRIC considered whether its Interpretation should have the same transition and effective date as IAS 32, or whether a later effective date should apply with an exemption from IAS 32 for members’ shares in the interim. Some co-operatives may wish to amend their governing charter in order to continue their existing practice under national accounting requirements of classifying members’ shares as equity. Such amendments usually require a general meeting of members and holding a meeting may not be possible before the effective date of IAS 32.
- BC25 After considering a number of alternatives, the IFRIC decided against any exemption from the transition requirements and effective date in IAS 32. In reaching this conclusion, the IFRIC noted that it was requested to provide guidance on the application of IAS 32 when it is first adopted by co-operative entities, ie from 1 January 2005. Also, the vast majority of those who commented on the draft Interpretation did not object to the proposed effective date of 1 January 2005. Finally, the IFRIC observed that classifying members’ shares as financial liabilities before the date that the terms of these shares are amended will affect only 2005 financial statements, as first-time adopters are not required to apply IAS 32 to earlier periods. As a result, any effect of the Interpretation on first-time adopters is expected to be limited. Furthermore, the IFRIC noted that regulators are familiar with the accounting issues involved. A co-operative entity may be required to present members’ shares as a liability until the governing charter is amended. The IFRIC understands that such amendments, if adopted, could be in place by mid-2005. Accordingly, the IFRIC decided that the effective date for the Interpretation would be annual periods beginning on or after 1 January 2005.