Compiled Interpretation **Interpretation 2**

Members' Shares in Co-operative Entities and Similar Instruments

This compiled UIG Interpretation applies to annual reporting periods beginning on or after 1 January 2011. Early application is permitted. It incorporates relevant amendments made up to and including 15 December 2009.

Prepared on 23 February 2010 by the staff of the Australian Accounting Standards Board.

Australian Government

Australian Accounting Standards Board

Obtaining Copies of Interpretations

Compiled versions of Interpretations, original Interpretations and amending pronouncements (see Compilation Details) are available on the AASB website: www.aasb.gov.au.

Printed copies of original Interpretations and amending pronouncements are available for purchase by contacting:

The Customer Service Officer	
Australian Accounting Standards Board	
Level 7	**Postal address:**
600 Bourke Street	PO Box 204
Melbourne Victoria	Collins Street West Victoria 8007
AUSTRALIA	AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aasb.gov.au
Website: www.aasb.gov.au

Other Enquiries

Phone: (03) 9617 7600
Fax: (03) 9617 7608
E-mail: standard@aasb.gov.au

CONTENTS

COMPILATION DETAILS

COMPARISON WITH IFRIC 2

UIG INTERPRETATION 2
MEMBERS' SHARES IN CO-OPERATIVE ENTITIES AND SIMILAR INSTRUMENTS

	Paragraphs
References	
Background	1 – 2
Scope	3
Issue	4
Consensus	5 – Aus12.2
Disclosure	13
Application	Aus13.1 – Aus13.4
Appendix: Examples of Application of the Consensus	A1
Unconditional Right to Refuse Redemption	A2 – A5
Prohibitions against Redemption	A6 – A19
BASIS FOR CONCLUSIONS ON IFRIC 2	*Page 19*

UIG Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* (as amended) is set out in paragraphs 1 – Aus13.4 and the Appendix. Interpretations are listed in Australian Accounting Standard AASB 1048 *Interpretation and Application of Standards*. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

COMPILATION DETAILS

UIG Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* as amended

This compiled Interpretation applies to annual reporting periods beginning on or after 1 January 2011. It takes into account amendments up to and including 15 December 2009 and was prepared on 23 February 2010 by the staff of the Australian Accounting Standards Board (AASB).

This compilation is not a separate Interpretation issued by the AASB. Instead, it is a representation of Interpretation 2 (March 2005) as amended by other pronouncements, which are listed in the Table below.

Table of Pronouncements

Pronouncement	**Month issued**	**Application date** ***(annual reporting periods … on or after …)***	**Application, saving or transitional provisions**
Interpretation 2	Mar 2005	*(ending)* 31 Dec 2005	see (a) below
AASB 2007-8	Sep 2007	*(beginning)* 1 Jan 2009	see (b) below
AASB 2008-2	Mar 2008	*(beginning)* 1 Jan 2009	see (c) below
AASB 2009-6	Jun 2009	*(beginning)* 1 Jan 2009 and *(ending)* 30 Jun 2009	see (d) below
AASB 2009-12	Dec 2009	*(beginning)* 1 Jan 2011	see (e) below

(a) Entities may elect to apply this Interpretation to annual reporting periods beginning on or after 1 January 2005 that end before 31 December 2005.

(b) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2009, provided that AASB 101 *Presentation of Financial Statements* (September 2007) is also applied to such periods.

(c) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2009.

(d) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2009, provided that AASB 101 *Presentation of Financial Statements* (September 2007) is also applied to such periods, and to annual reporting periods beginning on or after 1 January 2009 that end before 30 June 2009.

(e) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2011.

Table of Amendments

Paragraph affected	How affected	By … [paragraph]
6	amended	AASB 2008-2 [36]
9	amended	AASB 2008-2 [37]
Aus12.2	amended	AASB 2009-6 [105]
Aus13.1	amended	AASB 2007-8 [7, 8]
Aus13.3	amended amended	AASB 2007-8 [6] AASB 2009-12 [21]
Aus13.4	amended	AASB 2007-8 [8]
14A	note added	AASB 2008-2 [38]
A1	amended amended	AASB 2008-2 [39] AASB 2009-6 [106]
A11	amended	AASB 2007-8 [6]
A12	amended	AASB 2008-2 [40]
A14	amended	AASB 2007-8 [6]

COMPARISON WITH IFRIC 2

UIG Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* as amended incorporates International Financial Reporting Interpretations Committee Interpretation IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* as amended, issued by the International Accounting Standards Board. Paragraphs that have been added to this Interpretation (and do not appear in the text of IFRIC 2) are identified with the prefix "Aus", followed by the number of the preceding IFRIC paragraph and decimal numbering.

Entities that comply with Interpretation 2 as amended will simultaneously be in compliance with IFRIC 2 as amended.

INTERPRETATION 2

UIG Interpretation 2 was issued in March 2005.

This compiled version of Interpretation 2 applies to annual reporting periods beginning on or after 1 January 2011. It incorporates relevant amendments contained in other AASB pronouncements up to and including 15 December 2009 (see Compilation Details).

URGENT ISSUES GROUP

INTERPRETATION 2

MEMBERS' SHARES IN CO-OPERATIVE ENTITIES AND SIMILAR INSTRUMENTS

References

Accounting Standard AASB 132 *Financial Instruments: Presentation*

Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement*

Background

1 Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to below as 'members' shares'.

2 Accounting Standard AASB 132 *Financial Instruments: Presentation* establishes principles for the classification of financial instruments as financial liabilities or equity. In particular, those principles apply to the classification of puttable instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument. The application of those principles to members' shares in co-operative entities and similar instruments is difficult. Constituents have asked

for help in understanding how the principles in AASB 132 apply to members' shares and similar instruments that have certain features, and the circumstances in which those features affect the classification as liabilities or equity.

Scope

3 This Interpretation applies to financial instruments within the scope of AASB 132, including financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity. This Interpretation does not apply to financial instruments that will or may be settled in the entity's own equity instruments.

Issue

4 Many financial instruments, including members' shares, have characteristics of equity, including voting rights and rights to participate in dividend distributions. Some financial instruments give the holder the right to request redemption for cash or another financial asset, but may include or be subject to limits on whether the financial instruments will be redeemed. How should those redemption terms be evaluated in determining whether the financial instruments should be classified as liabilities or equity?

Consensus

5 The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

6 Members' shares that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 7 and 8 is present or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of AASB 132. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

7 Members’ shares are equity if the entity has an unconditional right to refuse redemption of the members’ shares.

8 Local law, regulation or the entity’s governing charter can impose various types of prohibitions on the redemption of members’ shares, for example unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity’s governing charter, members’ shares are equity. However, provisions in local law, regulation or the entity’s governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members’ shares being equity.

9 An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members’ shares if redemption would cause the number of members’ shares or amount of paid-in capital from members’ shares to fall below a specified level. Members’ shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7 or the members’ shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of AASB 132. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.

10 At initial recognition, the entity shall measure its financial liability for redemption at fair value. In the case of members’ shares with a redemption feature, the entity measures the fair value of the financial liability for redemption at no less than the maximum amount payable under the redemption provisions of its governing charter or applicable law discounted from the first date that the amount could be required to be paid (see example 3).

11 As required by paragraph 35 of AASB 132, distributions to holders of equity instruments are recognised directly in equity, net of any income tax benefits. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

12 The Appendix, which is an integral part of the consensus, provides examples of the application of this consensus.

Aus12.1 Local law may require that when a member has not been an active member of a co-operative for a specified period of time, the membership of the member is cancelled and the shares of the member are required to be redeemed. For example, the *Co-operatives Act 1992* (NSW) requires that when a member is not presently an active member of the co-operative and has not been an active member of a co-operative at any time during the past three years (or a shorter period, if provided for in the rules of the co-operative), the co-operative must declare the membership of the member cancelled and then has 12 months within which to repay to the former member the amount payable in respect of that cancellation.

Aus12.2 Local law that requires the redemption of members' shares where members cease to be active members of a co-operative creates an unconditional obligation on the co-operative to transfer cash or another financial asset to its members at the option of the members, who would exercise their option by ceasing to be an active member. The obligation meets the definition of a financial liability and the members' shares are classified as liabilities, measured in accordance with paragraph 10, unless the shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of AASB 132. For example, under the general New South Wales requirements noted in paragraph Aus12.1, a co-operative would measure the fair value of the financial liability (if the members' shares are so classified) by discounting the maximum amount payable on redemption over the four-year period to the first date that the amount could be required to be paid.

Disclosure

13 When a change in the redemption prohibition leads to a transfer between financial liabilities and equity, the entity shall disclose separately the amount, timing and reason for the transfer.

Application

Aus13.1 This Interpretation applies to:

(a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act 2001* and that is a reporting entity;

(b) general purpose financial statements of each other reporting entity; and

(c) financial statements that are, or are held out to be, general purpose financial statements.

Aus13.2 This Interpretation applies to annual reporting periods ending on or after 31 December 2005.

[Note: For application dates of paragraphs changed or added by an amending pronouncement, see Compilation Details.]

Aus13.3 This Interpretation may be applied to annual reporting periods beginning on or after 1 January 2005 that end before 31 December 2005, permitting early application only in the context of adopting all Australian equivalents to International Financial Reporting Standards for such periods. An entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act may apply this Interpretation to such an annual reporting period when an election has been made in accordance with subsection 334(5) of the Corporations Act in relation to AASB 1048 *Interpretation and Application of Standards*. When an entity applies this Interpretation to such an annual reporting period, it shall disclose that fact.

Aus13.4 The requirements specified in this Interpretation apply to the financial statements where information resulting from their application is material in accordance with AASB 1031 *Materiality*.

Effective Date of IFRIC 2

14 [Deleted by the UIG]

14A [Deleted by the AASB]

APPENDIX

Examples of Application of the Consensus

This appendix is an integral part of the Interpretation.

A1 This appendix sets out seven examples of the application of the UIG consensus. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability and that the financial instrument does not have all the features or does not meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of AASB 132.

Unconditional Right to Refuse Redemption (paragraph 7)

Example 1

Facts

A2 The entity's charter states that redemptions are made at the sole discretion of the entity. The charter does not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board has the right to do so.

Classification

A3 The entity has the unconditional right to refuse redemption and the members' shares are equity. AASB 132 establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph AG26 of AASB 132 states:

> When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an

equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Example 2

Facts

A4 The entity's charter states that redemptions are made at the sole discretion of the entity. However, the charter further states that approval of a redemption request is automatic unless the entity is unable to make payments without violating local regulations regarding liquidity or reserves.

Classification

A5 The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in AASB 132, result in the classification of the financial instrument as equity. Paragraph AG25 of AASB 132 states:

> Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability

because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation*. [Emphasis added]

Prohibitions against Redemption (paragraphs 8 and 9)

Example 3

Facts

A6 A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

(a) 1 January 20x1 100,000 shares at CU10 each[1] (CU1,000,000);

(b) 1 January 20x2 100,000 shares at CU20 each (a further CU2,000,000, so that the total for shares issued is CU3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

A7 The entity's charter states that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At 31 December 20x2 the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On 1 January 20x3 the entity amends its governing charter and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing charter is amended

A8 Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 49 of

1 [Aus] In these examples, monetary amounts are denominated in currency units (CU).

AASB 139 *Financial Instruments: Recognition and Measurement*, which states: 'The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand …'. Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

A9 On 1 January 20x1 the maximum amount payable under the redemption provisions is 20,000 shares at CU10 each and accordingly the entity classifies CU200,000 as financial liability and CU800,000 as equity. However, on 1 January 20x2 because of the new issue of shares at CU20, the maximum amount payable under the redemption provisions increases to 40,000 shares at CU20 each. The issue of additional shares at CU20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at CU20, or CU800,000. This requires recognition of an additional liability of CU600,000. In this example no gain or loss is recognised. Accordingly the entity now classifies CU800,000 as financial liabilities and CU2,200,000 as equity. This example assumes these amounts are not changed between 1 January 20x1 and 31 December 20x2.

After the governing charter is amended

A10 Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on 1 January 20x3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 49 of AASB 139. It therefore transfers on 1 January 20x3 from equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity. In this example the entity does not recognise a gain or loss on the transfer.

Example 4

Facts

A11 Local law governing the operations of co-operatives, or the terms of the entity's governing charter, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is CU1,000,000. At the end of the reporting period the balance of paid-in capital is CU900,000.

Classification

A12 In this case, CU750,000 would be classified as equity and CU150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 18(b) of AASB 132 states in part:

> … a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D. The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D.

A13 The redemption prohibition described in this example is different from the restrictions described in paragraphs 19 and AG25 of AASB 132. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, that is they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (e.g. given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-in capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

A14 The facts of this example are as stated in example 4. In addition, at the end of the reporting period, liquidity requirements imposed in the local jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the end of the reporting period is that the entity cannot pay more than CU50,000 to redeem the members' shares.

Classification

A15 As in example 4, the entity classifies CU750,000 as equity and CU150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 19 and AG25 of AASB 132 apply in this case.

Example 6

Facts

A16 The entity's governing charter prohibits it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been CU12,000 and no member's shares have been redeemed.

Classification

A17 The entity classifies CU12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7

Facts

A18 The entity is a co-operative bank. Local law governing the operations of co-operative banks state that at least 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the regulations to include members' share accounts) has to be in the form of members' paid-in capital. The effect of the regulation is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On 31 December 20x1 the entity has total outstanding liabilities of CU200,000, of which CU125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the entity's charter.

Classification

A19 In this example members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 19 and AG25 of AASB 132. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, that is they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (CU125,000) if it repaid all of its other liabilities (CU75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, that is the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

BASIS FOR CONCLUSIONS ON IFRIC 2

This IFRIC Basis for Conclusions accompanies, but is not part of, UIG Interpretation 2. The UIG considers that this Basis for Conclusions is an essential feature of the Interpretation. An IFRIC Basis for Conclusions may be amended to reflect the requirements of the UIG Interpretation and AASB Accounting Standards where they differ from the corresponding International pronouncements.

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 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 (e.g. 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 (e.g. 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*. Paragraph 49 states: 'The fair value of a financial liability with a demand feature (e.g. 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, 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 [Deleted by the UIG]

BC25 [Deleted by the UIG]