Commission Regulation (EC) No 1073/2005 of 7 July 2005 amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, as regards IFRIC 2 (Text with EEA relevance)

COMMISSION REGULATION (EC) No 1073/2005

of 7 July 2005

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(Text with EEA relevance)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community.

Having regard to Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards[(1)], and in particular Article 3 (1) thereof,

Whereas:

(1) By Commission Regulation (EC) No 1725/2003[(2)] certain international standards and interpretations that were extant at 14 September 2002 were adopted.

(2) On 17 December 2003 the International Accounting Standard Board (IASB) published revised International Accounting Standard (IAS) 32 *Financial Instruments: Disclosure and Presentation*. IAS 32 establishes basic principles for the classification of instruments as liabilities or equity and was adopted by the European Commission by Commission Regulation (EC) No 2237/2004[(3)] as of 29 December 2004.

(3) Following bilateral discussions with representatives of the cooperative world and due to a request by the Commission, the IASB invited its International Financial Reporting Interpretation Committee (IFRIC), to develop an interpretation to facilitate the application of the revised IAS 32.

(4) IFRIC 2 *Members' Shares in Cooperative Entities and Similar Instruments* was published on 25 November 2004. The Interpretation clarifies that the classification of members' shares as financial liabilities or as equity depends upon the characteristics of such shares, especially the redemption features. The effective date of application of this interpretation is the same as that for IAS 32, as already indicated in Recital 3 of Regulation (EC) No 2237/2004 as of 29 December 2004 adopting IAS 32.

(5) The consultation with technical experts in the field support that IFRIC Interpretation 2 Members' Shares in Cooperative Entities and Similar Instruments meet the technical criteria for adoption set out in Article 3(2) of Regulation (EC) No 1606/2002.

(6) Regulation (EC) No 1725/2003 should therefore be amended accordingly.

(7) This amendment should exceptionally take effect for company's financial year starting on or after 1 January 2005, i.e. from a point in time before the publication of this regulation. The retrospective application is exceptionally justified as to enable cooperatives the preparation of accounts in accordance with IAS 32, as construed by IFRIC 2, and as the companies concerned could legitimately expect such application already at the point of the adoption of IAS 32.

(8) The measures provided for in this Regulation are in accordance with the opinion of the Accounting Regulatory Committee.

HAS ADOPTED THIS REGULATION:

Article 1

Annex to Regulation (EC) No 1725/2003 is amended as follows:

The text of the Interpretation IFRIC 2 *Members' Shares in Cooperative Entities and Similar Instruments* set out in the Annex to this Regulation, is inserted.

Article 2

This Regulation shall enter into force on the third day following its publication in the *Official Journal of the European Union*.

It shall apply to each financial year of a company starting on or after 1 January 2005 at the latest.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 7 July 2005.

For the Commission

Charlie McCREEVY

Member of the Commission

ANNEX

INTERNATIONAL FINANCIAL REPORTING STANDARDS

IFRIC 2	*Members' Shares in Cooperative Entities and Similar Instruments*

IFRIC Members' Shares in Cooperative Entities and Similar Instruments
INTERPRETATION
2

References

— IAS 32 *Financial Instruments: Disclosure and Presentation* (as revised in 2003)

— IAS 39 *Financial Instruments: Recognition and Measurement* (as revised in 2003)

Background

1 Cooperatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a cooperative 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 cooperative are often characterised as members' shares, units or the like, and are referred to below as 'members' shares'.

2 IAS 32 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 cooperative entities and similar instruments is difficult. Some of the International Accounting Standards Board's constituents have asked for help in understanding how the principles in IAS 32 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 IAS 32, including financial instruments issued to members of cooperative 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 cooperative 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. 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, e.g. 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. 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 IAS 32, 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.

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.

Effective date

14 The effective date and transition requirements of this Interpretation are the same as those for IAS 32 (as revised in 2003). An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2005. If an entity applies this Interpretation for a period beginning before 1 January 2005, it shall disclose that fact. This Interpretation shall be applied retrospectively.

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 IFRIC 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.

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. IAS 32 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 IAS 32 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 IAS 32, result in the classification of the financial instrument as equity. Paragraph AG25 of IAS 32 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 cooperative 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 CU 10 each (CU 1 000 000);

(b) 1 January 20x2 100 000 shares at CU 20 each (a further CU 2 000 000, so that the total for shares issued is CU 3 000 000).

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 cooperative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the cooperative entity determines the fair value of such financial liabilities as required by paragraph 49 of IAS 39, 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 cooperative 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 CU 10 each and accordingly the entity classifies CU 200 000 as financial liability and CU 800 000 as equity. However, on 1 January 20x2 because of the new issue of shares at CU 20, the maximum amount payable under the redemption provisions increases to 40 000 shares at CU 20 each. The issue of additional shares at CU 20 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 CU 20, or CU 800 000. This requires recognition of an additional liability of CU 600 000. In this example no gain or loss is recognised. Accordingly the entity now classifies CU 800 000 as financial liabilities and CU 2 200 000 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 cooperative 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 CU 20 each. Accordingly, on 1 January 20x3 the cooperative entity classifies as financial liabilities an amount of CU 1 000 000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 49 of IAS 39. It therefore transfers on 1 January 20x3 from equity to financial liabilities an amount of CU 200 000, leaving CU 2 000 000 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 cooperatives, 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 cooperative is CU 1 000 000. At the balance sheet date the balance of paid-in capital is CU 900 000.

Classification

A12 In this case, CU 750 000 would be classified as equity and CU 150 000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 18(b) of IAS 32 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. This is so 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, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. 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.

A13 The redemption prohibition described in this example is different from the restrictions described in paragraphs 19 and AG25 of IAS 32. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, i.e. 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 balance sheet date, 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 balance sheet date is that the entity cannot pay more than CU 50 000 to redeem the members' shares.

Classification

A15 As in example 4, the entity classifies CU 750 000 as equity and CU 150 000 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 IAS 32 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 CU 12 000 and no member's shares have been redeemed.

Classification

A17 The entity classifies CU 12 000 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 cooperative bank. Local law governing the operations of cooperative 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 cooperative'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 CU 200 000, of which CU 125 000 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 IAS 32. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, i.e. 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 (CU 125 000) if it repaid all of its other liabilities (CU 75 000). 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, i.e. 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.

(**1**) OJ L 243, 11.9.2002, p. 1.

(**2**) OJ L 261, 13.10.2003, p. 1. Regulation as last amended by Regulation (EC) No 211/2005 (OJ L 41, 11.2.2005, p. 1).

(**3**) OJ L 393, 31.12.2004, p. 1.

Changes to legislation:
There are currently no known outstanding effects for the Commission Regulation (EC) No 1073/2005.