



International Financial Reporting Bulletin

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Status: Final

Effective date:

Accounting periods commencing on/after
1 January 2009

Accounting impact:

May change the classification of certain
financial liabilities to equity

Amendments to IAS 32 *Financial Instruments: Presentation*
and IAS 1 *Presentation of Financial Statements*

Puttable financial instruments and obligations arising on
liquidation

Background

IAS 32 contains precise requirements to be applied when determining whether a financial instrument should be classified as equity or as a liability. Certain types of financial instrument, such as the share capital of a company which has a limited life (for example, it may be required to be wound up after a specified period) or interests of partners in a partnership, have been classified as liabilities as these instruments contain an unconditional obligation on the part of the issuer to transfer cash or other financial assets to the holder.

The amendments to IAS 32 result in certain types of financial instrument that meet the definition of a liability, but represent the residual interest in the net assets of the entity, being classified as equity.

Requirements

The amendments to IAS 32 address the classification of, and make a distinction between:

- a) Puttable financial instruments; and
- b) Instruments, or components of 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.

The amendments introduce an exception such that, although certain instruments meet the definition of a financial liability, they are classified as equity.

A distinction is made between the two types of instrument because, unlike puttable instruments that can only be exercised on liquidation (and therefore need only to be analysed to the extent of obligations at that date), other puttable instruments can be exercised prior to liquidation. For the latter, it is necessary to identify all contractual obligations that exist throughout the instrument's life to ensure that it always represents the most residual interest.

Puttable instruments

Puttable instruments give the holder the right to require the issuer to purchase the instrument for cash or another financial instrument (e.g. a share which is redeemable for cash, with the redemption being at the option of the holder of the share), or where the issuer is automatically required to purchase the instrument on the occurrence of an uncertain future event, or the death or retirement of the instrument holder.

Under the current IAS 32, these instruments are classified as financial liabilities.

The amendments to IAS 32 mean that although these instruments meet the definition of a financial liability, the instruments may qualify to be classified as equity if all of the following conditions are met:

- a) The holder is entitled to a pro rata share of the net assets in the event of the entity's liquidation.
- b) The instrument belongs to a class of financial instruments that is subordinate to all other classes of instrument issued by the entity. In determining whether this is the case, the revised standard notes that the instrument's claim on liquidation should be analysed as if the entity were to liquidate on the date on which it classifies the instrument. The rights of the instrument are analysed in its form at that point; it must not need to be converted into another instrument before it is subordinate to all other classes of financial instrument.
- c) All instruments in the class that is subordinate to all other classes of financial instrument have identical features. No instrument holder in that class can have terms which are preferential to other holders (such as a fixed repayment on liquidation in addition to a share of the entity's net assets).
- d) Apart from the contractual obligation to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any such obligation (such as mandatory coupons) or any obligation to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuing entity (ie derivative features) other than the put option itself.
- e) The total expected cash flows attributable to the instrument over its life should be based substantially on the issuer's profit or loss, change in recognised net assets or change in the fair value of recognised and unrecognised net assets. Profit or loss and changes in the recognised net assets are required to be measured in accordance with IFRS.

In addition to the requirements of the instrument itself, certain conditions need to be met by the issuer. These conditions are:

- a) the issuer must have no other financial instrument or contract that has total cash flows based substantially on its:
 - i) profit or loss
 - ii) change in recognised net assets
 - iii) change in the fair value of recognised and unrecognised net assetsand
- b) the issuer must have no other financial instrument or contract that has the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

*Financial instruments that are
puttable only on liquidation*

Instruments that are puttable only on liquidation are required to meet only some of the conditions outlined above that apply to puttable instruments. The conditions that need to be met are:

- a) The holder is entitled to a pro rata share of the net assets in the event of the entity's liquidation.
- b) The instrument belongs to a class of financial instruments that is subordinate to all other classes of instrument issued by the entity. In determining whether this is the case, the revised standard notes that the instrument's claim on liquidation should be analysed as if the entity were to liquidate on the date on which it classifies the instrument. The rights of the instrument are analysed in its form at that point; it must not need to be converted into another instrument before it is subordinate to all other classes of financial instrument.
- c) All instruments in the class that is subordinate to all other classes of financial instrument have identical features. No instrument holder in that class can have terms which are preferential to other holders (such as a fixed repayment on liquidation in addition to a share of the entity's net assets).

The conditions that need to be met by the issuer are the same as for puttable instruments.

Classification and reclassification

A puttable financial instrument (whether puttable on liquidation or otherwise) is classified as equity from the date on which the financial instrument has all of the features, and the issuing entity meets all of the conditions, for equity classification.

An instrument is reclassified from equity to liabilities from the date on which either it or the capital structure of the issuer mean that the conditions for equity classification cease to be met.

An example given in the revised standard is where an entity redeems all of its non-puttable instruments, with the result that the entity and its puttable instruments that remain outstanding then have all of the features meet the conditions set out in IAS 32.16A and IAS 32.16B. In this case, the puttable instruments are reclassified to equity on the date on which the redemption of the non-puttable instruments takes place.

Where an instrument included within equity is reclassified within liabilities, the financial liability is measured at its fair value at the date of reclassification. Any difference between the carrying value in equity at the point of reclassification and the fair value of the liability is recognised directly in equity.

Where an instrument classified as a liability is reclassified to equity, the equity instrument is measured at the carrying amount of the liability at the point of reclassification to equity.

Transactions entered into by an instrument holder other than in its capacity as owner

The holder of an instrument covered by the amendments (whether a puttable financial instrument, or one which gives a pro rata entitlement on liquidation) may enter into transactions with the issuing entity in a role other than that of an owner. For example, the holder may also be an employee. In such cases, only the cash flows and contractual terms and conditions of the financial instrument which relate to the investment holder acting in its capacity as an owner of the entity should be considered when assessing whether the instrument should be classified as equity.

The revised standard includes a number of examples to illustrate the application of this guidance. In one of these, a distinction is made for holders of an instrument that allocates profits or losses to the holders on one of two bases:

- a) Services rendered or business generated during the current and previous years; and
- b) The nominal amount of the instruments, based on the nominal amount of each instrument relative to the nominal amounts of others in the class.

In the former situation, the transactions are viewed as being with the holders of the instrument in their capacity as non-owners, and are therefore excluded when analysing whether the instrument should be classified as a liability or as equity. In the latter situation, the allocation is considered to be transactions with instrument holders in their capacity as owners and is therefore included in the analysis.

Amendments to other standards and to interpretations

IAS 1 Presentation of Financial Statements

IAS 1 has been amended to require additional disclosures covering puttable financial instruments. These disclosures include:

- General disclosures, including summary quantitative information about the amount classified as equity, the objectives, policies and processes used by the issuer to manage its obligation to repurchase or redeem the instruments when required to do so, and the expected cash flows on redemption or repurchase;
- Amounts reclassified, and the reasons for the reclassification, where a puttable instrument, or one which requires payment of a pro rata share of net assets on liquidation, has been classified as an equity instrument; and
- For a limited life entity, information about the length of its life.

Consequential amendments to IFRS 7, IAS 39 and IFRIC 2

IFRS 7 and IAS 39 have been amended to exclude from their scope puttable instruments and instruments that are puttable only on liquidation that are now required to be classified as equity instruments in accordance with the amendments to IAS 32.

IFRIC 2 has been amended to extend the requirement for equity classification to those members' shares in co-operative entities and similar instruments that meet the conditions specified in the amendments to IAS 32.

Effective date and transition

The amendments are required to be applied for annual periods commencing on or after 1 January 2009. Early adoption is permitted provided that appropriate disclosure is made, and all of the consequential amendments to IFRS 7, IAS 39 and IFRIC 2 are adopted at the same time.

For companies reporting in accordance with IFRS as endorsed for use in the EU, it should be noted that the amendments have not yet been endorsed. The European Financial Reporting Advisory Group is expected to issue endorsement advice in April or May 2008, with endorsement expected by the end of 2008.

Effect Certain financial instruments that have hitherto been classified as liabilities may be reclassified as equity instruments.

Action required In advance of adopting the amended standards, entities which may be affected should review the potential effect on the classification of their financial instruments, and the associated changes that will be made to their financial statements.