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Financial instruments puttable at fair value and obligations arising on liquidation – proposed amendments to IAS 32

The International Accounting Standards Board (IASB) has published an Exposure Draft (ED) of proposed amendments to IAS 32 **Financial Instruments: Presentation** and IAS 1 **Presentation of Financial Statements**. The ED is relevant to entities that have issued financial instruments that entitle the holders of those instruments to either i) put the instrument to the issuer at the fair value of a pro rata share of the net assets of the entity, or ii) receive a pro rata share of the net assets of the entity upon liquidation. Subject to specified criteria being met, under the ED these instruments would be classified as equity, whereas under the existing requirements they may be classified as financial liabilities.

The ED would be retrospectively applied from a date that has yet to be finalised. The IASB has requested comments on the ED by 23 October 2006.

Ken Wild, Deloitte's global IFRS leader says:

"The greatest impact of this amendment will be in the fund management industry and those jurisdictions where local law permits or requires entities to have a limited life.

Mutual funds, and other entities that allow investors to withdraw their interest at a pro rata share of net assets, previously recognised liabilities equal to the assets in the fund. Although IAS 32 does allow alternative balance sheet and profit or loss disclosure, these instruments are currently treated as liabilities and therefore these entities have zero or potentially negative net assets. As with limited life entities, which are common in some jurisdictions, these amendments, if finalised, would result in these entities having equity and positive net assets. This is a significant change to current practice."

Main proposals

Under the current requirements of IAS 32, if an issuer can be forced to pay cash or another financial asset in return for redeeming or repurchasing a financial instrument, the issuer is required to recognise a financial liability. This applies even if the amount the issuer will pay the holder is equal to the holder's interest in the net assets of the issuer, or if the amount is only ever payable at liquidation and liquidation is certain because, say, there is a fixed liquidation date.

The current requirements often result in anomalies. For example, as the amount that could be required to be paid may equal the market value of the whole entity, this may well be in excess of the accounting net assets of the entity. The ED aims to provide "a limited scope, short-term solution" to overcome this.

The IASB considers that financial instruments puttable at fair value, and obligations arising on liquidation when liquidation is certain, are similar to ordinary shares. Accordingly, this ED proposes classifying them as equity provided that certain conditions are met. The proposals list a number of conditions – the most critical of these being that the amount that could be paid by the entity is equal to a pro rata share of the entity's net assets, and the instrument is in the most subordinated class[1] of instruments with a claim to the entity's net assets. Where liquidation is uncertain (e.g. some partnerships allow an exiting partner to require the partnership to be liquidated), these instruments would also be considered equity as long as the holder has a right to require liquidation of the entity and will receive a pro rata share of net assets.

Even though a financial instrument previously presented as a financial liability could be treated as equity under these proposals, the issuer of an instrument puttable at fair value would still be required to disclose the fair value of the instrument, but an issuer of an instrument that only has an obligation arising on liquidation would not.

The ED also includes proposals on how such an instrument issued by a subsidiary and treated as equity in its financial statements would be treated in the consolidated financial statements of the group. Because in the group financial statements such an instrument would no longer be the most subordinated instrument of the group, it would be presented as a financial liability. The proposals also state that derivatives over instruments within the scope of this amendment will not be classified as equity.

Effective date

The ED proposes retrospective application from a date that has yet to be determined. Early application will be encouraged.

Comment deadline

The comment deadline for the proposals is 23 October 2006.

[1] A financial instrument is in the most subordinated class if on liquidation the amount due to the holders of these instruments is calculated after deducting all other claims to the assets of the entity and the instrument holders are paid out last, after payments are made to all other claimants.

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