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Puttable financial instruments and obligations arising on liquidation

On 14 February 2008, the International Accounting Standards Board (IASB) published amendments to IAS 32 **Financial Instruments: Presentation** and IAS 1 **Presentation of Financial Statements**. The amendments are relevant to entities that have issued financial instruments that are (i) puttable financial instruments, or (ii) 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. Under the revised IAS 32, subject to specified criteria being met, these instruments will be classified as equity whereas, prior to these amendments, they would have been classified as financial liabilities. It should be noted that the amendments differ significantly in some respects compared to the Exposure Draft issued in June 2006.

The amendments are effective for annual periods beginning on or after 1 January 2009, with early adoption permitted.

Purpose of the amendments

Under the current requirements of IAS 32, if an issuer can be required to pay cash or another financial asset in return for redeeming or repurchasing a financial instrument, the instrument is classified as a financial liability. This principle applies even if the amount payable 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, for example, there is a fixed liquidation date.

The current requirements often lead to counter-intuitive results. For example, the total amount payable may equal the market value of the whole entity, which may well be in excess of the accounting net assets of the entity. In another scenario, where liquidation is certain or is at the option of the holder, instruments that represent the last residual interest in the entity may be recognised as financial liabilities even when the instruments have characteristics similar to equity. The objective of the February 2008 amendments is to provide a "short-term, limited scope amendment" designed to avoid these outcomes.

The IASB considers that some puttable financial instruments and financial instruments that impose on the issuer an obligation to deliver a pro-rata share of net assets of the entity only on liquidation are equity. The amendments deal with these two types of instruments separately and set out extensive detailed criteria that need to be met in order to present the instrument as equity. The impact of the amendments is restricted to the specific cases cited – no analogies can be made to these requirements.

Puttable financial instruments

Puttable financial instruments will be presented as equity only if all of the following criteria are met:

(i) the holder is entitled to a pro-rata share of the entity's net assets on liquidation;

(ii) the instrument is in the class of instruments that is the most subordinate and all instruments in that class have identical features;

(iii) the instrument has no other characteristics that would meet the definition of a financial liability; and

(iv) the total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of the instrument itself). Profit or loss or change in recognised net assets for this purpose is as measured in accordance with relevant IFRSs.

In addition to the criteria set out above, the entity must have no other instrument that has terms equivalent to (iv) above and that has the effect of substantially restricting or fixing the residual return to the holders of the puttable financial instruments.

Instruments that impose an obligation to deliver a pro-rata share of net assets only on liquidation

The criteria for equity classification for 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 are the same as above except (iii) and (iv) do not apply. Criterion (iii) does not apply because, if there is a component of the instrument that meets the definition of a liability (other than the right at liquidation itself), this will be recognised separately as a financial liability and the instrument will be presented as a compound instrument, i.e. with both liability and equity components. Criterion (iv) does not apply because should any cash flows be paid to the holder of the instrument during the instrument's life, this will reduce the amount ultimately payable at liquidation.

Instruments issued by subsidiaries

For instruments of this nature issued by a subsidiary that are held by non-controlling parties and presented as equity in the subsidiary's financial statements, equity presentation will not be appropriate in the consolidated financial statements as the instrument will not be the most subordinated instrument of the group.

Examples of impact of amendments

The following examples illustrate the types of instruments impacted by the new requirements.

Issued financial instrument	Classification under existing IAS 32	Classification under amended IAS 32
Share puttable throughout its life at fair value, that is also the most subordinate, does not contain any other obligation, with discretionary dividends based on profits of the issuer	Liability	Equity
Share puttable at fair value, that is not the most subordinate	Liability	Liability
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed non-discretionary dividend	Liability	Compound (part equity, part liability)
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed discretionary dividend and does not contain any other obligation	Liability	Equity
Any of the instruments described above issued by a subsidiary held by non-controlling parties, in the consolidated financial statements	Liability	Liability

Derivatives over instruments in the scope of the amendment

Even though the amendments permit certain instruments that were previously presented as financial liabilities to now be presented as equity, derivatives over such equity instruments may not be presented as equity.

Reclassifications

The amendments require reclassification from or to equity when the specified criteria are no longer met, or when they are subsequently met. If the instrument presented as equity is reclassified as a financial liability, it will be measured at fair value at the date of reclassification with any difference between the fair value and the carrying amount to be recognised in equity. When the inverse applies, the financial liability will be reclassified to equity at its carrying amount at the date of reclassification.

Disclosures

IAS 1 has been amended to require the following additional disclosures if an entity has a puttable instrument that is presented as equity:

- summary quantitative data about the amount classified as equity;
- the entity's objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;
- the expected cash outflow on redemption or repurchase of that class of financial instruments; and
- information about how the expected cash outflow on redemption or repurchase was determined.

If an instrument is reclassified into and out of each category (financial liabilities or equity) the amount, timing and reason for that reclassification must be disclosed. If an entity is a limited-life entity, disclosure is also required regarding the length of its life.

Effective date and transitional provisions

The amendments are effective for annual periods beginning on or after 1 January 2009, with earlier adoption permitted. If entities adopt the amendments for a period beginning before 1 January 2009, consequential amendments to IFRS 7 *Financial Instruments: Disclosures*, IAS 39 *Financial Instruments: Recognition and Measurement*, and IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* should be adopted from the same earlier date. The fact that the amendments have been adopted in advance of their effective date should be disclosed.

In the absence of specific transitional provisions, the amendments should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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