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Accounting Alert 2006/08

Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation-proposed amendments to AASB 132

The exposure drafts are now freely available on the IASB and AASB websites

The International Accounting Standards Board has published an Exposure Draft (ED) of proposed amendments to IAS 32 *Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements.* The AASB has consequently issued ED 150 *'Proposed Amendments to AASB 132 Financial Instruments: Presentation and AASB 101 Presentation of Financial Statements: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation'*.

This *Accounting Alert* provides an Australian perspective on some of the key proposals and their impacts.

Overview

Some instruments would be classified as equity, whereas under the existing requirements they may be classified as financial liabilities.

The ED is relevant to entities that have issued financial instruments that entitle the holders of those instruments to either:

- put the instrument to the issuer at the fair value of a pro rata share of the net assets of the entity, or
- 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.

Main proposals

Under the current requirements of AASB 132, 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 ED aims to provide 'a limited scope, short-term solution'.

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 financial instrument must be in the most subordinated class of instruments with a claim to the entity's net assets.

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 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.

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.

Disclosures

Additional disclosures are required

Where a financial instrument previously presented as a financial liability is treated as equity under these proposals, the issuer of an instrument puttable at the fair value of a pro rata share of the net assets of the entity would be required to disclose the fair value of the instrument.

In addition, there are sundry other proposed disclosures.

Expected impact in Australia

Changes may have limited impact in Australia

The AASB has noted that there are a number of entities in Australia including certain unlisted trusts that still retain termination dates in their constitutions and therefore the proposed amendments in the ED will be relevant to them. However, the methodology adopted by a number of Australian unit trusts to determine the unit redemption price may not be equal to fair value under the proposals.

In addition, there are reasons other than the right to put the instrument back to the issuer at fair value or receive a pro rata share of the net assets of the entity upon liquidation that may result in an instrument being classified as debt under the current requirements of AASB 132. These issues are not addressed by the ED.

For example:

- unit trusts that have a contractual obligation to distribute the annual profits of the trust to the unit holders will still be required to classify the units as debt (and not equity) under the ED proposals. This is because it is the obligation to distribute the annual profits, rather than the right of the holder to put the instrument back to the issuer at fair value or receive a pro rata share of the net assets of the entity upon liquidation, that results in the units being classified as debt
- co-operatives whose members are only entitled to put back their shares at the amount for which they were purchased, rather than at the fair value of a pro rata share of the net assets of the entity, will still be required to classify the shares as debt (and not equity) under the ED proposals.

This ED addresses some, but not all, of the issues that might result in an instrument being classified as debt rather than equity and therefore, as noted above, the classification of a number of instruments will remain unchanged.

Effective date

An application date has yet to be proposed

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

Early application will be encouraged.

Comment period

The IASB has requested comments on the ED by 23 October 2006. The AASB has requested comments on ED 150 by 22 September 2006 so that comments can be taken into account in the AASB's own submission to the IASB.

Feedback and assistance

We welcome your feedback on the matters covered in this *Accounting Alert* – please e-mail your comments to **accounting_alerts@deloitte.com.au**

For assistance in applying the requirements outlined in this *Accounting Alert* to your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, **Bruce Porter** on **+61 (0) 3 9208 7490**, or by e-mail to **bruporter@deloitte.com.au**

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