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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation (Agenda Paper 8A)**

TRANSITION AND EFFECTIVE DATE

Introduction

1. At the IASB's December 2005 meeting, the Board decided to proceed with the proposed amendments to IAS 32 *Financial Instrument: Presentation* to require equity classification for financial instruments puttable at the fair value of a pro rata share of the net assets of the entity ('financial instruments puttable at fair value') and financial instruments that entitle the holder to a pro rata share of the entity's net assets payable on liquidation (affecting partnerships and limited life entities) ('obligations arising on liquidation'), subject to these instruments meeting specified criteria.

2. This paper considers:

   (a) the proposed effective date for the amendments to IAS 32;

   (b) whether the proposed amendments should apply prospectively or retrospectively; and

   (c) an exemption from separating compound financial instruments on initial application of the proposed amendments.

3. For the convenience of Board members, the paper includes relevant extracts from IFRSs.

Effective Date

4. Staff recommends that the effective date for the proposed amendments to IAS 32 be for annual accounting periods beginning on or after 1 July 2007 with early adoption permitted.

5. [deleted]

6. Staff recommends that early adoption be permitted to allow entities wanting to apply the amendments before its effective date the ability to do so. There are likely to be many entities that will want to adopt the amendments as soon as practicable. Staff sees no reason against encouraging earlier application.

7. Hence, staff proposes the following as the effective date paragraph of the proposed amendments:

> 96A *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* (Amendments to IAS 32 and IAS 1), issued in [insert month], amended the definition of a financial liability and financial assets, and included new definitions for a financial instrument puttable at fair value and a financial instrument that entitles the holder to a pro rata share of the net assets of the entity in paragraph 11, amended paragraphs [insert paragraph references], and inserted paragraphs [insert paragraph references]. An entity shall apply those amendments for annual periods beginning on or after 1 July 2007. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to IAS 1, IAS 39 and IFRIC 2 at the same time.

Alternative — no proposed effective date

8. The alternative is not to propose an effective date in the forthcoming Exposure Draft. The Board decided that there should be no effective date proposed in the recently issued Exposure Draft of Proposed Amendments to IAS 1 Presentation of Financial Statements: *A Revised Presentation.* The advantage of not proposing an effective date is that it allows more flexibility in finalising the proposed amendments.

Retrospective or Prospective Application

9. Staff recommends that the amendments be applied retrospectively on first time application (for both first-time adopters and entities currently reporting under IFRSs) because the requirements of IAS 32 are retrospective. Moreover, staff believes that users are more likely to favour retrospective application over prospective application of the proposed amendments.

10. For entities currently applying IFRSs, the affected instruments are classified as financial liabilities and will be recognised and measured at no less than the amount payable on demand. If prospective application of the proposed amendments is required, these instruments would be reclassified from financial liabilities to equity at the amount payable on demand on the date of application of those proposed amendments. This is inconsistent with the principle that equity instruments are never remeasured. Therefore, staff do not recommend prospective application of the proposed amendments.

11. A first-time adopter is required to apply the requirements of IAS 32 retrospectively (except for the exemption permitted for compound instruments which will be discussed further in paragraph 13) under IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Hence, the staff do not recommend any amendments to IFRS 1 as a result of the proposed amendments. Thus, a first time adopter will have to apply the amendments retrospectively, which is consistent with the majority of IAS 32 requirements.

12. There may be some first-time adopters and entities currently applying IFRSs that will face difficulty in applying the proposed amendments retrospectively because these entities are unable to ascertain the issue price of their financial instruments puttable at fair value (eg some mutual funds). Staff notes that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraphs 23-27, provide relief when it is impracticable to apply new requirements retrospectively. Staff do not recommend additional guidance for when it is impracticable to apply the proposed amendments retrospectively.

An exemption for separating compound financial instruments on initial application of the proposed amendments

13. IFRS 1 requires a first-time IFRS adopter to apply the requirements of IAS 32 retrospectively in all cases except for compound financial instruments. IFRS 1, paragraph 23, allows an exemption from the requirement to split a compound financial instrument at inception into separate liability and equity components when the liability component is no longer outstanding at the date of transition to IFRSs (shown below).

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

Compound financial instruments

23 IAS 32 *Financial Instruments: Disclosure and Presentation* requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of IAS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, under this Standard, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to to IFRSs.

14. The proposed amendments require that financial instruments (or components of financial instruments) with an obligation for a pro rata share of the net assets of the entity upon its liquidation be classified as equity.[1] Hence, a compound instrument which contains such an obligation will have to be separated into liability and equity components. For example, if an instrument issued by a limited life entity contains a second obligation (eg the right to be paid a fixed dividend), then the instrument would be split into two components, with one component classified as a liability (the dividend rights) and the other component classified as equity (the right to a pro rata share of the net assets of the entity on liquidation). Previously under IAS 32, those components would be classified in their entirety as a financial liability.

15. Because the proposal is that the amendments be applied retrospectively, a compound instrument with an obligation for a pro rata share of net assets arising on liquidation will have to be separated into liability and equity components from the instrument's inception. It may be that for some instruments the liability component is no longer outstanding at the date of application of the proposed amendments and, consequently, separating these compound financial instruments would have no benefit. This is the same reason that the exemption in IFRS 1 is given. To ensure that the same exemption as IFRS 1 is available to entities currently applying IFRSs, staff proposes the following paragraph as a transitional provision to the proposed amendments to IAS 32 (based on IFRS 1, paragraph 23):

[1] This is not the case for a financial instrument puttable at fair value. The last condition (condition (d)) of the proposed definition of those instruments effectively means that if a financial instrument includes *another* contractual obligation to transfer cash or other assets to the instrument holder (eg the right to be paid a fixed dividend), in addition to the right to put the instrument back to the entity, then the puttable instrument will not qualify for equity classification. In other words, in the case of puttable instruments, the instrument is *not* divided into components, with one component classified as a liability (eg the dividend rights) and the other component classified as equity (the right to put).

97A When applying the amendments described in paragraph 96A, an entity is required to split a compound financial instrument with an obligation for a pro rata share of the net assets of the entity upon its liquidation into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of those amendments to IAS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, an entity need not separate these two portions if the liability component is no longer outstanding at the date of application of the amendments.