Project **Tentative agenda decision**

Topic **IFRS 4 *Insurance Contracts* / IAS 32 *Financial Instruments: Presentation* – Scope issue for investments in REITs**

Introduction

1. The IFRIC received a request in July asking for guidance on the liability / equity classification of financial instruments with specific features issued by Real Estate Investment Trusts (REITs). The submission is reproduced in full for ease of reference in Appendix B.

Background information on REITs

2. In some jurisdictions, a REIT is a tax designation for a corporation investing in real estate that reduces or eliminates corporate income taxes. In return, REITs are required to distribute 90% of their income, which may be taxable, into the hands of the investors. The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks.

3. In other jurisdictions, REITs follow legal / statutory requirements with a view to privatise properties formerly owned by government agencies.

4. A common feature of these REITs is that the requirements for distribution result from contractual agreements between the issuer and the investors in order to fulfil tax relief conditions or other legal requirements.

Objective

5. The objective of this paper is:

   (a) To analyse different views on the issue raised, and

This paper has been prepared by the technical staff of the IASB. The views considered in this paper are for discussion at a public meeting of the IFRIC. No such views are to be presumed to be acceptable or unacceptable applications of IFRSs until the IFRIC or the IASB makes such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(b) To recommend the IFRIC whether or not to take the issue on to its agenda and to propose a wording for the agenda decision.

The issue

6. The request focuses on the classification of the ownership units of the REIT as equity or liability in the REIT's (issuer's) financial statements. The question is whether such instruments should follow IFRS 4, Discretionary Participation Features (DPF) classification guidance, or IAS 32, given their specific features.

7. The ownership units under consideration have the following features as mentioned in the submission:

   (a) Issued by REIT entities with a fixed life of not more than 80 years.

   (b) All units are identical and have the same rights and features.

   (c) The unit holders have no right to demand the repurchase or redemption of their units. However, unit holders may realise the capital value of their investments by selling their units on a stock exchange.

   (d) The units represent the residual interests in the net assets of the REIT and there are no other classes of equity. Unit holders are entitled to a pro rata share of the REIT's net assets in the event of liquidation.

   (e) The REIT is required to distribute to the unit holders, as dividends at regular intervals, an amount of not less than 90% of Total Distributable Income (TDI), which is defined as annual net income after tax, adjusted for certain non-cash items, e.g., property revaluation gains and deferred tax. There may be circumstances under which the REIT might not pay dividends, e.g. an operating loss, downward revaluation of properties or insufficient cash flows.

8. The submission discusses the possibility that these ownership units be assessed as instruments containing DPF. Such instruments are defined in paragraph 35 of IFRS 4.

9. The submission details the following two divergent views primarily based on the existence or not of a guaranteed benefit[1]:

   (a) the ownership units are in the scope of IFRS 4. The guaranteed benefit exists and is represented by any accumulated declared, but unpaid, dividends from prior years and 90% of the TDI at each reporting date. Under this view, the DPF is the discretionary amount between 0% and 10% of the DTI the issuer may distribute,

   (b) the ownership units are not in the scope of IFRS 4. The guaranteed benefits do not exist. Guaranteed benefits and DPF must exist *on inception* of the contract. In the case of REITs, the investors can potentially lose all of their investment, i.e. their entitlement to distributions equal to 90% of total distribution income ('TDI') earned by the REIT each year is conditional on profits being made by the REIT. Although these minimum distributions are not subject to the discretion of the issuer, they are not "unconditional", as required by the definition.

10. The staff understands the issue is a scope issue. The constituent does not seek any guidance on how to account for financial instruments with DPF.

11. The accounting consequences of the ownership units falling under IAS 32 or IFRS 4 are that IAS 32 requires bifurcating into debt and equity components, whereas IFRS 4 gives a choice as to bifurcating or presenting the whole instrument as liability.

12. The staff also acknowledges that until the publication of the Amendment to IAS 32 *Puttable Financial Instruments and Obligations Arising on Liquidation*, issuers considered such ownership units as liabilities. Constituents are concerned that this amendment could lead to reclassification as equity. The provisions in the amendment are effective for annual periods beginning on or after 1 January 2009.

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[1] Guaranteed benefits are defined in IFRS 4 – Appendix A as "Payments or other benefits to which a particular ***policyholder*** or investor has an unconditional right that is not subject to the contractual discretion of the issuer."

Staff analysis

Analysis of the ownership units

13. The staff analyses the ownership units as containing three elements:

    (a) a contractual obligation to distribute 90% of TDI,

    (b) a discretionary ability to distribute up to the remaining 10% of TDI, and

    (c) a contractual obligation to deliver to the holder a pro rata share of the net assets of the REIT on liquidation.

14. At this stage, the staff understands that the TDI is defined as excluding unrealised property revaluations. Therefore, whatever the accounting policy to measure properties in accordance with IAS 40 *Investment Properties* – namely at cost or at fair value - the revaluations will only be reflected upon realisation (eg on liquidation).

Scope considerations

15. The staff notes that financial instruments are defined in IAS 32. Therefore, one should turn to IAS 32 to assess that the ownership units are financial instruments. The staff is of the opinion that the units are financial instruments because of the contractual obligation to deliver cash and the right to the residual interest.

16. The staff then notes that paragraph 4 (e) of IAS 32 excludes financial instruments that are within the scope of IFRS 4 because they contain a DPF.

Conditions for a feature to be a DPF

17. For ease of reference, the staff reproduced the definition of DPF in Appendix C.

18. The staff notes that the definition of a DPF assumes the existence of guaranteed benefits. Given the features of the ownership units, one could argue that the guaranteed benefits are:

    (a) the pro rata share of the REIT's net assets in the event of liquidation,

    (b) the distribution at regular intervals of an amount of not less than 90% of TDI as dividends.

19. The staff believes the holder of the ownership units has an unconditional right to receive dividends that is not subject to the contractual discretion of the issuer.

The REIT cannot avoid distributing 90% of the TDI as it is a contractual obligation, whatever the amount distributed. Therefore, the distribution is a guaranteed benefit as defined in IFRS 4.

20. In the light of the above analysis, the remaining question is whether the discretionary distribution of up to 10% in addition to the 90% of TDI represents additional benefits and meets the definition of a DPF.

21. At this stage of the analysis, two views arise as to whether the distribution of up to 10% in addition to the 90% of TDI can be considered as additional benefits:

    (a) **view A**: the discretionary distribution is not additional benefits. Having liaised with the insurance project team, they are of the opinion that it is merely distributions of the holders' existing interest, and those amounts are not lost for the holders if not distributed because they contribute to increase equity, hence the unit holders' pro rata share in net assets on liquidation. This is in contrast to those financial instruments that are typically identified as having a DPF, in which feature to make a discretionary distribution results in different unit holders benefiting.

    (b) **view B**: the discretionary distribution is an additional benefit and this additional benefit needs to be assessed against the definition of a DPF, as discussed in the paragraphs below.

22. Under view B, the staff notes that the additional benefits need to meet three criteria in order to conclude that they are DPF. The table below lists the required criteria and discusses whether the ownership units fit these criteria.

Criteria **Additional benefits:**	**Assessment of the discretionary distribution of up to 10% in addition to the 90% of TDI**
(a) are likely to be a significant portion of the total contractual benefits	The staff is of the opinion that significance is to be assessed against both guaranteed benefits, ie the pro rata share of net assets on liquidation and the distribution of 90% of TDI. The conclusion of whether this criterion is met will require the specific facts and circumstances to be assessed.
(b) whose amount or timing is contractually at the discretion of the issuer	This criterion is met as the issuer has the choice of whether to distribute the additional 10% of TDI.
(c) are contractually based on:	
(i). the performance of a specified pool of contracts or a specified type of contract;	No
(ii).realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or	Yes
(iii). the profit or loss of the company, fund or other entity that issues the contract.	Yes

23. The staff is of the opinion that under view B the main issue remains with the first criterion which is to assess the significance of the additional benefits

compared to the total contractual benefits. Such assessment requires judgement and depends on facts and circumstances.

Consequences of the above analysis

24. The staff believes that if facts and circumstances entitle the discretionary distribution of up to 10% on top of the 90% of TDI to be assessed as a DPF, then the whole ownership unit should be classified as required by paragraph 34 of IFRS 4.

25. Otherwise, the ownership units are to be assessed against IAS 32 requirements for classification. Given the two contractual obligations listed in paragraph 13 (a) and (c) of this paper, the staff believes the ownership units would likely be compound financial instruments under the provisions of IAS 32.

Staff assessment of view A and view B

26. The staff believes that arguments in both views are finely balanced. The focus is on whether the discretionary distribution is an additional benefit or not.

27. The staff notes that the paragraphs BC154 and BC155 of the Basis for Conclusions to IFRS 4 focus on the discretionary nature of the feature, and not on the additional aspect of the benefit. However, the definition clearly describes discretionary feature as being an additional benefit supplemental to guaranteed benefits.

28. The staff therefore concludes that DPF must be additional.

29. The staff believes that practical implementation could be improved if there was more guidance on what represents additional benefits.

Agenda criteria assessment

30. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*
    Yes. The issue arises in several jurisdictions.

(b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*

Yes. The submission states that similar instruments have been issued in two countries. The staff acknowledges that many countries have been recently implementing such REIT for tax relief purposes.

(c) *Would financial reporting be improved through elimination of the diversity?*

Yes.

(d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*

The staff believes that providing additional guidance on whether an additional distribution of dividends is an additional benefit when the holder is also entitled to a pro rata share of the net assets of the entity on liquidation is in the nature of application guidance rather than interpretive guidance.

(e) It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis?

Yes.

(f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)*

Current related projects "Financial Instruments with Characteristics of Equity "and "Insurance Contracts" are currently being discussed by the Board. The staff is not aware that the specific issue of REITs is currently being discussed within these projects.

Staff recommendation

31. Given the above analysis and the agenda criteria assessment, the staff recommends that the IFRIC do not add the issue to its agenda. The staff proposes a wording for a tentative agenda decision in Appendix A

32. However, the staff seeks the IFRIC view on whether the issue should be directed to the Board in order to develop application guidance.

Recommendation and question for the IFRIC
Does the IFRIC agree not to take the issue to its agenda? Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix A? Does the IFRIC believe that the Board should be encouraged to develop application guidance on this matter?

[Appendix A is omitted from this observer note]

Appendix B

<u>The issue</u>

Applicability of IFRS 4 *Insurance Contracts* to unit holders' interests in certain real estate investment trusts

Certain real estate investment trusts (REITs) issue financial instruments with the following typical terms:

• Issued by REIT entities with a fixed life of not more than 80 years.

• All units are identical and have the same rights and features.

• The unit holders have no right to demand the repurchase or redemption of their units. However, unit holders may realise the capital value of their investments by selling their units on a stock exchange.

• The units represent the residual interests in the net assets of the REIT and there are no other classes of equity. Unit holders are entitled to a *pro rata* share of the REIT's net assets in the event of liquidation.

• The REIT is required to distribute to the unit holders, as dividends at regular intervals, an amount of not less than 90% of Total Distributable Income ('TDI'), which is defined as annual net income after tax, adjusted for certain non-cash items, e.g., property revaluation gains and deferred tax. There may be circumstances under which the REIT may not pay dividends, e.g. an operating loss, downward revaluation of properties or insufficient cash flows.

The issue is whether the issuer should determine the classification of the units and their components as liabilities or as equity following the guidance in (a) IFRS 4 for financial instruments with discretionary participation features or (b) IAS 32 *Financial Instruments: Presentation* for financial instruments generally.

Application of IFRS 4

Under this approach, the unit holder's interest in the REIT is an investment contract with a discretionary participation feature (DPF) as defined in IFRS 4 Appendix A. Contracts with DPF are within the scope of IFRS 4, and hence excluded from the scope of IAS 32.

IFRS 4 defines a DPF as 'a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

(a) that are likely to be a significant portion of the total contractual benefits;

(b) whose amount or timing is contractually at the discretion of the issuer; and

(c) that are contractually based on:

i. the performance of a specified pool of contracts or a specified type of contract;

ii. realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
iii. the profit or loss of the company, fund or other entity that issues the contract'.

The investor in an investment contract with a DPF is entitled to a guaranteed benefit which is an unconditional right that is not subject to the contractual discretion of the issuer. This right is defined as the guaranteed element of the contract.

Proponents of this approach argue that, for a REIT unit, there is a guaranteed benefit represented by any accumulated declared but unpaid dividends from prior years and 90% of the TDI at each reporting date.

In addition the investor in a REIT unit has an additional contractual right to receive, as a supplement to guaranteed benefits, additional benefits which the issuer can discretionarily decide based on accumulated TDI. This approach proposes that the additional benefits are a DPF because:

- It is likely to be a significant proportion of the total contractual benefits since the annual dividend could be increased up to 100% of TDI for that year, together with amounts unpaid in prior years, at the issuer's discretion.

- The amount or timing is contractually at the discretion of the issuer who can distribute between 0% up to 10% of the annual TDI and can also decide the timing of distribution through its discretionary decision to realise or not existing unrealised gains via property sales.

- Finally, the TDI meets the definition of the underlying of a DPF because it is based on realised investment returns on a specified pool of assets held by the issuer.

IFRS 4.34(a) explains that when a financial instrument contains a DPF the issuer may, but need not, recognise the guaranteed element separately from the DPF. If the issuer does not recognise them separately, it shall classify the whole contract as a liability. Accordingly, under this approach, the entire instrument may be classified as a financial liability.

Counter-argument to the application of IFRS 4

Unit holders' interests in REITs are not within the scope of IFRS 4 for the following reasons:

- As defined in IFRS 4, a DPF is a contractual right to receive additional benefits as a supplement to guaranteed benefits. IFRS 4 defines guaranteed benefits as payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

- To be within scope of IFRS 4, a financial instrument must have both a DPF and guaranteed benefits.

- In the case of unit holders' interests in REITs, there are no guaranteed benefits on inception of the contract as the investors can potentially lose all of their investment, i.e. their entitlement to distributions equal to 90% of total distribution income ('TDI') earned by the REIT each year is *conditional* on profits being made by the REIT in the first place. Although these minimum distributions are not subject to the discretion of the issuer, they are not "unconditional".

- Further, to be within scope of IFRS 4, a financial instrument must have both DPF and guaranteed benefits *on inception*. Hence, even if payments subsequently become 'guaranteed', e.g. when TDI is earned by the REIT and/or dividends are declared, this does not affect the initial assessment that the instrument did not have a guaranteed element and hence falls outside the scope of IFRS 4.

Current practice

Prior to the adoption of the Amendments to IAS 32 and IAS 1 *Presentation of Financial Statements - Puttable Financial Instruments and Obligations Arising on Liquidation* issued in February 2008, we believe that consistent practice has been to present these interests entirely as financial liabilities under IAS 32. We believe that some entities are considering applying IFRS 4 as this will also result in continuing to present such interests in their entirety as financial liabilities. The views of the large networks of accounting firms are mixed and therefore we believe that both current and future diversity in practice is likely.

Reasons for the IFRIC to address the issue

(a) We understand that instruments with similar features have been issued in Hong Kong and Australia. The issue may become more widespread as more instruments with these features are issued or as more jurisdictions transition to IFRS.

(b) The possible approach to accounting for such interests under IFRS 4 outlined above may potentially broaden the scope of IFRS 4 and may produce significantly divergent results from the accounting for such interests under IAS 32. We believe that either IFRS 4 or IAS 32 will be applied in practice during 2009.

(c) Financial reporting would be improved if similar instruments issued by different issuers were accounted for on a consistent basis.

(d) The issue is capable of interpretation within the confines of IFRSs and the *Framework for the Preparation and Presentation of Financial Statements.*

(e) The IASB has a project on *Financial Instruments with Characteristics of Equity* and another project on *Insurance Contracts*. Both projects are not planned to result in the issue of a new standards to replace IAS 32 and IFRS 4 respectively until 2011. Based on recent Board discussions, there is no indication that the projects would resolve or eliminate the issue discussed above.

Appendix C

C1 The definition below is an extract from Appendix A of IFRS 4.

C2 **Discretionary Participation Feature**: A contractual right to receive, as a supplement to ***guaranteed benefits***, additional benefits:

(a) that are likely to be a significant portion of the total contractual benefits;

(b) whose amount or timing is contractually at the discretion of the issuer; and

(c) that are contractually based on:

(i) the performance of a specified pool of contracts or a specified type of contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the company, fund or other entity that issues the contract.