Appendix B – Agenda request

B1 The staff received the following Committee agenda requests. All information relating to the Classification of Income Trust Units issue included in the request has been copied without modification by the staff.

Mr. Michael Stewart
Director of Implementation Activities
International Accounting Standards Board
First Floor
30 Cannon Street
London EC4M 6XH
United Kingdom

31 March 2010

Capitalization of Borrowing Costs and
Classification of Income Trust Units

Dear Michael

As we previously discussed, we request that the IASB clarify how to account for previously capitalized borrowing costs on transition to IFRSs and *clarify the classification requirement for a puttable instrument in IAS 32.16A(d) in respect of contractual obligations to provide pro rata distributions, such as those commonly associated with income trust units.* (emphasis added)

In sending this request, we are conscious of the IASB's current work load. We think these two issues raised by XXXX practitioners could be handled expeditiously by the Annual Improvements project with minimal consumption of Board time.

Early this month, these issues were discussed by the XXXX Board's IFRS Discussion Group, a group of people experienced in the implementation of IFRS in XXXX. The Group meets in public to consider implementation/ application questions that have arisen in practice and to provide advice to the XXXX Board on whether the issues should be submitted to the IFRIC, the AIP or the IASB for consideration. Our intention is to help our constituents develop a better appreciation of how to apply IFRSs in practice and to promote consistent application, while avoiding any appearance that the Board is providing interpretations of IFRSs.

We have attached the agenda papers that explain the issues and the different views the Group considered. The following discussion outlines the conclusions the Group reached and suggests the clarifications needed.

IAS 32: Classification of income trust units

In XXXX, income trusts generally issue units that are redeemable by the holder on demand. IAS 32 Financial Instruments: Presentation addresses classification of these “puttable” instruments. The instruments would usually be classified as liabilities unless they meet the criteria in IAS 32 paragraphs 16A and 16B that allow them to be classified as equity. In XXXX, these trust structures commonly contain a requirement to distribute in cash or additional units a value equivalent to the taxable income. We note that the agenda paper for the Group discusses these structures in terms of operating companies but we understand that the issue also applies to mutual funds as in XXXX they operate as trusts.

The Group was asked to consider whether the existence of the requirement to make a distribution violated the requirements of IAS 32 paragraph 16A, subparagraph (d) and whether that conclusion was affected by whether the distribution had to be in cash or could be in additional trust units at the discretion of the trust. The Group discussed the situations described in the agenda paper.

In our opinion, View A and View B described in the agenda paper are based on literal interpretations of the IAS 32.16A(d) requirements. We think that the spirit of these requirements is to classify as equity financial instruments that result in the pro rata distributions of cash and other financial assets of the entity such that all the existing holders of these financial instruments are in the same financial position before the distribution as they are after it. Thus, the holders of the trust units are receiving these distributions in their capacity as residual owners. Whether the trust distributes cash or distributes additional units that maintains each holder’s proportionate rights to undistributed cash does not affect each holder’s economic interest. We note that this rationale is consistent with the IASB’s decision to require the equity classification of rights, options or warrants to acquire a fixed number of an entity’s own equity instruments for a fixed amount of any currency in the "Classification of Rights Issues (Amendment to IAS 32)" in October 2009.

We also note that subparagraph 16A(d) was included in the revisions to IAS 32 to prevent puttable instruments being classified as equity if they included terms that required distributions to other entities that could permit significant portions of the entity's earnings to be distributed to parties other than the holders of the puttable instruments. The problem appears to be that people are reading "another entity" in this subparagraph to include holders of the instruments that are being classified.

Accordingly, we request that, as part of the annual improvements project, the IASB amend IAS 32.16A subparagraph (d) to clarify that it does not apply to contractual obligations to make pro rata distributions of cash, other financial assets or a variable number of the entity's own equity instruments to all existing holders of that class of financial instrument.

Thank you for considering these issues. If you need any other information, please let me know.

Classification of Income Trust Units Under IFRS where Distributions may be Settled in Shares

Purpose

1. XXXX income trusts generally issue units which are redeemable by the holder at a discount to market value. Such trust units are considered to be "puttable" instruments as defined in IAS 32.16A. Such puttable instruments are required to be classified as financial liabilities unless they meet all the conditions in both IAS 32.16A and IAS 32.16B.

2. Assume that all conditions in IAS 32.16A and .16B except IAS 32.16A(d) have been determined to be met for trust units issued by a XXXX income trust. Furthermore, assume that the trust indenture indicates that all taxable income of the trust shall be distributed meaning that the trustees do not have the discretion avoid a distribution.

3. However, assume that the distribution at the sole and absolute discretion of the trustees* may be made in cash or in additional trust units with a value equivalent to the taxable income.

   IAS 32.16A(d) would indicate the trust units should be classified as a liability unless:

   > Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

* The interpretation of whether payment in units is discretionary may be complex and require consultation with legal counsel.

The Issue

4. a. Do the terms of the trust violate the condition in IAS 32.16A(d)?

View A

Yes, the trust violates the conditions in IAS 32.16A(d) because the trustees have an obligation to distribute cash or trust units to the unitholders. This is an obligation that is separate from the obligation to repurchase or redeem the unit.

Although the units can be settled in shares, they are settled in a variable number of shares which meets the definition of a liability as set out in part (b) of the definition of a liability.

View B
No, the trust does not violate the conditions in IAS 32.16A(d).

Presuming that the trust units are the most subordinated instrument issued by the income trust to the unitholders (as required by IAS 32.16A(b)), the distribution pro-rata to unitholders in additional units should not substantively effect the economic position of the stakeholders in the trust. The unitholders will be in substantively the same position before and after distributions are paid in units similar to a stock dividend or stock split.

Although the distribution is paid in a variable number of units and therefore prima facie would appear to violate the condition in part (b) of the definition of a financial liability, the pre-amble to the definition of a financial liability in IAS 32.11 indicates:

"A financial liability is any liability that is:…"

Therefore, a financial liability would need to meet the framework definition of a liability which is stated in Framework.49(b):

> A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Before and after the payment of the distribution in trust units each holder of an interest in the entity is in the same position with respect to the value of its interests and its relative ownership of the entity. Therefore, there is no outflow of resources from the entity where a distribution is made pro-rata in trust units to the existing unitholders.

This rationale is supported by the language in IAS 33.27 which indicates:

27. Ordinary shares may be issued, or the number of ordinary shares outstanding may be
reduced, without a corresponding change in resources. Examples include:

(a) a capitalisation or bonus issue (sometimes referred to as a stock dividend);

Accordingly, the ability (at the absolute discretion of the trustees) to pay a distribution in trust units does not represent a "contractual obligation" and would not meet the conditions in part (b) of the definition of a financial liability because it does not represent an obligation of the entity.

Critics of this view may argue that if this situation is not the one contemplated by referring to subparagraph (b) of the definition of a financial liability in IAS 32.16A(b) that the applicability of that reference would be a null set. However, proponents of this view point out that subparagraph (b) be violated in this context if the holders of a fund unit could choose whether his or her distribution were in cash or units because this has the potential to change the relative interests of unitholders in the Fund.

Furthermore, it should be noted that a past practice of paying distributions in cash would not cause IAS 32.16A(d) to be violated because even if the trustees are economically compelled to pay distributions in cash, the IFRIC in a March 2006 rejection (See Appendix) noted:

> …by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

b. Certain trust indentures require distributions to be paid in cash to the extent it is on hand and allow any deficiency to be made up in units. Would such trust units violate the conditions in IAS 32.16A(d)?

View A

Yes, such trust units violate the conditions in IAS 32.16A(d) and would be classified as a financial liability. The trustees are obligated to make a payment of cash to the unitholders to the extent that cash is on hand.

As cash could be held by the trust at some point in the future, the condition would be violated even if there is no cash held by the trust at the balance sheet date.

View B

IAS 32.16E indicates that an entity would reassess whether the puttable instrument meets the conditions in IAS 32.16A and B at each balance sheet date.

If cash is actually on hand in the income trust at the balance sheet date, this condition would be violated and the trust units would be classified as a financial liability. If there is not cash on hand at the balance sheet date, the trust unit should be classified as equity as the distribution in units would be at the discretion of the trustees at the balance sheet date.

Question

a) Which view does the XXXX support for Issue 1?

b) Which view does the XXXX support for Issue 2?

IFRIC Criteria

1. *Is the issue widespread and practical*?

   The issue is widespread for XXXX income trusts, REITs and mutual funds. Certain income trusts will convert to corporations in 2011, in which case this will be an issue for the 2010 comparative figures and others will not convert to corporations and this will be an ongoing issue.

   However, this appears to be a XXXX specific issue and therefore might not have widespread applicability outside of XXXX.

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

   Yes, this issue is subject to ongoing debate in XXXX and a consensus view has not yet been reached.

3. *Would financial reporting be improved through elimination of the diversity?*

   Yes, the comparability in XXXX would be improved.

4. *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 interpretations process?*

   The issue is fairly narrow in scope particularly outside of XXXX and therefore probably not a good candidate for IFRIC interpretation.

5. *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.)*

The IASB is undertaking a project to re-consider principles associated with debt versus equity classification. However, the project will not be completed before 2011 when XXXX adopts IFRS. Accordingly, there is a need for guidance in XXXX on this issue.

Question #1 - IFRIC Criteria

It is recommended that this issue not be submitted to IFRIC.

Does the XXXX agree with the recommendation?