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| Project | **IAS 32 *Financial Instruments: Presentation*** |
| Topic | **Clarification of the puttable instruments criteria for income trust units** |

## Purpose of this paper

1. The purpose of this paper is to respond to a request for clarification on guidance relating to the classification of puttable financial instruments (puts) that include contractual obligations to provide pro rata distributions.

2. The request identifies that these obligations are often included within the terms of income trust units that are redeemable on demand by the holder. The obligation is frequently to distribute cash or additional trust units with a value equivalent to taxable income.

3. The request proposes an amendment to the guidance in IAS 32 *Financial Instruments: Presentation* as part of the *Annual Improvements Process* (AIP).

4. The proposed amendment would clarify that a put can be classified as equity if it has a contractual obligation to deliver cash, or another financial asset, to all existing holders of the instrument on a pro rata basis.

5. This reflects the rationale that these pro rata distributions are to all existing holders and do not result in any changes in their financial position. Consequently, this feature should not, in isolation, lead to the put being classified as a liability, rather than equity.

6. The requestor believes this rationale is consistent with that applied by the Board when issuing *Classification of Rights Issues (Amendment of IAS 32)* (the Rights Amendment) in October 2009.

7. The staff do not believe the Committee should:

   (a) add the issue to its agenda; or

   (b) recommend the Board amend the guidance in current IFRSs to address the issue.

8. Consequently, this paper:

   (a) provides background information on the request received;

   (b) includes a summary, but not a full analysis, of the issue including a staff recommendation; and

   (c) asks the Committee whether they agree with the staff recommendation.

## Background information

9. The request identifies that IAS 32.16 includes an exception to the definition of a financial liability, requiring some puts to be classified as equity instruments. This exception applies to puts if **all** of the conditions in IAS 32.16A and IAS 32.16B are met.

10. If the exception applies, the put is classified as an equity instrument and not as a financial liability.

11. IAS 32.16A(d) describes one of the conditions required to qualify for this exception:

    > 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. (emphasis added)

12. The request identifies a situation when a put includes an obligation to deliver cash, or additional trust units, with a value equivalent to taxable income to all existing holders of the put on a pro rata basis.

13. The requestor believes that IAS 32.16A(d) should be clarified to permit a put instrument, such as the example in the request, to be classified as equity if the put includes a contractual obligation to deliver cash or another financial asset to **all existing holders** of the instrument on a **pro rata basis**.

14. This is because all holders of the put are in the same financial and economic position both before, and after, the distribution.

15. They believe that this would be consistent with the Board's recent rationale in issuing the Rights Amendment, specifically:

> BC4G The Board decided that a financial instrument that gives the holder the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency *is an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners* of the same class of its own non-derivative equity instruments. (emphasis added)

## Staff summary analysis and recommendation

16. In January 2010 the Committee published a final agenda decision relating to application of the 'fixed for fixed' condition in paragraph 22 of IAS 32. [1]

17. This stated that the Committee decided not to add the issue to its agenda because of the Board's current project on *Financial Instruments with Characteristics of Equity* (FICE).

18. The staff agenda paper on this issue also noted that the basis of the Board's conclusions relating to the Rights Amendment justified the amendment because:

    (a) such rights were being issued frequently in the current economic environment.

    (b) they are usually relatively large transactions that can have a substantial effect on entities' financial statement amounts.

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[1] http://www.iasb.org/NR/rdonlyres/4155F66B-6961-4F0D-A062-7AA242481E48/0/January2010IFRICUpdatehtml.pdf

(c) this exception to the fixed for fixed condition in IAS 32 is for a narrowly-targeted transaction with owners (shareholders) in their capacity as owners.

19. The staff believe that many of the arguments supporting the decision taken in January 2010 relating to application of the fixed for fixed condition also apply in considering this amendment request.

20. Consequently the staff do not think an amendment to IAS 32 to address this issue should be included in the AIP 2009-11 cycle.

21. This is because:

(a) the Board clearly identified unique circumstances that justified the Rights Amendment. The staff does not believe these unique circumstances exist in relation to the fact pattern in this request.

(b) it could be considered an additional exception to the definition of a financial liability.

This would be outside the scope of the AIP and could create additional financial reporting issues (for example complicating further concerns constituents have in interpreting the 'fixed for fixed' condition).

(c) it would only be effective for annual periods beginning on or after 1 January 2012. This effective date is expected to be after the Board have issued a final FICE standard.

| **Question for the Committee** |
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| 1. Do the Committee agree with the staff's recommendation not to add this issue to AIP? If not, how does the Committee recommend the staff to proceed? |