
September 2006

AIFRS update 04

Following the international board (IASB), the Australian Accounting Standards Board has recently published an exposure draft (ED) proposing amendments to AASB 132 Financial Instruments: Presentation. The ED allows some financial instruments with characteristics similar to ordinary shares (those classified as liabilities under the current version of AASB 132) to be reclassified as equity if specified criteria are met.

In Australia, the requirement to classify some instruments as liabilities had caused some investor confusion in relation to limited life trusts, co-operatives and similar entities. Many of these entities may still need to classify their instruments as liabilities, even if the proposals go ahead. Although these proposals can't be applied to 30 June 2006 AIFRS financial statements, entities are advised to take note now so as they are aware of how certain types of financial instruments may be accounted for in the future. Regina Fikkers and Craig Thomason, from the firm's technical group, consider the principal requirements of the new ED and its impact on Australian entities.

ED: financial instruments puttable at fair value

The IASB published proposals in June 2006 to improve the financial reporting of particular types of financial instruments that have characteristics similar to ordinary shares but that are currently classified as financial liabilities.

The financial instruments in question are:

- (a)** instruments puttable at fair value;
- (b)** instruments with obligations payable on liquidation, for which liquidation is certain (this affects limited-life entities); and
- (c)** instruments with obligations payable on liquidation, for which liquidation is at the option of the holder (this affects partnership interests).

Example of unexpected accounting under current requirements

The IASB has proposed the following exemption to the definition of a financial liability. The terms in bold are explained below. A contractual obligation does not include:

- an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the **most subordinated** class of instruments with a claim to the assets of the entity are financial instruments puttable at **fair value**; or
- an obligation to deliver to another entity a **pro rata share of the net assets** of the entity upon its liquidation, provided that all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation.

Most subordinated means the amount paid on liquidation is after all other claims are paid out.

Fair value is determined using the guidance set out in AASB 139.48A *Financial Instruments: Recognition and Measurement* and Application Guidance AG69-AG 82. Formula-based methods of fair valuing are permitted only where the formula is intended to approximate fair value.

Formula-based methods can only be used by entities whose securities are not publicly traded or that do not hold assets in a fiduciary capacity for a broad group of outsiders.

Pro rata share of the net assets means that the financial instrument's right to the entity's net assets is neither limited nor guaranteed.

The IASB's proposals do, however, change the classification of instruments from debt to equity for a narrow group of instruments as they had intended.

In Australia the classification as liabilities has created some unexpected accounting outcomes, which are often difficult for a user to understand.

Example of unexpected accounting under current requirements

Let's consider the following example. A unit trust in Australia has an 80 year mandatory redemption clause. After 80 years, the trust has an obligation to deliver a pro-rata share of the net assets of the trust to the holder of the units. Unit trusts of this type are commonly known as "limited life" trusts and the units are classified as liabilities under AASB 132.

Units worth \$25 are issued to unit-holders in year 1. The trust draws a bank loan of \$25 and acquires an investment property for \$50.

The unit trust enters into an interest rate swap to hedge its exposure to interest rate movements and qualifies for cash flow hedge accounting. An interest rate loss of \$5 is generated in year 2. The derivative liability is measured at \$5 and the loss is deferred directly in equity in accordance with AASB 139.

The unit trust must account for amounts due to unitholders at fair value. The interest rate loss has caused a reduction in the fair value of amount due to unitholders. This reduction leads to a credit to finance costs being recognised in the trust's profit and loss statement. The interest rate loss has led to the unexpected result of a profit being recorded!

Unit trust balance sheet Year 1		Unit trust balance sheet Year 2	
Assets		Assets	
Investment Properties	50	Investment properties	50
Liabilities		Liabilities	
Interest bearing liabilities	(25)	Interest bearing liabilities	(25)
Other financial liabilities - derivatives	0	Other financial liabilities - derivatives	(5)
Amounts due to unitholders	(25)	Amounts due to unitholders	(20)
Net assets	0	Net assets	(0)
Contributed equity		Contributed equity	
Retained earnings	0	Retained earnings	(5)
Cash flow hedging reserve	0	Cash flow hedging reserve	5
Total equity	0	Total equity	0

For certain limited life trusts, such as our example, the IASB's proposals will allow the instruments to be reclassified to equity and rectify this confusing situation. However for many other trusts, liability classification will remain.

Other important issues – classification as financial liability continues

Unit trusts

In Australia, certain unit trusts have no discretion over the payment of distributions to unitholders. Entities are reminded that the ED does not address this present entitlement characteristic so the financial instrument classification would remain as debt for these entities rather than equity. There may be an invalid expectation in the market that the ED will solve the classification problem for these unit trusts.

Additionally, some entities have multiple classes of units. The holder of a class of unit is entitled to a pro-rata share of the 'pool' of the entity's net assets that are attributable to that class of unit, not a share of the net assets of the entity. Consequently, these instruments would not meet the criteria required by the ED and the debt classification would remain.

There may also be some funds where the unitholder's redemption is not at fair value – such as those where the redemption price is formula driven - so debt classification would remain.

Minority interests

Minority interests in a subsidiary that are puttable at fair value would not be classified as equity in the group's financial statements because such minority interests are not in the most subordinated class of instruments. These types of minority interests would, therefore, continue to be classified as financial liabilities in the consolidated financial statements.

Warrants

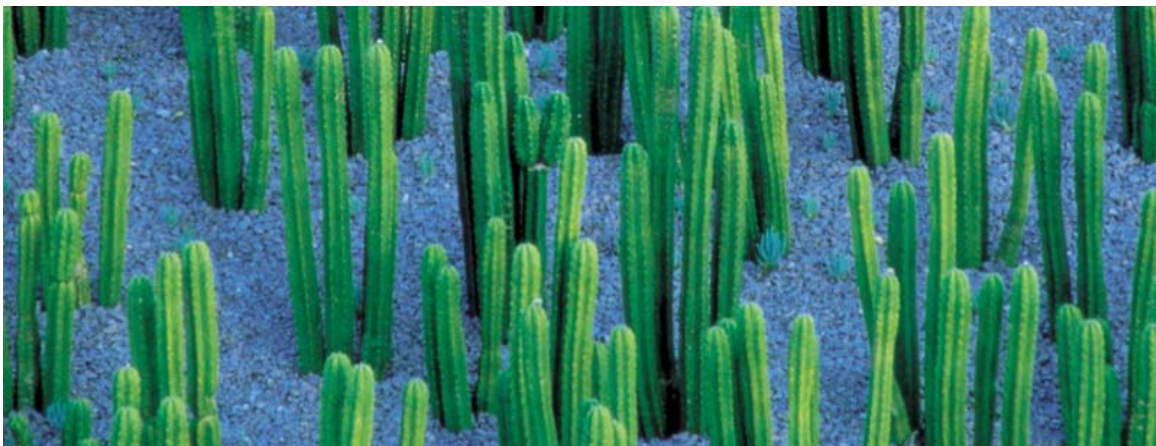
Warrants (and other derivatives) to be settled by the issue of financial instruments puttable at fair value are excluded from equity classification and continue to be classified as financial liabilities. The objective of the proposed amendment is to improve the financial reporting of financial instruments that have characteristics similar to ordinary shares. Warrants do not have characteristics similar to ordinary shares.

The classification of the pre-existing instrument should be reassessed if another class of financial instrument is issued that is 'more subordinate' than the instrument in question.

Disclosures

Additional disclosures are proposed in the exposure draft. They relate to:

- Reclassifications between liabilities and equity;
- Fair value;
- Quantitative data about the amount classified as equity; and
- How the entity manages its obligation to redeem the instruments when required to do so by the instrument holders.



AIFRS update: September 2006

AIFRS update provides you with a series of quick tips to keep you abreast of some of the key issues occurring within the financial reporting space. Designed as a short and sharp update, we trust you will find this a convenient way to keep in touch with issues relevant to your business.

Tips for applying the new set of standards

- Director and executive remuneration is now more topical than ever thanks to the revised AASB 124 *Related Party Disclosures* (AASB 124). To help those entities that are still coming to grips with what's required under the revised AASB 124, PricewaterhouseCoopers has developed guidance. A soft copy of the paper titled '**Understanding related party and remuneration disclosures**' can be downloaded from www.pwc.com/au/ifrs.
- Entities should be aware of their **long-service leave obligations** to employees. From 1 January 2006, Victorian based employees who leave employment after seven years service will receive a pro-rata payout for long service leave. This should be recognised by the employer as a current liability. In addition, when a company has an industry fund set up to meet its long service leave obligations, the company usually pays the leave entitlements to the employee and is then reimbursed by the fund. According to AASB 119 *Employee Benefits*, the company should record the long service leave liability separately from the asset (i.e. the right to reimbursement).

News from the International Accounting Standards Board

- The International Accounting Standards Board (IASB) has recognised that companies are still finding the transition to IFRS challenging and has recently announced that there will be **no new standards effective until 2009**. Although the Board will continue to develop, amend and potentially issue new standards and interpretations, their adoption won't be mandatory until 2009. This comes as welcome relief for Australian entities, many of whom will spend the next few years of stability coming to grips with the standards currently in place.
- As mentioned in last month's edition of *Headlines*, the international board and the US Financial Accounting Standards Board have added a joint project on **leasing** to their respective agendas. The project scope includes a reconsideration of existing standards of accounting for both lessees and lessors. The IASB and FASB are currently seeking nominations for an international working group to advise on lease accounting issues. The closing date for nominations to the working group is 30 September 2006.

News from the International Financial Reporting & Interpretations Committee

- IFRIC has released IFRIC D19 *IAS 19 - The Asset Ceiling: **Availability of Economic Benefits and Minimum Funding Requirements*** for public comment. IFRIC has developed the proposed interpretation in response to requests to clarify the interaction between statutory or contractual minimum funding requirements and the requirements of the pensions standard, IAS 19 *Employee Benefits* (equivalent to AASB 19 *Employee Benefits*). The proposals are open for public comments until 31 October 2006.
- IFRIC has released a draft Interpretation, IFRIC D20 **Customer Loyalty Programmes**, for public comment. The draft Interpretation addresses accounting by entities that grant their customers 'points', 'air miles' or other award credits when the customers buy goods or services. Specifically, it addresses how such entities should recognise and measure their obligations to provide free or discounted goods or services if and when the customers redeem the award credits. All comments on this draft Interpretation should be sent to IFRIC by 6 November 2006 – details can be found via the IASB website www.iasb.org.