

## Impact of the amendments to IAS 32 for investment funds

### What is the issue?

The amendment to IAS 32, 'Financial instruments: Presentation', is significant for investment funds. It changes the accounting for financial instruments where the instrument holder has the choice to redeem or repurchase it from the issuer (for example, units held in an open-ended mutual fund would be considered puttable financial instruments, as the unit holders have the right to redeem the units for cash at any time).

|                                     |   |
|-------------------------------------|---|
| Impact on profit and loss           | ✓ |
| Impact on balance sheet             | ✓ |
| Impact on disclosures               | ✓ |
| Impact on stakeholder communication | ✓ |

Prior to the amendment, it was common for these types of financial instruments to be classified as liabilities; under the new rules, they may need to be reclassified as equity. Many investment funds applied the amended IAS 32 for the first time in their 31 December 2009 accounts; others will be doing so at 30 June 2010. This edition of *IFRS in brief* provides insights into some of the challenges that have arisen in practice when applying the amendment.

### Who is impacted by the amendment?

All entities with financial instruments that:

- give the holder of the instrument the option to redeem or repurchase it from the issuing entity (often referred to as puttable instruments)
- include a contractual obligation for the issuing entity to make a payment on liquidation where liquidation is certain to occur (for example, a limited life entity) or where liquidation is at the option of the instrument holder.

### What is the impact of the amendment?

For some entities, the amendment will change the classification of these types of financial instrument from financial liabilities to equity instruments (where certain criteria are met). In practice, the impact of the amendment on investment funds will typically result in retaining financial liability classification, but this will vary for each fund depending on the specific terms of their constitutions and any other contractual obligations they have in place.

### When is equity classification required for these types of financial instruments?

Equity classification is required where the financial instrument meets certain criteria. For example:

- The investment fund has a single class of puttable financial instruments with identical features. Different management fees for wholesale and retail investors or multiple unit classes that are redeemed in different foreign currencies would indicate that the financial instruments do not have identical features. In these cases, liability classification may be required.
- The investment fund does not have a contractual obligation to pay distributions. An obligation within the fund's constitution to distribute an amount (for example, taxable income or accounting profit) indicates the fund does not have the discretion to avoid paying the distribution. In these cases, liability classification may be required.
- The investment fund does not have performance fees that substantially restrict or fix the return to unit holders. Determining what is 'substantial' in this context is a matter of judgement.

### When does the amendment apply?

The amendments apply prospectively (that is, annual reporting periods beginning on or after 1 January 2009) using the contractual terms of the financial instruments in place at each balance sheet.

Investment funds will need to re-assess the criteria in the amendment at each future period end to take account of any subsequent changes to constitutional documents that may effect the classification of the financial instruments.

## Impact of the amendments to IAS 32 for investment funds...continued

How should funds prepare to apply the amendment?

### 1. Review the wording in constitutions, amendments to constitutions and product disclosure statements

**Our experience.** There may be differences between entities' constitutions and product disclosure statements, which can make it difficult to apply the criteria in the amendment. For example, some entities have been surprised to find their constitutions imply that distributions are discretionary, but the wording in their product disclosure statements suggest that distributions are mandatory.

**Our insight.** Involve legal counsel and management outside the finance team to help understand the structure, terms and fees of the fund(s), and agree on any existing wording inconsistencies.

### 2. Understand the rationale for the existing classification of financial instruments

**Our experience.** Understanding why instruments have been classified as equity or liability will help entities apply the criteria in the amendment. For example, if the previous classification of the puttable financial instruments is based on, say, the units in the fund having mandatory distributions, management can focus on that criteria alone to determine whether the liability classification remains appropriate.

**Our insight.** Having a clear understanding of the existing classification of financial instruments and being familiar with the criteria under the amendment will speed up the process of applying the amended rules.

### 3. Be aware of the complexities when applying the amendment to group structures

**Our experience.** Some entities have presumed that the classification of the financial instruments in the stand-alone accounts can be reflected without change in the consolidated accounts. This is not always the case. For example, where a fund owns 60% of another fund, the units of the remaining 40% that the fund does not own should be classified in the group accounts as a financial liability (regardless of whether it has equity classification in the stand-alone accounts).

**Our insight.** Some entities have assumed that the portion of a fund that is not owned (the 40% in the above example) can be classified as non-controlling interests within equity. However, the guidance included in the amended IAS 32 makes clear that any portion of a fund that is not owned should be classified as a liability on consolidation.

### 4. Do not underestimate the task

**Our experience.** Analysis often takes longer than expected due to the time taken to obtain and read the relevant literature and engage experts, such as legal counsel, where necessary. Entities with multiple funds may assume that each fund's constitution is identically worded and consistent with the others, but it is worth double-checking. Our experience indicates that constitutions are often drafted at different times and by different lawyers, and the relevant clauses may be different. This means an assessment of whether the criteria are fulfilled will be needed for each fund.

**Our insight.** The wording in trust constitutions may be unclear, as generally these constitutions are not written to specifically address the detailed criteria of the amendment. Some trusts may need to obtain legal advice to help clarify the clauses that are most relevant to entities' analysis – for example, whether there is a requirement to pay a distribution or whether it is discretionary.

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