Investment Management and Real Estate

A practical guide for investment funds to IAS 32 amendments

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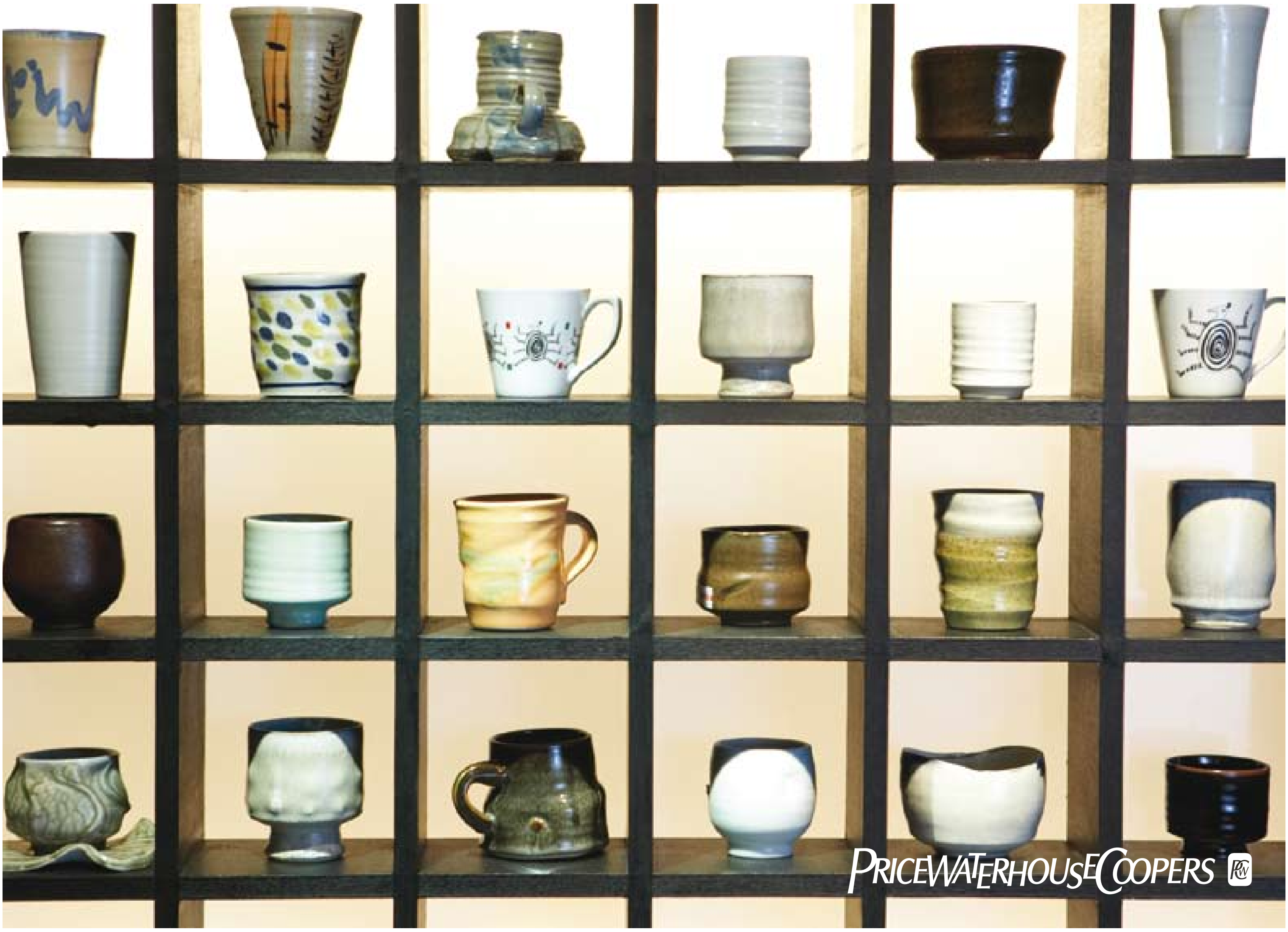

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Introduction

An amendment to IAS 32 and IAS 1, 'Puttable financial instrument and obligations arising in liquidation', was issued in February 2008. It requires the classification in equity of some puttable financial instruments and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation if certain criteria are met. This publication addresses the questions that are arising in applying the amendments in practice.

Investment funds that classify amounts attributable to unit holders as liabilities under the previous IAS 32 should look to the amendment in IAS 32 to evaluate whether the fund is required to reclassify such amounts in equity. However, investment funds that already achieved equity classification under the previous IAS 32 are not impacted by the amendment. Equity classification for these investment funds is not addressed in this publication. While the IAS 32 amendment applies to both puttable instruments and certain instruments with obligations arising on liquidation, the focus of this publication is on puttable instruments.

Investment funds should apply these amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted if that fact is disclosed and the related amendments to IAS 1, IAS 39, IFRS 7 and IFRIC 2 are applied at the same time.

Debt/equity classification of puttable instruments

A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception, such a puttable financial instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in IAS 32 para 16A and 16B [IAS 32 para 16].

A puttable financial instrument is therefore classified as an equity instrument only if it has all of the following features:

- It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation [IAS 32 para 16A(a)].
- The instrument is in the class of instruments that is subordinate to all other classes of instrument [IAS 32 para 16A(b)].
- All financial instruments in the class of instruments that is subordinate to all other classes of instrument have identical features [IAS 32 para 16A(c)].
- 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 [IAS 32 para 16A(d)].
- The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument) [IAS 32 para 16A(e)].

For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has [IAS 32 para 16B]:

- Total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract); and
- The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying the condition in IAS 32 para 16B, the entity should not consider non-financial contracts with a holder of an instrument described in IAS 32 para 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity when applying the conditions in IAS 32 para 16B. Management should not classify the puttable instrument as an equity instrument if it cannot determine that this condition is met.

1.1 Investment Fund A is an open-ended mutual fund. There is only one class of shares, and the only shares in issue are redeemable participating shares. These shares are puttable and impose an obligation on A to deliver to the holder of the shares a pro rata share of the net assets of the fund on liquidation.

Are the shares in issue of investment fund A classified as 'equity'?

Yes. The redeemable participating shares of investment fund A are classified as 'equity' because:

- The shares entitle the holder to a pro rata share of the fund's net assets on liquidation [IAS 32 para 16A(a)];
- There are no other financial instruments in issue that have total cash flows based substantially on the profit or loss, the changes in the recognised net assets or the changes in the fair value of the recognised and unrecognised net assets of the fund that would restrict or fix the residual return of the puttable instruments [IAS 32 para 16B]; and
- The shares meet all the remaining conditions in IAS 32 para 16A (for example, the instrument being most subordinated to all other classes of instrument, all instruments in the most subordinated class have identical features, and no other features require liability classification).

The same principle applies to unit trusts and other types of fund, as the legal form does not impact the classification of the shares in issue.

1.2 Investment fund B has two classes of redeemable participating shares in issue: class X and class Y. X and Y shares are equally subordinated. The shares, which are available to different types of investor, are subject to different fee arrangements. X shares are liable to management fees at a rate of 1.5%; Y shares pay management fees at a rate of 2.0%. The share classes are identical in all other respects.

Does B classify the redeemable participating shares as 'equity'?

No. Both classes of investment fund B's shares are classified as 'financial liabilities'. Class X and Y shares are equally subordinated; however, as Y shares are liable to a higher management fee than X shares, they do not have 'identical features' [IAS 32 para 16A(c)]. This also results in different net asset values [IAS 32 para 16A(a)].

1.3 Investment fund C has three classes of redeemable participating shares in issue, which are equally subordinated. The only feature that distinguishes these classes from each other is the fact that they are denominated in different currencies (euros, US dollars and British pounds) and that the non-base currency classes have entered into foreign currency contracts to limit the impact of the movement in exchange rates. C's functional and presentation currency is the euro.

Are C's redeemable participating shares classified as 'equity'?

No. Investment fund C classifies all three share classes as 'financial liabilities'. The three share classes do not have 'identical features' and therefore do not comply with the requirements of IAS 32 para 16A(c).

1.4 Investment fund D has two redeemable participating share classes in issue, which are legally equally subordinate: the accumulating class X and the distributing class Y. The only feature that distinguishes these classes from each other is the fact that the holders of the Y shares may receive a distribution at the end of the year depending on the net income of the fund. However, the payment of the distribution at year end is discretionary. The income attributable to holders of the accumulating share class is re-invested in the fund and attributable to X only. The net asset value of the share classes might therefore be different at redemption.

Does D classify the redeemable participating shares as 'equity'?

No. Investment fund D classifies both classes of the redeemable participating shares as 'financial liabilities'. Both share classes fail the criteria of 'identical features' [IAS 32 para 16A(c)], as class X shares are accumulating the attributable net income, and class Y shares may distribute the attributable net income. This method of allocation may also give rise to different net asset values for each class upon distribution [IAS 32 para 16A(a)].

In addition, although the classes may be equally subordinate from a legal perspective, the class Y shares receive priority in the distributions over the class X shares [IAS 32 para 16A(b)]. However, even if class X shares were assessed individually for 'equity' classification (as the most subordinate class), they would fail the criteria on IAS 32 para 16B, as class Y is participating in the net income of the fund and hence restricting the returns to class X.

1.5 Investment fund E, an unlimited life company, is required by law to issue 100 management shares at inception. These shares, to which voting rights are attached, are issued at $1 per share and entitle the holder of the shares to repayment of the $100 on wind-up. The rest of the shares in issue by E are redeemable participating shares, which have identical features. E is a billion-dollar fund.

Are the redeemable participating shares in issue classified as 'equity' in E's balance sheet?

No. The redeemable participating shares are classified as 'financial liabilities'. As investment fund E has 100 management shares in issue that are classified as 'equity' in accordance with IAS 32 para 11, the redeemable participating shares do not represent the most 'subordinate' class of instrument [IAS 32 para 16A(b)]. They have priority over other claims to the assets of the entity on liquidation. The size of the class that is the most 'subordinated class' is not a factor in determining the classification.

1.6 Investment fund F is a mutual fund. The only units in issue are redeemable participating units. These units are puttable and impose an obligation on F to deliver to the holder of units a pro rata share of the net assets of the fund on liquidation. F has, in addition to the above, a contractual obligation to pay distributions on an annual basis to the holders of F's redeemable participating shares.

Are F's shares in issue classified as 'equity'?

No. Investment fund F's shares are classified as 'financial liabilities'. This is because F has, in addition to the contractual obligation to redeem the shares for cash, an additional obligation 'to deliver cash' in the form of distributions. The requirement in IAS 32 para 16A(d) is not therefore met.

Debt/equity re-classification of puttable instruments

Management classifies a financial instrument as 'equity' in accordance with IAS 32 para 16A and 16B from the date when the instrument has all the features and meets the conditions set out in those paragraphs [IAS 32 para 16E]. An equity instrument is measured at the carrying value of the financial liability at the date of reclassification.

Management reclassifies a financial instrument from the date when the instrument ceases to have all the features or meet all the conditions set out in those paragraphs [IAS 32 para 16E and 16F]. The financial liability is measured at the instrument's fair value at the date of reclassification. Management recognises in equity any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification.

IAS 32 is applied retrospectively [IAS 32 para 97].

2.1 Investment fund G is an existing IFRS preparer that classified its redeemable participating shares as 'financial liabilities'. When applying the IAS 32 amendment, the redeemable participating shares have to be reclassified into 'equity'.

How is this reclassification accounted for?

The reclassification of the instrument from 'financial liability' to 'equity' is from the date the instrument meets all the criteria in accordance with IAS 32 para 16A and 16B [IAS 32 para 16E]. Investment fund G therefore reclassifies the shares retrospectively. The comparative figures are adjusted accordingly.

2.2 Investment fund H had only one class of redeemable participating shares in issue (class X shares) in the prior year. These shares are puttable and there is an obligation on H to deliver to the holder of shares a pro rata share of the net assets of the fund on liquidation. These shares in issue were classified as 'equity' in accordance with the amendments of IAS 32.

In the current year, H has launched a new share class (class Y shares), which is equally subordinate as the existing class of shares. This share class is aimed at different investors and is liable to a higher management fee than the existing class X shares.

Does H classify the shares in issue as 'financial liabilities'?

Yes. Investment fund H classifies both share classes as financial liabilities, which would require H to reclassify the class X shares from 'equity' to 'financial liability' and classify the class Y shares as 'financial liability' at initial recognition.

Class X shares cannot remain classified as 'equity', as they are not subordinated to the class Y shares [IAS 32 para 16A(b)]. X and Y shares would need to have 'identical features' in order to form one class of instrument that would be most subordinated to all other classes of instrument. This would then allow for an equity classification for both share classes [IAS 32 para 16A(c)]. As Y shares are liable to a higher management fee than the existing X shares, X and Y shares do not have identical features [IAS 32 para 16A(c)]. Furthermore, this results in different net asset values [IAS 32 para 16A(a)].

Both classes of redeemable participating shares are classified as ‘financial liabilities’ from the date when Y shares are issued. The financial liability is measured at fair value at the date of (re-)classification. If applicable, the difference between class X shares’ carrying value at the date of reclassification and the fair value of the class X shares’ portion of the ‘financial liability’ is recognised in equity.

2.3 Investment Fund J had two share classes in issue (class X and class Y shares). Both classes were previously classified as ‘financial liabilities’ given that there was no subordination and that they had different fee arrangements (no identical features). During the year, Y was fully redeemed, leaving only X shares remaining in the fund.

Class X shares entitle the holder to a pro rata share of the entity’s net assets at liquidation. No other financial instruments are in issue that have total cash flows based substantially on the profit or loss, the changes in the recognised net assets or the changes in the fair value of the recognised and unrecognised net assets of the fund. The class X shares have no other contractual obligation than the obligation to redeem the puttable instrument.

Does J continue to classify the class X shares in issue as ‘financial liabilities’?

No. Class X shares are reclassified as ‘equity’, as they meet all of the conditions in IAS 32 para 16A and 16B. X shares are measured at the carrying value of the recognised ‘financial liability’ at the date of reclassification.

2.4 Investment fund K had two share classes in issue in the prior years (class X and class Y shares). Both classes were previously classified as ‘financial liabilities’ given that they had different fee arrangements. During the year, Y was fully redeemed, leaving only X remaining in the fund. The X shares are reclassified as ‘equity’, as they meet all of the conditions in IAS 32 para 16A and 16B.

Can K adjust the prior-year figures to give comparative information on the amounts attributable to unit holders?

No. Investment fund K reclassifies the redeemable class X shares from the date the class Y shares are fully redeemed. The current-year financial statements will therefore reflect this change. There will be no adjustment to the comparative figures.

Debt/equity classification in consolidated and combined financial statements

Some types of instrument that impose a contractual obligation on the entity are classified as equity instruments in accordance with IAS 32 para 16A and 16B. The amendment to IAS 32 introduced a limited scope exception; an entity does not therefore apply the exception by analogy [IAS 32 para 96B].

This exception is not extended to the classification of non-controlling interests in the consolidated financial statements. Therefore, instruments classified as equity instruments in accordance with IAS 32 para 16A and 16B in the separate or individual financial statements that are non-controlling interests are classified as liabilities in the consolidated financial statements of the group [IAS 32 para AG29A].

3.1 Investment fund L issues voting redeemable participating shares. Based on the provisions of IAS 32 para 16A and 16B, these redeemable participating shares are classified as 'equity'. This is due to the fact that they are the only class of financial instruments issued by the fund and therefore are the 'most subordinate' (assuming all other criteria are met). Investment fund L is an 80% owned subsidiary of Company A. A's capital base consists of issued fully paid up common shares.

How does A account for the non-controlling interest in the fund in its consolidated financial statements?

Company A classifies the non-controlling interest as a 'financial liability'. The IAS 32 amendment introduced a limited scope exception, which prohibits extending the exception to non-controlling interests in a group's consolidated financial statements [IAS 32 AG29A].

From the perspective of the group formed by Company A and its subsidiaries, the non-controlling interest does not comply with the 'equity' classification criteria of IAS 32 para 16A and 16B. This is because:

- The redeemable participating shares do not entitle the holder to a pro rata share of the net assets of the group as a whole [IAS 32 para 16A(a)];
- The redeemable participating shares do not represent the most subordinated class [IAS 32 para16A(b)]; and
- The expected cash flows attributable to the redeemable participating shares over the life of the shares are not substantially based on the profit or loss, the changes in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the group over the life of the shares [IAS 32 para 16A(e)].

3.2 Investment fund M is an open-ended fund that is set up in an umbrella-fund structure. Each sub-fund operates autonomously. Investments are made separately from the investments in the other sub-funds. The assets of each sub-fund are only liable to the liabilities of the respective sub-fund (there are no cross-fund liabilities), and each sub-fund participates only in its own profit or loss.

Each sub-fund individually is considered to be the reporting entity. However, M presents one set of financial statements, with separate columns for each sub-fund. Additionally, the fund is required by law to present a 'total column' with aggregated numbers for the fund as a whole. The notes to the financial statements are common to all sub-funds where possible, with sub-fund-specific notes included where necessary.

Each sub-fund has one class of redeemable participating shares in issue whose net asset value is based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the individual sub-fund. Redeemable participating shares of each individual sub-fund are therefore classified in 'equity' in accordance with in IAS 32 para 16A and 16B.

Does M present the redeemable participating shares in the 'total' column as 'financial liabilities'?

No. The 'total' column is only an aggregation (sum) of the financial statements of each individual sub-fund, given that each sub-fund is the reporting entity for which the users rely on the financial statements as the major source of financial information [IFRS F 8]. No reclassification of the redeemable participating shares into 'financial liabilities' therefore has to be done.

3.3 Investment fund N is an open-ended fund that is set up in an umbrella-fund structure. Each sub-fund operates autonomously and investments are made separately from the investments in the other sub-funds. Each sub-fund participates only in its own profit or loss. However, the sub-funds are subject to cross-sub-fund liability risk.

Given that the cross-sub-fund liability risk is not remote, N as a whole is considered to be the reporting entity for which consolidated financial statements are prepared. Each sub-fund has one class of redeemable participating shares in issue whose net asset value is based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the individual sub-fund.

Does N classify the redeemable participating shares as 'financial liabilities' in its consolidated financial statements?

Yes. The redeemable participating shares are classified as 'financial liabilities', as the redeemable participating shares, which are equally subordinated with respect to the fund as a whole, do not have identical features. They do not therefore qualify for the 'equity' classification considering the fund as a whole [IAS 32 para 16A(c)].

Earnings per share

Entities whose ordinary equity shares or potential ordinary equity shares are publicly traded or who are in the process of issuing such shares in public markets are required to present basic and diluted earnings per share.

The classification of instruments as equity instruments under the amendment to IAS 32 are restricted to the accounting for such instruments under IAS 1, IAS 32, IAS 39 and IFRS 7. The instrument is not considered an equity instrument under other guidance such as IFRS 2 [IAS 32 para 96C].

4.1 Investment fund P issued redeemable participating shares, which are traded at a stock exchange considered to be a public market. The fund classifies its redeemable participating shares as 'equity'.

Does investment fund P present EPS figures in accordance with IAS 33 in its financial statements if all the other criteria are met?

No. The classification of instruments under the amended IAS 32 is a limited scope exception, which is restricted to the accounting for such instruments under IAS 1, IAS 32, IAS 39 and IFRS 7. The instrument is not considered an equity instrument under other guidance such as IFRS 2 [IAS 32 para 96C]. As IAS 33 is not mentioned in the list of standards to which the exception applies, no EPS figures need to be presented.

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