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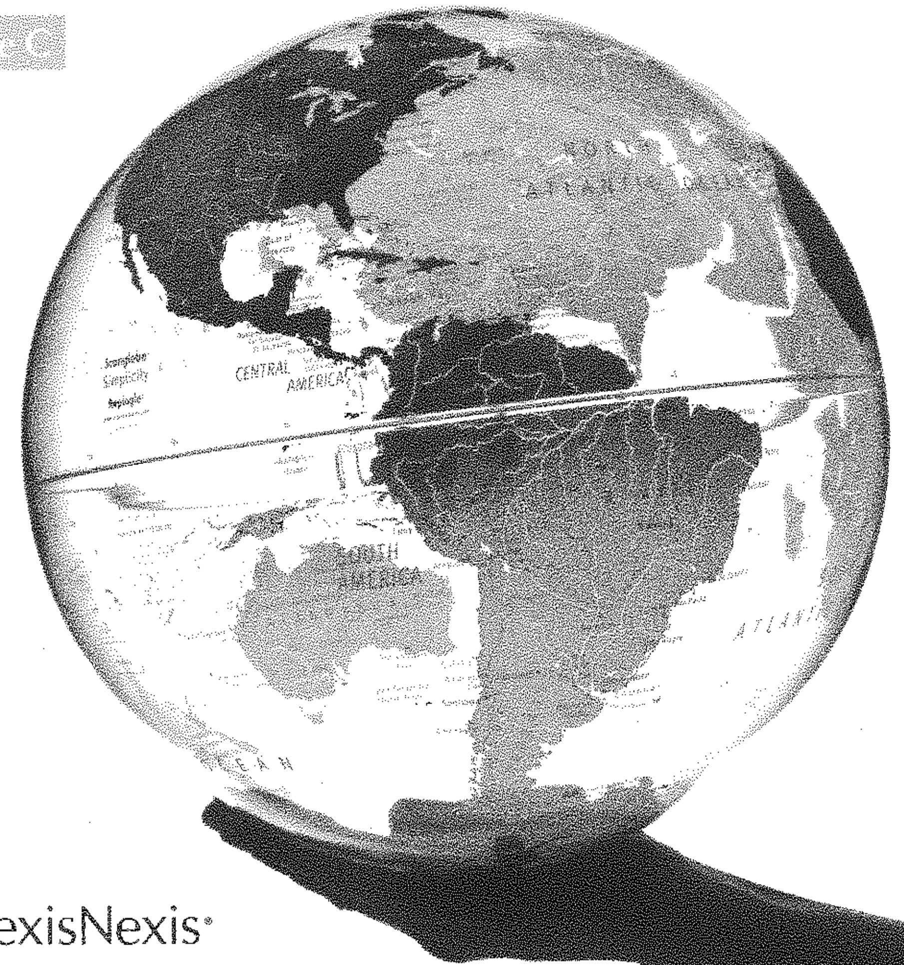
Financial Instruments - IAS 39 and related Standards

Volume C



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1 Introduction

In IFRS accounting literature, three Standards deal with the accounting for financial instruments.

- IAS 32 *Financial Instruments: Presentation* deals with the presentation and classification of financial instruments as financial liabilities or equity, and sets out requirements regarding the offset of financial assets and financial liabilities in the statement of financial position.
- IAS 39 *Financial Instruments: Recognition and Measurement* contains the key guidance regarding the recognition and measurement of financial instruments other than equity.
- IFRS 7 *Financial Instruments: Disclosures* sets out the disclosures required in respect of financial instruments.

The IASB is currently reforming the literature for financial instruments accounting, so that:

- IAS 39 will be replaced by a new Standard, IFRS 9 *Financial Instruments*;
- IFRS 7 will be consequentially amended to reflect the requirements of IFRS 9; and
- IAS 32 will be unchanged except for some anticipated amendments to the offset requirements.

The new and revised Standards are expected to be effective in 2013. At the time of writing, some aspects of IFRS 9 have been finalised but the project is not complete. *iGAAP 2012 – Financial Instruments: IFRS 9 and related Standards – Volume B*, Deloitte's companion volume for this manual, provides equivalent guidance regarding the application of the requirements of IFRS 9.

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The definition of a financial instrument is broad; a financial instrument is defined as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Trade receivables and payables, bank loans and overdrafts, issued debt, ordinary and preference shares, investments in securities (e.g. shares and bonds), and various derivatives are just some examples of financial instruments. In addition, some contracts to buy and sell non-financial items that would not meet the definition of financial instruments are specifically brought

within the scope of the financial instruments Standards on the basis that they behave and are used in a similar way to financial instruments (see 2.5 below).

This chapter explains which items that meet the definition of a financial instrument are scoped out of IAS 32 and/or IAS 39 and IFRS 7. The detailed scope exclusions of IFRS 7 are discussed in more detail in **section 2** of **chapter C12**.

The scoping paragraphs of the three Standards (IAS 32, IAS 39 and IFRS 7) differ slightly so that:

- all financial instruments that are scoped out of IAS 32 are also scoped out of IAS 39;
- financial instruments that an entity issues with a discretionary participation feature are accounted for under IFRS 4 *Insurance Contracts* and are scoped out of IAS 39. Such instruments are within the scope of IFRS 7 and IAS 32 except that, for such contracts, the requirements of IAS 32 regarding the distinction between financial liabilities and equity instruments are not applicable;
- IAS 39 has some additional scope exclusions that go beyond the scope exclusions in IAS 32 (see **section 3** below); and
- IAS 39 excludes all instruments classified as equity from its scope, whereas IFRS 7 appears to exclude only those derivatives over own equity, puttable instruments and instruments that impose on the entity an obligation to deliver a pro rata share of the net assets upon liquidation that are classified as equity, making no reference to other non-derivative instruments such as ordinary shares. It appears that this difference does not have any practical effect (see **3.1** below).

2 Financial instruments scoped out of IAS 32, IAS 39 and IFRS 7

The following table summarises the scope of IAS 32, IAS 39 and IFRS 7 with respect to financial instruments only.

Financial instrument	Within scope of IAS 32?	Within scope of IFRS 7?	Within scope of IAS 39?
Interests in subsidiaries, associates and joint ventures accounted for in accordance with IAS 27(2008), IAS 28(2008), IAS 31(2008), IAS 27(2011) or IAS 28(2011)	No	No	No
Interests in subsidiaries, associates and joint ventures accounted for in accordance with IAS 39 as permitted by IAS 27:38(b) or IAS 27(2011):10(b)	Yes	Yes	Yes
Investments in equity securities (either as available-for-sale investments or at fair value through profit or loss)	Yes	Yes	Yes
Investments in debt securities (as available-for-sale investments, at fair value through profit or loss, loans and receivables or held-to-maturity investments)	Yes	Yes	Yes
Trade receivables and payables	Yes	Yes	Yes
Finance lease receivables of a lessor	Yes	Yes	No[(1)]
Construction contract receivables that do not qualify as financial instruments and are accounted for under IAS 11 *Construction Contracts* (see 2.7 below)	No	No	No
Cash and cash equivalents	Yes	Yes	Yes
Borrowings and other financial liabilities (e.g. preference shares classified as financial liabilities)	Yes	Yes	Yes
Derivatives (and non-closely related embedded derivatives)	Yes	Yes	Yes
Derivatives over interests in subsidiaries, associates and joint ventures in individual financial statements	Yes	Yes	Yes
Derivatives over interests in associates and joint ventures in consolidated financial statements	Yes	Yes	Yes
Contracts over non-financial items that do not meet the purchase, sale or usage exemption in IAS 39:5	Yes	Yes	Yes

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should make any classifications or designations concerning financial assets acquired or financial liabilities assumed in a business combination in accordance with pertinent conditions (e.g. contractual terms, economic conditions, acquirer's operating or accounting policies) at that date. IFRS 3(2008) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009.

6 Future developments

In November 2009 the IASB issued IFRS 9 *Financial Instruments*. The Standard replaces the classification and measurement requirements in IAS 39 *Financial Instruments: Recognition and Measurement* for financial assets which are discussed in this chapter. IFRS 9 is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. However, in August 2011 the IASB issued an exposure draft, ED/2011/3, *Mandatory Effective Date of IFRS 9*, which proposed deferring the effective to annual periods beginning on or after 1 January 2015.

IFRS 9 requires entities to classify financial assets as being measured at either amortised cost or fair value. Gains and losses on assets measured at fair value are recognised either in profit or loss ("fair value through profit or loss") or for certain investments in equity instruments in other comprehensive income ("fair value through other comprehensive income"). The criteria for amortised cost measurement differs to IAS 39 in that there is greater focus on the entity's business model in determining how financial assets are classified.

The issuance of IFRS 9 in November 2009 represented the completion of the first phase of the IASB's project to replace IAS 39. Since then, further amendments to IFRS 9 have been made in October 2010 with respect to the classification and measurement of financial liabilities and incorporating the IAS 39 requirements for measurement and recognition and derecognition into IFRS 9.

The requirements of IFRS 9 are described at length in *iGAAP 2012 – Financial Instruments: IFRS 9 and related Standards – Volume B*.

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C3 Financial liabilities and equity

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1 Introduction

IAS 32 *Financial Instruments: Presentation* requires an issuer of a financial instrument to classify the financial instrument, or its component parts, as a financial liability or as equity in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. The overriding principles are that when the issuer does not have an unconditional right to avoid the obligation to deliver cash, and when the contract does not, in substance, evidence a residual interest in the net assets of the issuer after deducting all of its liabilities, the instrument is not an equity instrument (see **section 2** below).

A more complex area, in respect of which the Standard provides additional guidance, is the treatment of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments. The definitions of a financial asset and a financial liability also include certain contracts on own equity and are applied to evaluate whether such contracts are, in substance, equity, financial liabilities or derivatives (derivatives can be either financial assets or financial liabilities). For example, a written put option on own shares that will be settled, if the option is exercised by the holder, by delivering cash in exchange for the entity's own shares, is a financial liability because the entity will have an obligation to deliver cash (see **section 6** below).

This chapter addresses the application of the financial liability and equity definitions to various types of financial instruments issued in practice and contracts indexed to and settled in an entity's own equity. It also indicates the implications of classification as either debt, equity or a derivative for the measurement of that contract or its component parts.

2 Principles of liability/equity classification

A financial instrument or its component parts should be classified upon initial recognition as a financial liability or an equity instrument according to the substance of the contractual arrangement, rather than its legal form, and the definitions of a financial liability and an equity instrument. [IAS 32:15 & 18] For some financial instruments, although their legal form may be equity, the substance of the arrangements is that they are liabilities. A preference share, for example, may display either equity or liability characteristics depending on the substance of the rights attaching to it.

The appropriate classification as a financial liability, equity or a combination of both, is determined by the entity when the financial instrument is

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initially recognised and that classification is not generally changed subsequently unless the terms of the instrument change. As exceptions to this general principle, **section 8** below discusses a number of circumstances in which reclassification may be appropriate even though the terms of the instrument have not changed. In addition, when the specific requirements for puttable instruments and instruments that contain an obligation to deliver a pro rata share of net assets at liquidation described in **2.1.2.1** and **2.1.3** respectively no longer apply or start to apply, reclassification may be appropriate.

When classifying a financial instrument in consolidated financial statements, an entity should consider all of the terms and conditions agreed upon between members of the group and the holders of the instrument. For example, a financial instrument issued by a subsidiary could be classified as equity in the subsidiary's individual financial statements and as a liability in the consolidated financial statements if another group entity has provided a guarantee to make payments to the holder of the instrument.

IAS 32 defines a financial liability as any liability that is: [IAS 32:11]

(a) a contractual obligation:

  (i) to deliver cash or another financial asset to another entity (e.g. a payable); or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (e.g. a financial option written by the entity); or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

  (i) a non-derivative contract for which the entity is or may be obliged to deliver a variable number of its own equity instruments (e.g. an instrument that is redeemable in own shares to the value of the carrying amount of the instrument); or

  (ii) a derivative contract over own equity that will or may be settled other than by the exchange of a fixed amount of cash (or another financial asset) for a fixed number of the entity's own equity instruments (e.g. a net-share settled written call over own shares). For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative

equity instruments. Also for these purposes, the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, 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 and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an 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 paragraphs 16A and 16B or paragraphs 16C and 16D.

The definition of a financial liability above reflects the amendment to IAS 32:11(b)(ii) contained in *Classification of Rights Issues* issued in October 2009. The classification of rights issues is discussed in more detail at **6.1.1** below.

The Standard defines an equity instrument as any contract that represents a residual interest in the assets of an entity after deducting all of its liabilities.

In May 2008, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision on IAS 32, *Deposits on Returnable Containers*. The IFRIC was asked to provide guidance on the accounting for the obligation to refund deposits on returnable containers. In some industries, entities that distribute their products in returnable containers collect a deposit for each container delivered and have an obligation to refund this deposit when containers are returned by the customer. The issue is whether the obligation should be accounted for in accordance with IAS 39.

The IFRIC noted that IAS 32:11 defines a financial instrument as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity". Following delivery of the containers to its customers, the seller has an obligation only to refund the deposit for any returned containers. In circumstances in which the containers are derecognised as part of the sale transaction, the obligation is an exchange of cash (the deposit) for the containers (non-financial assets). Whether that exchange transaction occurs is at the option of the customer. Because the transaction involves the exchange of a non-financial item, it does not

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meet the definition of a financial instrument in accordance with IAS 32. In contrast, when the containers are not derecognised as part of the sale transaction, the customer's only asset is its right to the refund. In such circumstances, the obligation meets the definition of a financial instrument in accordance with IAS 32 and is therefore within the scope of IAS 39. In particular, IAS 39:49 states that "the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid".

2.1 Contractual obligation to deliver cash or another financial asset

The key feature in determining whether a financial instrument is a liability is the existence of a contractual obligation of one party (the issuer) to deliver cash or another financial asset to another party (the holder), or to exchange financial assets or liabilities under conditions that are potentially unfavourable. In contrast, in the case of an equity instrument (e.g. ordinary shares) the right to receive cash in the form of dividends or other distributions is at the issuer's discretion and, therefore, there is no obligation to deliver cash or another financial asset to the holder of the instrument. There is an exception to this rule for certain puttable instruments and instruments with an obligation to deliver a pro rata share of net assets only at liquidation (see **2.1.2.1** and **2.1.3** below).

Items such as deferred revenue and warranty obligations require delivery of goods or services rather than an obligation to deliver cash or another financial asset and, therefore, are not financial liabilities. [IAS 32:AG11] Obligations to pay tax, company registration fees and other similar charges are obligations to pay cash. However, these are statutory rather than contractual requirements and, therefore, they are not financial liabilities. Similarly, constructive obligations (as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) do not arise from contracts and are not financial liabilities. [IAS 32:AG12]

Liability characteristics are established in practice in a number of ways, as demonstrated below.

2.1.1 Mandatory redemption and/or mandatory interest payments

When an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at

redemption exists and, therefore, the instrument includes, and is presented as, a liability. An exception to this principle applies for certain puttable instruments and certain instruments that contain an obligation to deliver a pro rata share of net assets at liquidation as described in **2.1.2.1** and **2.1.3**.

Example 2.1.1A

Mandatorily redeemable preference shares

Entity A issues preference shares that are mandatorily redeemable at par in ten years. A contractual obligation to deliver cash exists for the repayment of principal – the issuer cannot avoid the outflow of cash in Year 10. Therefore, the preferences shares should be classified as a financial liability.

Perpetual instruments provide the holder with no right to require redemption. However, the terms of such instruments often require the issuer to make coupon payments into perpetuity. A perpetual instrument with a mandatory coupon is a liability in its entirety because the whole of its value is derived from the stream of future coupon payments.

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Example 2.1.1B

Perpetual coupon-bearing preference shares

A perpetual instrument is issued at a par amount of CU100 million requiring coupon payments of 6 per cent to be made annually. Provided that 6 per cent is the market rate of interest for this type of instrument when issued, the issuer has assumed a contractual obligation to make a future stream of 6 per cent interest payments. The net present value of the interest payments is CU100 million and represents the fair value of the instrument. The preference shares should be classified as a financial liability.

Many traditional debt instruments such as bonds and bank loans involve both mandatory redemption and mandatory interest payments.

Other instruments may require a mandatory distribution of a percentage of the profits of an entity (to the extent that such profits are generated) rather than a traditional interest payment. Such an instrument meets the definition of a liability because it is a contractual obligation of the issuer to deliver cash or another financial asset to the holder. The issuer has no discretion over paying out a percentage of its profits.

A distinction must be drawn between those circumstances in which the issuer genuinely contractually has no discretion over payment of interest (or the distribution of a percentage of profits) and those in which payment may be avoided but this decision will have consequences (even if significant). For example, an entity may issue

instruments under which it contractually retains the discretion regarding the distribution of a percentage of profits but, if the distribution is not paid, the entity ceases to benefit from a favourable tax treatment. Such arrangements are common for Real Estate Investment Trusts (REITs) in some jurisdictions. In such circumstances, although the entity may intend to pay the distribution in order to retain the significant tax benefits, it has no contractual obligation to deliver cash (or other financial asset) to the holder of the instrument and, therefore, the instrument is not a financial liability.

The scope of REITs from the perspective of the issuer is also discussed in **2.3.9** in **chapter C1**.

2.1.2 *Puttable instruments*

A puttable instrument is defined as a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or that is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. [IAS 32:11]

2.1.2.1 *Puttable instruments presented as equity*

Because puttable instruments contain a contractual obligation for the issuer to deliver cash or another financial asset to the holder, such instruments are generally classified as financial liabilities. However, certain puttable instruments that meet specified criteria must be presented as equity. The criteria for equity classification are extensive and restrictive.

The requirements regarding equity classification for some puttable instruments originated from an amendment to IAS 32 issued in February 2008, *Puttable Financial Instruments and Obligations Arising on Liquidation*. The purpose of the amendment was to provide a limited scope exception to the definition of a financial liability that would apply to certain financial instruments that contain obligations but that, in the IASB's view, also represent a residual interest in the net assets of the issuing entity. The exception applies to puttable instruments (described in this section) as well as to instruments containing an obligation to deliver a pro rata share of the net assets of the entity only on liquidation (see **2.1.3** below). Because the requirements of the amendment are designed as an exception, they should be applied narrowly and should not be used by analogy (IAS 32:96B).

Failure to meet one of the requirements results in failure to qualify for the exception, in which case the instrument will not meet the criteria for classification as equity.

A puttable instrument is classified as equity if it meets all of the following criteria:
[IAS 32:16A]

(a) the holder is entitled to a pro rata share of the entity's net assets in the event of the entity's liquidation;

The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by: (i) dividing the entity's net assets on liquidation into units of equal amount; and (ii) multiplying that amount by the number of the units held by the financial instrument holder. The IASB decided that the instrument must entitle the holder to a pro rata share of the net assets on liquidation because the net assets on liquidation represent the ultimate residual interest in the entity. [IAS 32:BC57]

An instrument that has a preferential right on liquidation of the entity is not an instrument with an entitlement to a pro rata share of the net assets of the entity. An instrument has a preferential right on liquidation, for example, if it entitles the holder to a fixed dividend on liquidation in addition to a share of the entity's net assets, when other instruments in the subordinate class with a right to a pro rata share of the net assets of the entity do not have the same right on liquidation. [IAS 32:AG14C]

(b) the instrument is in the class of instruments that is subordinate to all other classes of instruments;

For an instrument to be in the most subordinate class, the financial instrument must have no priority over other claims to the assets of the entity on liquidation and must not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments. [IAS 32:BC58] The instrument must be in the class of instruments that is subordinate to all other classes of instruments on liquidation in order to represent the residual interest in the entity.

When determining whether an instrument is in the subordinate class, an entity evaluates the instrument's claims on liquidation as if liquidation were to occur on the date when the instrument is classified. The initial classification should be reassessed if there is a change

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in relevant circumstances. For example, if the entity issues or redeems another financial instrument, this may affect whether the instrument under consideration is in the class of instruments that is subordinate to all other classes. [IAS 32:AG14B]

If an entity has only one class of financial instruments, that class is treated as if it were subordinate to all other classes. [IAS 32:AG14D]

In some circumstances, the most subordinate class of instruments is immaterial compared to the overall capital structure of the entity. This is particularly so when the most subordinate instruments are 'founder shares' (i.e. shares issued when the entity was formed) but the entity is capitalised by other issued instruments (e.g. puttable instruments issued after the founder shares were issued). The founder shares in this case, although immaterial, cannot be ignored in determining whether the puttable instruments should be classified as equity. Because the puttable instruments are not the most subordinate instruments issued by the entity, they are not classified as equity.

(c) all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class;

In January 2009, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision on IAS 32, Classification of Puttable and Perpetual Instruments. The IFRIC considered whether a puttable instrument is subordinate to all other classes of instruments when an entity also has perpetual instruments that meet the definition of equity instruments.

The IFRIC noted that a financial instrument is first classified as a liability or equity instrument in accordance with the general requirements of IAS 32. That classification is not affected by the existence of puttable instruments. As a second step, if a financial instrument would meet the general definition of a liability because it is puttable to the issuer, the entity considers the conditions in IAS 32:16A & 16B to determine whether it should be classified as equity. Consequently, the IFRIC noted that IAS 32 does not preclude the existence of several classes of equity.

The IFRIC also noted that IAS 32:16A(c) applies only to "instruments in the class of instruments that is subordinate to all other classes of

instruments". IAS 32:16A(b) specifies that the level of an instrument's subordination is determined by its priority in liquidation. Accordingly, the existence of the put does not of itself imply that the puttable instruments are less subordinate than the perpetual instruments.

(d) 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; and

The requirements of IAS 32:16A(d) restrict equity classification to instruments where the only obligation in the instrument is the put right held by the holder; the limited scope exception cannot be applied to puttable instruments containing contractual obligations in addition to the put right because the holder may have a claim to some of the net assets in preference to other instrument holders and, consequently, such instruments may not represent a residual interest in the entity. [IAS 32:BC68]

(e) 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).

Profit or loss and the change in the recognised net assets should be measured in accordance with relevant IFRSs. [IAS 32:AG14E]

For a puttable instrument to be classified as equity, in addition to meeting the above criteria in IAS 32:16A, the issuer must have no other financial instrument or contract that has:
[IAS 32:16B]

(a) 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

(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

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When applying IAS 32:16B(a) and (b), the issuer is not required to consider non-financial contracts with a holder of an instrument described in IAS 32:16A 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.

The application guidance issued with IAS 32 (which is an integral part of the Standard) provides guidance on how to determine whether transactions and arrangements were entered into by the instrument holder other than as an owner of the entity. The general principle is that a transaction or arrangement between the instrument holder and the issuing entity will only be considered to have been entered into by the instrument holder in a capacity other than as an owner if the cash flows and contractual terms and conditions of the transaction or arrangement are similar to an equivalent transaction that might occur between a non-instrument holder and the issuing entity; in other words, the arrangement must be similar to an arrangement that could have been entered into with a non-owner.

If an instrument holder is also an employee of the issuing entity, the cash flows payable to the instrument holder in his or her capacity as an employee are ignored because those cash flows do not arise in their capacity as an owner. Similarly, a profit- or loss-sharing arrangement that allocates profit or loss to the instrument holders on the basis of services rendered or business generated during the current or prior years are arrangements with instrument as holders in a non-owner role and should not be considered when assessing the features listed in IAS 32:16A. However, if the profit- or loss-sharing arrangement allocates profit or loss based on the nominal amount of the instrument holder's interest relative to others in the class, this would represent an arrangement with the holders in their capacity as owners and should be considered when applying IAS 32:16A. [IAS 32:AG14H]

IAS 32:AG14G provides a further example of a partnership structure where some partners provide a guarantee to the entity and are remunerated for that guarantee. In determining whether the partners' interests in the partnership are identical, the guarantee is ignored because the guarantee is not provided by the partners in their capacity as owners.

IAS 32:AG14J provides examples of some instruments and arrangements that, when entered into on normal commercial terms with unrelated parties, are unlikely to prevent instruments that otherwise meet the criteria in IAS 32:16A from being classified as equity:

(a) instruments with total cash flows substantially based on specific assets of the entity;

(b) instruments with total cash flows based on a percentage of revenue;

(c) contracts designed to reward individual employees for services rendered to the entity; and

(d) contracts requiring the payment of an insignificant percentage of profit for services rendered or goods provided.

In May 2010, the IFRS Interpretations Committee considered a request for clarification of guidance relating to the classification of puttable financial instruments that include contractual obligations to provide pro rata distributions. The request proposed an amendment to the guidance in IAS 32 as part of *Improvements to IFRSs* to clarify that a puttable instrument 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.

The Committee decided not to propose an amendment to IAS 32 because they considered that the identified unique circumstances that justified amending IAS 32, titled *Classification of Rights Issues* (see **6.1.1** below), did not apply in this case. Further, an amendment to IAS 32 in this regard would introduce an additional exception to the general definition of a financial liability, which would be beyond the scope of the annual improvements process. At the date the decision was made, the Committee considered that an amendment would only be effective for annual periods beginning on or after 1 January 2012 and this was expected to be after the IASB had issued a final *Financial Instruments with Characteristics of Equity* (FICE) Standard.

Since the IFRIC reached the agenda decision the FICE project has been deferred. See future development in **9.1** below.

If a puttable instrument is presented as equity, IAS 1 *Presentation of Financial Statements* requires the following disclosures:
[IAS 1:136A]

- summary quantitative data about the amount classified as equity;
- the entity's objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;
- the expected cash outflow on redemption or repurchase of that class of financial instruments; and

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- information about how the expected cash outflow on redemption or repurchase was determined.

When a puttable instrument is presented as equity, but subsequently fails to meet any of the criteria detailed in IAS 32:16A & 16B, the entity should reclassify it from the date when the instrument ceases to have all of the features or meet all of the conditions set out in those paragraphs. The financial liability should be measured at the instrument's fair value at the date of reclassification with any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification recognised in equity. Similarly, if an entity redeems all of its issued non-puttable instruments and any puttable instruments that remain outstanding have all of the features and meet all of the conditions in IAS 32:16A & 16B, the entity should reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments. The reclassification to equity should be at the carrying amount of the financial liability at the date of reclassification. [IAS 32:16E & 16F]

IAS 1 requires that when an entity reclassifies a puttable financial instrument between financial liabilities and equity, it should disclose the amount reclassified into and out of each category, and the timing and reason for that reclassification. [IAS 1:80A(a)]

Because the presentation of some puttable instruments as equity, rather than as financial liabilities, is an exception to the principles in IAS 32, the Standard does not permit the extension of this amendment to the classification of non-controlling interests in the consolidated financial statements. Therefore, puttable instruments presented as equity in the separate or individual financial statements that represent non-controlling interests in the consolidated financial statements are classified as financial liabilities in the consolidated financial statements.

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Example 2.1.2.1A

Puttable instruments held by non-controlling interests

Entity P controls Entity Q, which therefore is included in Entity P's consolidated financial statements. Entity Q's capital structure consists partly of puttable instruments, partly held by Entity P and partly by other external investors, which meet the requirements for equity classification in its separate financial statements. Entity P's interest in the puttable instruments is eliminated on consolidation. Even though the puttable instruments held by the non-controlling interests meet the definition of equity in Entity Q's separate financial statements, they are presented as a financial liability in the consolidated financial statements of Entity P.

The prohibition on equity classification in the consolidated financial statements for certain puttable instruments presented as equity in the subsidiary financial statements appears at odds with the general principles in IAS 27 *Consolidated and Separate Financial Statements* and IFRS 10 *Consolidated Financial Statements* under which equity instruments issued by subsidiaries not held by the parent are presented as non-controlling interests. This is further evidence that the requirement to present certain puttable instruments as equity is a limited scope exception that not only overrides the general definition of a financial liability, but also overrides other principles within IFRSs.

2.1.2.2 *Puttable instruments presented as financial liabilities*

A puttable instrument that does not meet the definition of equity as described in **2.1.2.1** above will be classified either wholly as a financial liability, or partly as a financial liability in the case of an instrument that is a compound instrument (i.e. the instrument consists partly of a financial liability and partly an equity component). In considering whether an instrument is a financial liability or equity, an entity must first apply the criteria in section **2.1.2.1** to determine whether the instrument is equity. If it is not, this section is relevant.

The fact that the contractual put right in a puttable instrument is conditional upon the holder exercising its right to require redemption does not negate the existence of a financial liability, because the issuer does not have the unconditional right to avoid delivering cash or another financial asset. [IAS 32:19(b)] An obligation is not negated if the instrument gives the holder the right to a residual interest in the assets of the issuer as is the case, for example, for a unit in a mutual fund. [IAS 32:18(b)]

Example 2.1.2.2A

Preference shares puttable at par

An entity issues preference shares that are puttable at par at the option of the holder at a particular date. The issuer recognises a financial liability for the present value of the obligation to redeem the preference shares at par in exchange for cash on that date.

Example 2.1.2.2B

Instrument puttable at net asset value

Entity A issues Class B shares that allow the holder of the instrument to put the instrument back to Entity A at a price equal to the number of Class B