

MEMO# 20244

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IASB Issues Proposal Treating Fund Shares as Equity

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ACCOUNTING/TREASURERS COMMITTEE No. 10-06 INTERNATIONAL COMMITTEE No. 20-06

RE: IASB ISSUES PROPOSAL TREATING FUND SHARES AS EQUITY The International Accounting Standards Board recently issued proposed amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements.¹ Currently IAS 32 requires shares issued by open-end funds and units issued by unit investment trusts to be treated as liabilities in the balance sheet. The proposed amendments to IAS 32 would permit these shares and units to be treated as equity under certain circumstances. The proposed amendments to IAS 1 would require footnote disclosures addressing risks arising from the ability of shareholders to redeem shares at any time. Comments on the IASB proposal are due Monday, October 23, 2006. If you have comments that you would like the Institute to consider in a comment letter on the proposal, please provide them to Greg Smith at 202/326-5851 or smith@ici.org by Friday, September 8. IAS 32 currently treats any financial instrument that gives the holder the right to put it back to the issuer for cash (a "puttable instrument") as a liability. Application of IAS 32 to fund financial statements causes fund shares to be characterized as liabilities. Furthermore, changes in the fair value of a puttable instrument are recognized in the income statement as gain/loss.

Consequently, when the fund performs well and the value of the "liability" increases, a loss is recognized in the income statement. When the fund performs poorly and the value of the "liability" decreases, a gain is recognized. The Institute and others have criticized IAS 32's characterization of fund shares as liabilities.² In particular, presentation of fund shares as liabilities is confusing to fund shareholders as it causes the 1 The proposed amendments are available at the IASB website <http://www.iasb.org/current/ed.asp>. 2 See Institute Memorandum to Accounting/Treasurers Committee No. 47-02, International Committee No. 74-02 [15262], dated October 15, 2002. 2 fund to report zero net assets or equity in the balance sheet. Further, the income statement presentation of the change in the liability is counter intuitive. Finally, fund shares entail indicia of equity ownership (e.g., participation in profits/losses, pro-rata share of net assets in liquidation, and voting rights). Proposed Amendments to IAS 32 The proposed amendments to IAS 32 would classify financial instruments puttable at fair value (e.g., open-end fund shares) as equity under the following circumstances: a) the instrument entitles the holder to require the entity to repurchase or redeem the instrument for the fair value of a pro rata share of the net assets of the entity; and would, but for this entitlement and the entitlement that may arise from condition b) below, have met the definition of an equity instrument; b) the instrument entitles the holder to a pro rata share of the net assets of the entity in the event of the entity's

liquidation; c) the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, either before or at liquidation; d) the instrument is in the most subordinated class of instruments with a claim to the entity's net assets; e) the instrument's issue price is the fair value of a pro rata share of the net assets of the entity at the time of issue; and f) the instruments in the most subordinated class are all financial instruments puttable at fair value. The proposed amendments to IAS 32 would classify financial instruments that entitle the holder to a pro rata share of the net assets of the entity upon liquidation, including when liquidation is certain to occur and outside the control of the entity (e.g., units issued by unit investment trusts) as equity under the following circumstances: a) the instrument entitles the holder to a pro rata share of the net assets of the entity in the event of the entity's liquidation; b) the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, either before or at liquidation; 3 c) the instrument is in the most subordinated class of instruments with a claim to the entity's net assets; d) the instruments in the most subordinated class are all instruments with the entitlement in sub- paragraph b) above. Amendments to IAS 1 For financial instruments puttable at fair value classified as equity, an entity shall disclose (to the extent not disclosed elsewhere): a) summary quantitative data about the amount classified as equity; b) its 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; c) information about how fair value was determined. Gregory M. Smith Director Operations/Compliance & Fund Accounting