Technical Reference

Overview

The classification of a financial instrument by the issuer as either a liability (debt) or equity can have a significant impact on an entity's gearing (debt-to-equity ratio) and reported earnings. It could also affect the entity's debt covenants.

The critical feature of a liability is that under the terms of the instrument, the issuer is or can be required to deliver either cash or another financial asset to the holder; it cannot avoid this obligation. For example, a debenture under which the issuer is required to make interest payments and redeem the debenture for cash is a financial liability.

An instrument is classified as equity when it represents a residual interest in the issuer's assets after deducting all its liabilities; or, put another way, when the issuer has no obligation under the terms of the instrument to deliver cash or other financial assets to another entity. Ordinary shares or common stock where all the payments are at the discretion of the issuer are examples of equity of the issuer.

In addition, the following types of financial instrument are accounted for as equity, provided they have particular features and meet specific conditions:

- Puttable financial instruments (for example, some shares issued by co-operative entities and some partnership interests).
- Instruments or components of 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 (for example, some shares issued by limited life entities).

The classification of the financial instrument as either debt or equity is based on the substance of the contractual arrangement of the instrument rather than its legal form. This means, for example, that a redeemable preference share, which is economically the same as a bond, is accounted for in the same way as a bond. The redeemable preference share is therefore treated as a liability rather than equity, even though legally it is a share of the issuer.

Other instruments may not be as straightforward. An analysis of the terms of each instrument in light of the detailed classification requirements is necessary, particularly as some financial instruments contain both liability and equity features. Such instruments, for example, bonds that are convertible into a fixed number of equity shares, are accounted for as separate liability and equity (being the option to convert if all the criteria for equity are met) components.

The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument. If a preference share is classified as a liability, its coupon is shown as interest. However, the discretionary coupon on an instrument that is treated as equity is shown as a distribution within equity.

Summary of key requirements

2.1 An issuer of a financial instrument should classify a financial instrument, or *its component parts,* on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the contractual arrangement's substance and the definitions of a financial liability, a financial asset and an equity instrument. [IAS 32 para 15]. It is necessary to examine the contractual terms of each component carefully, bearing in mind the definitions of a financial liability and an equity instrument, to determine whether they exhibit characteristics of a financial liability or equity. Once the characteristics of the individual components are determined, they can be combined to arrive at the overall assessment of whether the entire instrument is classified as a financial liability, or an equity instrument, or a compound instrument containing both liability and equity features.

Definitions

2.2 A financial liability is defined as any liability that is:

- A 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.
- A contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. 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 meet the specific conditions to be classified as equity instruments, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. [IAS 32 para 11].

2.3 An equity instrument is defined as any contract that evidences a residual interest in an entity's assets after deducting all of its liabilities. [IAS 32 para 11]. Therefore, only those instruments that do not meet the definition of a liability will fall to be classified as equity. In other words, the entity must have an unconditional right to avoid delivery of cash or another financial asset. A typical example is an entity's ordinary shares where all cash flows are discretionary. For the purposes of determining whether a financial instrument is an equity instrument rather than a financial liability, the issuer is required to apply the expanded definition of an equity instrument that is essentially a converse of the above definition of a financial liability. [IAS 32 para 16].

Contractual obligation to settle in cash or another financial asset

2.4 It is apparent from the above definitions that the critical feature that distinguishes a liability from an equity instrument is the existence of a contractual obligation to deliver cash or another financial asset to the holder or to exchange a financial asset or a financial liability with the holder under conditions that are potentially unfavourable to the issuer. In other words, if the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a liability. [IAS 32 para 17].

2.5 Such a contractual obligation could be established explicitly or indirectly. However, the obligation must be established through the terms and conditions of the financial instrument. [IAS 32 para 20]. Economic compulsion, by itself, would not result in a financial liability being classified as a liability. Similarly, a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument. [IAS 32 para 19(a)]. For example, an obligation is not negated even if the instrument's terms are such that the amount payable on redemption is dependent on the company having sufficient distributable profits or reserves.

Puttable instruments

2.6 A financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. For example, an entity that issues a preference share that is puttable by the holder at some future date recognises a financial liability. This is so even when the amount of cash or other financial assets to be delivered to the holder is not fixed, but is determined on the basis of an index or other item that has the potential to increase or decrease the final amount payable, or when the puttable instrument's legal form gives the holder a right to a residual interest in the issuer's assets. [IAS 32 para 18(b)]. Only if the issuer has an unconditional right to avoid redemption, or in the limited circumstances described below, should the instrument be classified as an equity instrument.

2.7 There is a limited exception to the principles in IAS 32 for certain puttable instruments and other instruments containing obligations arising on liquidation. Such instruments that meet very specific criteria are classified as equity, rather than financial liabilities. These criteria include being the most subordinated instrument of the entity and entitling the holder to a *pro rata* share of net assets on liquidation.

Contracts that will or may be settled in an entity's own equity instruments

2.8 Some financial instruments are settled in the issuer's own equity instruments (for example by an issue of its ordinary shares), rather than cash or other financial assets. Such a financial instrument will be classified as equity only if it can be settled by a fixed number of its own equity shares in exchange for a fixed amount of cash. [IAS 32 para 22]. By fixing the amount paid and the number of shares received the holder benefits from any upside and suffers the loss from any fall in the residual value of the entity, hence the equity classification is appropriate.

2.9 However, an entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instrument to be received or delivered equals the amount of the contractual right or obligation. Such a contract may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable, which can include the entity's own share price. [IAS 32 para 21]. Such a contract is classified as a financial liability.

Contingent settlement provisions

2.10 The obligation to deliver cash or financial assets need not be certain of occurring, it may be contingent on the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer or the holder of the instrument. Examples of such uncertain future events include changes in stock market index, or changes in the issuer's key performance indicators such as revenue or debt-to-equity ratios.

2.11 As the issuer does not have an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) the financial instrument is classified as a liability. However, if the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not *genuine* or only applies on the liquidation of the issuer, or the instrument has all the features of puttable instruments that meet the criteria for equity classification (as defined in IAS 32 - paras 16A, 16B), then the contingent settlement provision should be ignored for the purposes of determining the classification of the instrument. [IAS 32 para 25].

Derivative financial instruments

2.12 Derivatives that only result in the gross physical delivery of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments are classified as equity instruments. [IAS 32 para 16(b)(ii)]. All other derivatives on own equity are treated as derivative financial liabilities or assets and accounted for as such. This includes derivatives that may be settled gross by delivery of a variable number of own shares; or may be settled by delivery of a fixed number of own shares for a variable amount of cash (or other financial assets). [IAS 32 paras 21, 24].

2.13 When a derivative financial instrument gives one party a choice over how it is settled (for example, the issuer or holder can choose to settle the contract net in cash, or by exchanging shares for cash), it is a financial asset or a financial liability, unless all of the settlement alternatives would result in it being an equity instrument. [IAS 32 para 26].

Compound financial instruments

2.14 Not all instruments are either debt or equity. Compound instruments, contain elements of both in a single contract. In this case the issuer should identify the instrument's component parts and account for them separately, allocating the proceeds between liability and equity. The debt element is determined first by measuring it at fair value in accordance with IAS 39 (for example, by discounting the contractual future cash flows to their present value at the current rate of interest applicable to instruments of comparable credit status and providing substantially the same cash flows on the same terms excluding any equity component). The difference between the proceeds and the value of the debt component is assigned to equity. For example, the vanilla debt element of a convertible bond is recognised as a financial liability, whereas the option to convert the bond into a fixed number of ordinary shares should be separately recognised as equity, even though the bond and the option are part of the same financial instrument.

2.15 On conversion of a convertible instrument into the entity's ordinary shares at maturity, the entity derecognises the liability component and recognises it as equity. There is no gain or loss on conversion at maturity. [IAS 32 para AG32].

Interest, dividends, gains and losses

2.16 The treatment of interest, dividends, losses and gains in the statement of comprehensive income follows the classification of the related instrument. Therefore, interest, dividends, gains and losses on financial instruments classified as liabilities are recognised in the income statement. On the other hand, interest, dividends, gains and losses arising in respect of equity instruments (for example on the redemption of an equity share) are recognised directly in equity and do not affect profit or loss. [IAS 32 para 35].

Treasury shares

2.17 When an entity purchases its own shares and holds them in treasury ('treasury shares'), any consideration paid or received for the purchase or sale of an entity's own equity instruments should be recognised directly in equity and no gain or loss should be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instrument. [IAS 32 paras 33, AG36].