Solutions

Question 1

Which statement is true in the definition of a financial liability?

a) The key component to the definition is that it is based on a written contract.
b) It includes a contractual obligation to deliver cash or other financial asset.
c) It includes instruments that economically obligate one entity to deliver cash or other financial asset to another entity.
d) It does not include instruments that can be settled only using the entity's own equity shares.

Solution

Answer: B

A contractual obligation to deliver cash is a key component of the definition of a liability. Economic compulsion alone would not result in a financial liability. Furthermore, though there is a contractual obligation that forms part of the definition under IFRS, it is not required for this to be only in the form of a written contract.

Question 2

Which of the following would preclude the classification of an instrument as equity?

a) The entity's ability to make distributions
b) The entity's history of making distributions in prior years
c) Cash payments are not at the discretion of the entity
d) The liquidation ranking (for example, preferred share versus ordinary share)

Solution

Answer: C

The entity must have discretion to avoid cash payment to be classified as equity. The entity's historical trend or ability to make distributions is not considered as part of the analysis.

Question 3

Which instrument would be classified as equity under IFRS?

a) A preferred share that is redeemable only if there is a change in control of the entity
b) A warrant where the issuer can decide to settle either in cash or by delivering own shares
c) A warrant giving the counterparty a right to acquire a fixed number of the entity's shares for a fixed amount of cash
d) A contract where the amount of cash that will be delivered is based on changes in the market price of the entity's own equity

Solution

Answer: C

This warrant meets the definition of equity as it meets the “fixed for fixed” rule (that is, the holder can exchange a fixed amount of cash for a fixed number of shares). Derivative contracts that can be settled through any method other than gross physical exchange (for example, net cash or net share settlement) fails the definition of equity in accordance with IAS 32.26, regardless of who controls the decision. Finally, simply because an event is contingent (for example, there is a change in control), does not negate a contractual obligation.

Question 4

A company has issued non-cumulative, non-redeemable, 5% preference shares where the payment of the dividend is solely at the discretion of the board of directors. How should the instrument be classified?

a) As equity, because the shares are non-redeemable and dividends are solely at the issuer’s discretion
b) It depends on the legal form of the instrument.
c) As a liability, because of the stated dividend percentage and the intention of the company to pay
d) As mezzanine or temporary equity, because the preference shares have characteristics of both a liability and equity

Solution

Answer: A

When preferred shares are non-redeemable, the appropriate classification is determined by the other rights that may attach to them under IFRS. Distributions to holders of the preferred shares that are at the discretion of the issuer would meet the definition of equity as the entity does not have a contractual obligation to pay cash. The legal form of an instrument and economic compulsion by the entity does not impact classification of the instrument.

Question 5

Which of the following is the best example of a “compound” instrument (that is, has both a liability component and an equity component) based on the facts provided?

a) A non-redeemable preference share that converts into a fixed number of equity shares anytime at the option of the holder
b) A preference share that is redeemable for cash in ten years and pays discretionary dividends
c) A convertible bond that may be converted into a variable number of equity shares in three years and has cumulative mandatory coupons
d) Not applicable − instruments should not be split into different components.

Solution

Answer: B

There is a concept of a compound instrument in IFRS. The preference shares are redeemable for cash at a future date, so this represents the liability component. However, the discretionary dividends, until the instrument is redeemed, represent an equity component.

A convertible bond to convert into a variable number of shares results in a liability with an embedded derivative; and a preference share that converts into a fixed number of shares or otherwise non-redeemable is equity in its entirety. Finally, there is no concept of “mezzanine” equity under IFRS.

Question 6

A puttable instrument is one that requires the issuer to repurchase or redeem the instrument for cash or other financial asset on exercise of the put. The “puttables amendment” was issued in 2008. Which of the following statements is true about the amendment?

a) It is an exception, whereby all puttable instruments may be classified as equity.
b) It requires the put to be accounted for as a derivative and the rest of the instrument (that is, the share) to be classified as equity.
c) The puttable instrument can be classified in equity if the issuer is only required to redeem the instrument based on a contingent event that is very remote.
d) One of the criteria for a puttable instrument to be classified in equity is that it is the most subordinate instrument.

Solution

Answer: D

The IASB issued a very narrow amendment in 2008, whereby certain instruments that would otherwise meet the deinition of a liability (because of the obligation to redeem the instrument at the option of the holder) could be classiied as equity if very strict criteria are met. One of those criteria in IAS 32.16A-B is that the puttable share is the most subordinate instrument.

Question 7

When evaluating a bond that is convertible into equity shares, which of the following features would result in the conversion option’s being classified as equity?

a) The convertible bond is denominated in a foreign currency.
b) An adjustment is made to the number of shares converted that entitles the instrument holder to additional benefits over that of the shareholder.
c) Cash settlement alternatives at the discretion of either the issuer or the holder
d) Gross physical settlement for a fixed amount of cash in exchange for a fixed amount of shares (that is, considered to be fixed for fixed)

Solution

Answer: D

Only instruments that are gross physically settled by exchanging a fixed amount of cash for a fixed amount of equity may be classified as equity. A foreign currency bond will result in a variable amount of cash in settlement. Furthermore: (i) cash settlement alternatives (even those at discretion of the issuer) and (ii) adjustments to the conversion ratio, where the rights and relative ownership of the shareholder as compared to the instrument holder, are not maintained violate the fixed-for-fixed rule.

Question 8

On December 1, 2011, an entity enters into a contract to purchase 10 million shares of its common stock after one year at C2 per share. The contract can only be settled “gross” in shares (physical delivery) in exchange for a fixed amount of cash (C2 per share). Which statement describes the most appropriate accounting?

a) Liability for the present value of the redemption amount (that is, the proceeds to be paid on settlement), with the offsetting entry to equity
b) Derivative based on the fair value of the forward contract

c) Equity only
d) Liability only

Solution

Answer: A

The forward contract itself is equity (that is, it meets the fixed for fixed rule), but IAS 32.23 requires that a financial liability be set up for the present value of the forward purchase price (the present value of C20m). This amount is reclassified from equity to liability. This forward is not accounted for as a typical derivative because of the explicit guidance in this area.

Question 9

Other than financial liabilities measured at fair value through profit or loss, how are financial liabilities subsequently measured under IFRS?

a) The amount of undiscounted cash that would be required to settle the obligation at the reporting date
b) Amortized cost using the effective interest rate method
c) Amortized cost using the stated interest rate of the debt
d) Either fair value or amortized cost at the choice of the issuer

Solution

Answer: B

The instrument is carried at amortized cost; the effective interest rate method is the correct method of calculating the amortized cost of a financial liability. The stated rate is not appropriate. Furthermore, all financial liabilities not classified at fair value through profit or loss at initial recognition are subsequently measured at amortized cost.

Question 10

Where should interest payments on a financial liability be recognized?

a) Equity
b) Profit or loss
c) It is management’s policy choice.
d) It depends on the facts and circumstances (for example, whether the instrument is subsequently convertible).

Solution

Answer: B

IFRS guidance is clear that interest payments on a liability should be recorded in profit or loss. this is not a policy choice.