IFRIC submission: Classification of capital instruments as equity or debt instruments in the accounts of the investor

The Issue

Under IFRS a financial instrument is any contract that gives rise to an asset of one entity and a financial liability or equity instrument of another entity (IAS 32.11.) An entity whose capital instruments issued are puttable, such as a partnership or a co-operative, would generally be deemed to have classified that capital as financial liabilities, because the instrument encompasses a contractual obligation to deliver cash to the holder of those instruments (IAS 32.11 and .18.) In many cases, the amount at which the instrument can be put back to the issuer is not at fair value, hence, the entity cannot benefit from the proposed amendments under the June 2006 Exposure Draft on financial instruments puttable at fair value.

Since IAS 32 deals with the classification of these instruments on the part of the issuer only, uncertainty exists as to whether that treatment should also govern the treatment in the accounts of the holder of the instrument. I.e., are puttable financial instruments being held by an entity regarded an *equity instrument* or a *debt instrument*? Clarification of this issue has an influence on, for instance, the consolidation technique an entity must apply if it had a majority stake in an entity where all of its capital was puttable, or which impairment pronouncements prevail.

Current practice

There are two ways to look at this issue:

- View A: Proponents of this view hold that any accounting for capital instruments should be based on the definitions in IAS 32. They point at the fact that the definitions of the terms “financial asset,” “financial liability” and “equity instrument” as laid down in IAS 32 are carried over unchanged to IAS 39 (cf. IAS 32.11 and IAS 39.8.) In other words, if the issuer classifies an instrument as financial liability, that very same instrument cannot be classified as an equity financial instrument in the accounts of the holder. Those who support this view would point at the definitions of an equity instrument and a financial asset (IAS 32.11:)

*"An equity instrument is any contract that evidences a residual interest in the assets of an entity **after deducting all of its liabilities**." (emphasis added)*

"A financial asset is any asset that is:
(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
- ***(i) to receive cash or another financial asset from another entity**; or*
- *(ii) […] to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or*

(d) […]" (emphasis added)

An entity whose capital instruments are all puttable and are, thus, being classified as financial liabilities would not have any equity (instruments,) since all of its residual interest instruments contain an obligation to deliver cash to another entity. If these instruments are judged not be an equity instrument for the accounts of the entity, they cannot qualify as a equity instrument financial asset in the accounts of the investor given letter (b) of the financial asset definition.

- On the other side, proponents of View B would point out that the character of the instrument held does not change merely with an issuer classifying the instrument as equity or debt. The capital instrument itself entitles the holder to a share into the net assets of the issuer; hence, it "evidences a residual interest." In their view, it is the entitlement to a residual interest in the assets of an entity that constitutes the equity instrument notion. Those who take this view would, therefore, question that an instrument cannot be classified as equity instrument in the accounts of the holder whilst at the same time being classified as financial liability in the accounts of the issuer on grounds of substance over form.

The views expressed above are merely meant to highlight the issue, but do not try to imply that there are only these two views. There may be other methods of accounting and there may different reasons to defend or reject the views cited.

Reasons for the IFRIC to address the issue

Clarification of the issue is considered being important, because the impact of whether or not an investor has to consider the issuer's classification when deriving an accounting policy has widespread implications: If the issuer's classification would ap-

ply also to the accounts of the investor, this would prevent the holder from considering any paragraph in IAS 39 that applies solely to equity instruments, such as

- the prohibition to classify non-quoted equity instruments whose fair value cannot be measured reliably as at fair value through profit or loss; (IAS 39.9)
- the subsequent measurement of these instruments at cost; (IAS 39.46(c))
- the recognition of income from these instruments as interest or dividend; (IAS 39.55)
- the prohibition to reverse an impairment charge that was recorded for an equity instrument in prior years following a loss event, but which is no longer prevalent. (IAS 39.66)

Apart from the accounting treatment in the holder's separate accounts, classification of the instrument would have further impacts on the preparation of the group accounts. Under IAS 27, the parent's investment would have to be consolidated against the subsidiary's equity:

> *"In preparing consolidated financial statements, an entity combines the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single economic entity, the following steps are then taken:*
>
> *(a) the carrying amount of the parent's investment in each subsidiary and **the parent's portion of equity of each subsidiary** are eliminated (see IFRS 3, which describes the treatment of any resultant goodwill); […]" (IAS 27.22; emphasis added)*

If, as a consequence of IAS 32, all of the subsidiary's capital was to be classified as financial liability, the a.m. paragraph could be read as requiring the holder to record its entire purchase price as goodwill.

In summary, the IFRIC's view on the following two issues would be highly appreciated:

1) Clarification as to whether View A or View B of this paper should be followed.
2) Guidance on the issue of consolidation of the subsidiary if IFRIC reaches the conclusion that View B is the correct interpretation of IAS 32 / IAS 39.

Submitted by:

Accounting Interpretations Committee (AIC)
c/o Accounting Standards Committee of Germany (ASCG)
Zimmerstr. 30
10969 Berlin

Staff contact:

Dr. Stefan Schreiber
Phone: +4930-20641225
Email: schreiber@drsc.de