Equity Instruments according to IAS 39

In July 2007, the Accounting Interpretations Committee (AIC) of the Accounting Standards Committee of Germany resumed its discussion of how the term "equity instrument", as used in IAS 39, should be interpreted. Having discussed this issue during the first half of 2006 already, the AIC had submitted the matter to the IFRIC in July 2006. However, the IFRIC refrained from adding the issue to its agenda and published a rejection note in January 2007. The AIC believes that this does not solve the issue that is of significant importance for German preparers. Therefore, the AIC seeks to further discuss the issue with IFRIC staff and to eventually bring it to the IFRIC again.

The question

The accounting treatment of a financial instrument by the holder depends, in certain situations, on whether the financial instrument in question is an equity instrument or a debt instrument. For example,

- the exemption from the requirement to measure the instrument at its fair value (if the instrument does not have a quoted market price in an active market and whose fair value cannot be determined reliably) is restricted to equity instruments and certain derivatives (see IAS 32.46(c));
- according to IAS 39.66 and IAS 39.69, any impaiment losses that occured in prior reporting periods may not be reversed (through profit or loss). In the case of a debt instrument, impairment losses shall be reversed through profit or loss.

In Germany, this question is of particular relevance, as – with regard to certain legal forms - the shares, or the capital contributed by the members respectively, are classified as liabilities under IAS 32 due to legal or contractual put rights of the members. If the holder of these instruments is an entity reporting under IFRSs, the question of whether these instruments are to be classified as either equity or debt instrument arises on a regular basis. Follow-up questions will arise on consolidation of these shares or accounting for the shares „at equity".

Possible views

View 1: Symmetry between IAS 32 und IAS 39

With respect to the definition of a “financial liability” and an “equity instrument”, IAS 39 refers to IAS 32.11 and thus incorporates the definition contained in IAS 32.11 into IAS 39 (see IAS 39.8). This reference to IAS 32 could be interpreteted as if the IASB intended symmetry between both standards. This view can be argued for on the basis of IAS 32.16, which states that the additional guidance in IAS 32.16 et seq. shall be considered when applying the definitions in IAS 32.11. If a financial instrument is a debt instrument (i.e. a liability) form the point of view of the issuer under IAS 32, the same instrument must also be a debt instrument from the point of view of the holder. In addition, a consistent set of standards does not allow for the same item to be treated differently across standards.

View 2: The classification is assessed on a stand-alone basis according to IAS 39 only

Under this view, the classification of a financial instrument as either an equity instrument or a debt instrument by the holder is assessed following IAS 39’s guidance only and based on the terms, conditions and characteristics of the financial instrument. The essential feature would be whether the instrument conveys a claim to the residual (see IAS 32.11 and Framework.49). Such a claim may be conveyed from the point of view of the holder even if the instrument is puttable, provided the put right does grant him any benefits apart from the residual claim. This view takes into account that an individual put right of the holder is be relevant for classification purposes at the level of the issuer, due to the financial risks associated with it. However, at the level of the holder, the put right simply adds to the instrument’s fungibility, and thus, is not relevant for classification purposes.

Since under view 2 the classification at the level of the issuer (under IAS 32) does not influence the classification at the level of the issuer (under IAS 39), the two classifications may be symmetrical or they may be different. In Germany, the most common situation will probably be the one in which a financial instrument puttable by the holder is classified as a financial liability (i.e. debt instrument) at the issuer’s level and the same instrument may be classified as an equity instrument at the holder’s level.

Tentative AIC View

The AIC tentatively decided to take view 2. Consequently, the holder would have to assess the instrument’s classification only according to IAS 39, based on the terms, conditions and characteristics of the instrument.