



AIC Position Paper:

Definition of an Equity Instrument in Accordance with IAS 39

A Introduction

International Financial Reporting Standards (IFRSs) define a financial instrument as a contract that gives rise to a financial asset of one entity to the contract and a financial liability or equity instrument of another entity (IAS 32.11). A financial liability also exists if the holder of the financial instrument has the right to put it back to the issuer and the issuer of the financial instrument does not have the unconditional right to avoid delivering cash or assets if the holder exercises its put right (IAS 32.11 and IAS 32.18).

It is questionable to what extent the classification of such an instrument by the issuer in accordance with IAS 32 takes priority and has an effect on the holder's accounting treatment of the instrument in accordance with IAS 39.

B Classification by the holder as an equity or debt instrument: Implications of the issue

In certain cases, the accounting treatment of a financial instrument depends on whether it is an equity or a debt instrument:

- For example, according to the definition of the 'financial asset or financial liability at fair value through profit or loss' (IAS 39.9) category, 'investments in **equity instruments** that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured' may not be allocated to this category.
- The exception to fair value measurement in IAS 39.46(c) only applies to investments in **equity instruments** that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives¹ that are linked to and must be settled by delivery of such unquoted **equity instruments**.
- IAS 39.61 contains additional requirements with regard to indications of objective evidence of the impairment of **equity instruments**.
- Under IAS 39.66 and IAS 39.69, impairment losses charged on **equity instruments** in prior reporting periods may not be reversed in subsequent periods even if the reasons for the impairment loss no longer apply. By contrast, impairment losses on debt instruments must be reversed.

¹ IAS 39.47(a) contains a similar exception if the derivative has a negative market price and therefore represents a financial liability.



This uncertainty is particularly significant in Germany because, in the case of certain legal forms, the shares or contributions by shareholders represent financial liabilities in accordance with IAS 32 by virtue of statutory or contractual put rights. If the holder of these shares is an entity reporting under IFRSs, the question of whether these shares are to be classified as equity or debt instruments in accordance with IAS 39 arises regularly.

C Possible views

C.1 View 1: Symmetry between IAS 32 and IAS 39

With regard to the definitions of a ‘financial liability’ and an ‘equity instrument’, IAS 39 refers to IAS 32.11 and uses the definitions contained there (see IAS 39.8). This reference could imply that the IASB intended to create symmetry between the two standards. A financial instrument that represents a financial liability from the issuer’s perspective in accordance with IAS 32 is therefore also a debt instrument from the holder’s perspective. In addition, it can be argued that the objective of a consistent set of standards does not allow the same item to be accounted for differently across standards.

C.2 View 2: Separate assessment exclusively in accordance with IAS 39

According to this view, the question of whether the holder must recognise an equity instrument is determined by the characteristics of the financial instrument in question exclusively on the basis of IAS 39. IAS 32.16 focuses explicitly on recognition by the issuer and it is questionable whether IAS 32.16 is relevant for the recognition of the instrument by the holder. The concept for recognising certain compound financial instruments adopted by IAS 32 (IAS 32.16 ff.) is not identical to the concept for recognising financial instruments with embedded derivatives in IAS 39 (IAS 39.10 ff. in conjunction with IAS 39.AG27 ff., see section D). Classification by the issuer (in accordance with IAS 32) has no effect on recognition by the holder (in accordance with IAS 39).

As a result, this could lead to both symmetrical and different classifications (by the issuer and the holder). Under the current version of IAS 32, different classifications could arise in particular because, simply due to certain legal corporate forms, it cannot be ruled out in Germany that the shareholders have the right to put back their shares to the issuer and, consequently, the shares must be recognised by the issuer as a debt instrument and by the holder as an equity instrument.

D Position of the Accounting Interpretations Committee (AIC)

In line with the guidance issued by the IFRIC², the AIC takes view 2, according to which the instrument must be classified by the issuer in accordance with IAS 32; by

² See IFRIC Update January 2007, p. 5.



contrast, the holder must assess the instrument separately and exclusively on the basis of IAS 39.

In line with the IFRIC, the AIC believes that a financial instrument that is puttable by the holder is a hybrid (combined) financial instrument in accordance with IAS 39.10 ff. The host contract is a puttable delivery of cash (shareholder contribution) and the embedded derivative is a put option. The issue of whether an embedded derivative must be accounted for separately is addressed by the guidance in IAS 39.AG27 ff.

From the holder's perspective, the guidance in IAS 32.18(b) therefore does not govern the classification of the delivery of cash. The only key issue determining classification as an equity or debt instrument here is whether the delivery of cash represents a residual interest in accordance with IAS 32.11 and F.49:

'An *equity interest* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.'

From the holder's perspective, a residual interest also exists in the case of a put right, which means that recognition as an equity instrument is appropriate. While the put right may be regarded as relevant for classification by the issuer (due to the financial risks caused by the individual put right), it merely increases the fungibility of the instrument for the holder. It therefore does not affect classification as an equity instrument.