

IAS 32 – Distinguishing between liabilities and equity

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“These proposals could mean more liabilities and less equity – plus enhanced presentation and disclosure – for hybrid capital instruments.”

Proposals for clearer classification principles and enhanced presentation and disclosure

Highlights

- Proposals aim to improve information about financial instruments issued by entities
- Clearer classification principles would help issuers distinguish liabilities and equity
- Enhanced presentation and disclosure proposed
- Next steps – Have your say

IAS 32 *Financial Instruments: Presentation* sets out how an issuer distinguishes between a financial liability and equity and works well for many, simpler financial instruments. However, classifying more complex financial instruments under IAS 32 – e.g. those with characteristics of equity – can be more challenging, leading to diversity in practice.

Proposals aim to improve information about financial instruments issued

In response, the IASB has published a discussion paper (DP) [Financial Instruments with Characteristics of Equity](#) (FICE) that seeks to improve IAS 32 by:

- establishing clearer principles for classifying financial instruments as either financial liabilities or equity;
- improving the clarity and consistency of the classification requirements for the more complex financial instruments that create a challenge in practice – e.g. derivatives on own equity; and
- enhancing the presentation and disclosures about financial liabilities and equity.

Clearer classification principles

To help issuers of financial instruments distinguish between a liability and equity, the Board proposes that issuers assess the presence or otherwise of two particular features of an instrument – i.e. the timing and the amount.

A non-derivative financial instrument would be classified as a financial liability if it contains:

- an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (timing); and/or
- an unavoidable contractual obligation for an amount independent of the entity's available economic resources¹ (amount).

1. An entity's available economic resources are the total recognised and unrecognised assets of the entity that remain after deducting all other recognised and unrecognised claims against the entity (except for the financial instrument in question).

Since equity is ‘the residual interest in the assets of the entity after deducting all of its liabilities’, a contract that contains neither of the two features would be classified as equity.

| | | Amount | |
|--------|--|---|--|
| | | Obligation for an amount independent of issuer's available economic resources | No obligation for an amount independent of issuer's available economic resources |
| Timing | Obligation to transfer economic resources at a specified time other than liquidation | Liability | Liability |
| | Obligation to transfer economic resources only at liquidation | Liability | Equity |

In a change to current IAS 32 requirements, the timing and the amount features would be applied consistently, regardless of whether a contract is settled by delivering an entity's own equity. For example, irredeemable fixed-rate cumulative preference shares would be classified as a financial liability. This is because the amount is independent of an entity's available economic resources – i.e. an issuer is not required to pay the principal and dividend before liquidation but the fixed-rate dividends accumulate over time. These preference shares might be classified as equity under current IAS 32.

Derivatives on own equity are currently classified as equity using the fixed-for-fixed condition. However, since IAS 32 does not explain the rationale for this condition, it is difficult to apply in practice when a derivative is more complex.

Consistent with the principles for classifying non-derivative financial instruments, the DP clarifies that the classification of a derivative on own equity would be determined using the timing and amount features. This means that a derivative on own equity would be classified as a financial asset or a financial liability if:

- it is net-cash settled – i.e. the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation (timing); and/or
- the net amount of the derivative is affected by a variable that is independent of an entity's available economic resources (amount).

A derivative on own equity is classified as equity if neither of the conditions above are met.

The DP also discusses the relationship between compound instruments and redemption obligation arrangements and proposes that transactions that have the same settlement outcome should be accounted for consistently, regardless of how the transaction is structured – e.g. a convertible bond and a written put option on own equity.

Enhanced presentation and disclosure proposed

To help distinguish the broad spectrum of financial instruments, the Board proposes that more information is disclosed in the financial statements to help users assess an entity's financial position and performance and ease comparison between entities.

For example, financial liabilities that provide equity-like returns would be distinguished from other financial liabilities by separate presentation in the statement of financial position, and presentation of their income and expenses in other comprehensive income (OCI) without subsequent reclassification. This would also apply to non-equity derivatives.

In response to investors' requests for more information, the Board is proposing additional disclosures on equity instruments as well as considering how returns on equity are distributed or attributed among the different equity instruments an entity issues.

Have your say

The deadline for comments on the DP is 7 January 2019. The Board will consider the comments received on this DP before deciding whether to develop an exposure draft with proposals to amend or replace parts of IAS 32 and/or to develop non-mandatory guidance.

We encourage you to take this opportunity to comment on the proposals.