IAS 32: Classification of a Liability Following a Change in Functional Currency

Excerpt, IFRS Discussion Group Report on Meeting – September 28, 2011

IAS 32 Financial Instruments: Presentation establishes principles for presenting financial instruments as liabilities and equity, including whether contracts settled in an entity's own equity instruments are financial liabilities or equity instruments. Paragraphs 21-24 of IAS 32 address the classification of a contract that involves settlement in an entity's own equity instruments. Paragraph 22 of IAS 32 states that "a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument." This requirement is often referred to as the "fixed for fixed" criterion. If this fixed for fixed criterion is not met, an instrument would be considered a financial liability. For example, an instrument denominated in a currency other than the entity's functional currency would be classified as a financial liability because this instrument is considered to violate the fixed for fixed criterion.

The IFRS Interpretations Committee has previously issued agenda decisions on IAS 32 that provide further information on the application of IAS 32 (see "Convertible instruments denominated in a foreign currency" on page 2 in the April 2005 IFRIC Update and "Changes in the contractual terms of an existing equity instrument resulting in it being reclassified to financial liability" on page 7 in the November 2006 IFRIC Update).

The issue considered by the Group was whether a change in functional currency subsequent to initial recognition that results in the financial instrument now meeting the fixed for fixed criterion should result in reclassifying the financial liability to equity:

> View A – The instrument is not to be reclassified
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> Paragraph 15 of IAS 32 requires an instrument to be classified as a financial liability or equity instrument on initial recognition. This requirement can be interpreted to mean that classification occurs only on initial recognition and it is not subsequently revisited. This view is further supported by paragraphs IG35 and IG36 in the implementation guidance in IFRS 1 First-time Adoption of International Financial Reporting Standards, IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments and IFRIC 9 Reassessment of Embedded Derivatives.
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> View B – The instrument should be reclassified
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> The definitions of financial liability and equity are in the present tense and imply that the definitions are to be applied at each reporting period. The references cited in View A are not relevant because IFRIC 9 is an interpretation of standards other than IAS 32 or they are not authoritative.
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> View C – Select View A or B

> An entity can make an accounting policy choice to either reclassify or not reclassify the instrument because IAS 32 does not provide specific guidance. This accounting policy should be followed consistently.

Some Group members observed that the various references to the standards cited in support of each view were not particularly convincing. Group members were concerned that under View A an entity could have two identical instruments with different classifications solely because the two instruments were issued at two different points of time (i.e., one issued before a change in functional currency and the other after that change). Some noted that, although View A is supported by a narrow reading of the standard, given that functional currency was the key in determining the initial classification, a change in functional currency should reasonably be considered in assessing classification subsequently. Others noted that the paragraphs added to IAS 32 in the February 2008 amendments "Puttable Financial Instruments and Obligations Arising on Liquidation (Amendments to IAS 32 and IAS 1)" (i.e., paragraphs 16A to 16F) would not have been necessary if the IASB intended entities to change initial classifications generally. Some observed that IFRIC 9 should be applied by analogy and others noted that The Conceptual Framework for Financial Reporting supports a different approach.

Some Group members acknowledged they hadn't previously considered whether an instrument should be reclassified but thought that there was a need for further consideration of the measurement basis and whether the change in functional currency triggers derecognition.

Group members observed that the existence of a number of IFRIC agenda decisions and the subsequent amendments to IAS 32 in 2008 contributes to the overall confusion surrounding this issue. The Group observed that in 2005 the IFRS Interpretations Committee asked the IASB to consider addressing this issue and the IASB had drafted proposed amendments. However, the IASB did not proceed with those proposed amendments.

The Group concluded that the issue should not be brought to the attention of the IFRS Interpretations Committee because the issue is multi-faceted and a change in functional currency is not expected to occur for most entities. Group members noted that this issue is most likely to be resolved if the IASB decides to complete its project on financial instruments with the characteristics of equity or add a project to its agenda on foreign currency.