IAS 1 and IAS 32: Classification of Debt with Embedded Equity-linked Derivatives

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IAS 1 *Presentation of Financial Statements* contains guidance regarding the classification of liabilities as either current or non-current in an entity's financial statements.

Paragraph 69(d) of IAS 1 states that an entity shall classify a liability as current when "it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period." It further clarifies that the "terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification."

For the purposes of this discussion, the latter portion of paragraph 69(d) of IAS 1 will be referred to as the "clarifying guidance."

Paragraphs BC38E-BC38F in the Basis for Conclusions to IAS 1 provide further background regarding the IASB's decision to add clarifying guidance to amend paragraph 69(d) of IAS 1 as part of its improvement project in 2007. Absent the clarifying guidance, the conversion of a liability into equity would be considered a form of settlement. This means that if the conversion option can be exercised by the holder at any time, the liability component would be classified as current.

Convertible debt is a common type of financial instrument used to raise financing. The terms of a financial instrument may contain elements that are representative of both equity and liability instruments. This instrument, as a whole, would be known as a compound financial instrument and the equity and liability components are accounted for separately.

It should be noted that many conversion features (or other equity-linked features) do not meet the criteria for equity classification because the "fixed-for-fixed" condition in IAS 32 *Financial Instruments: Presentation* is not met, notwithstanding the fact that shares are issued in satisfaction of the holder exercising the conversion feature. However, the Basis for Conclusions to IAS 1 does not contemplate explicitly the situation whereby the conversion (or other equity-linked) feature of a convertible debt instrument is classified as a derivative liability rather than as an equity instrument. The issue that arises is whether the clarifying guidance noted in paragraph 69(d) of IAS 1 regarding the classification of a liability as either current or non-current can also be applied to a hybrid contract that contains a non-derivative host component and an embedded derivative component (for example, an embedded derivative liability).

Issue: May the clarifying guidance in paragraph 69(d) of IAS 1 be applied to convertible debt with a conversion feature that is classified as a derivative liability?

View A – Yes, the clarifying guidance in paragraph 69(d) of IAS 1 may be applied.

Although the Basis for Conclusions to IAS 1 does not specifically contemplate a situation when the conversion feature of the convertible instrument is classified as a liability, the settlement of the conversion feature through the issuance of a variable number of equity instruments rather than a fixed number should not affect the classification of the convertible feature as either current or non-current. In both situations, the derivative liability will be settled through issuance of the entity's own equity.

Further, paragraphs BC38G and BC38H in the Basis for Conclusions to IAS 1 articulate the IASB's position that "information about the liquidity and solvency positions of an entity is useful to users" and that "classifying the liability on the basis of the requirements to transfer <u>cash or other assets</u> rather than on settlement better reflects the liquidity and solvency position of an entity" (emphasis added). Therefore, under this view, it is presumed that the clarifying guidance can be applied because the classification of the shares issued to settle the conversion feature as either liabilities or equity instruments is not relevant.

View B – No, the clarifying guidance in paragraph 69(d) of IAS 1 may not be applied.

The clarifying guidance in paragraph 69(d) of IAS 1 was written in the context of a convertible instrument whose conversion feature is classified as an equity instrument as opposed to a liability.

Paragraph BC38E of the Basis for Conclusions to IAS 1 begins by considering the "classification of the liability component of a convertible instrument" and states that "conversion of liability into equity is a form of settlement", both of which could imply that the situation contemplated was in relation to a compound financial instrument when there is a liability component and an equity component. The clarifying guidance refers to "settlement by the issue of <u>equity instruments</u>" (emphasis added), which leads to the question as to whether shares issued in satisfaction of a conversion feature that does not meet the "fixed-for-fixed" condition in IAS 32 are considered "equity instruments."

The Group's Discussion

The majority of Group members supported View A, that the "clarifying guidance" in paragraph 69(d) of IAS 1 can be applied by analogy. The rationale is that the derivative liability will not be settled by a cash outflow, but rather will be settled using the entity's own equity even if it violates the "fixed-for-fixed" condition in IAS 32. Therefore, the debt host component of the hybrid contract would be classified as non-current (assuming the other criteria requiring current classification are not met).

One Group member also observed that this perspective can be extended to other similar instruments (for example, a warrant) but noted that complicating circumstances may exist when the instrument could be settled in either shares or cash. In such cases, professional judgment is required to interpret the guidance in paragraph 69 of IAS 1 to determine the appropriate classification.

Some Group members noted there is support for View B in that the "clarifying guidance" was written for equity instruments that meet the "fixed-for-fixed" condition in IAS 32. However, Group members observed that View A could be considered a more sensible approach because if the instrument is classified as current but the settlement does not result in a transfer of cash, View B does not appear to provide meaningful information to users of financial statements.

The Group also discussed that the debt host component of the hybrid contract and the derivative liability should be presented together as a whole such that both components would be classified using the same current or non-current classification.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.