Debt or equity: The role of shareholder decisions

The classification of an instrument as debt or equity is often complex. The overall substance of the instrument determines its classification. This may require judgement about certain features of the instrument. This article considers one such aspect, namely the effect of decisions by shareholders.

It is often a complex decision to classify an instrument issued by an entity as debt or equity. IAS 32 *Financial Instruments - Presentation* ('IAS 32') governs this classification. The standard provides broad principles as well as detailed guidelines to assist preparers. In this article, I consider a specific aspect that affects the question of classification and that is contentious in practice. This is the effect of decisions of shareholders. A recent submission to the IFRS Interpretations Committee ('the IFRIC') raised this question.

Principles for classification as debt or equity

The core principle in IAS 32 is that an instrument is an equity instrument if it complies with two requirements. The first requirement is that the instrument contains no contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or liabilities under potentially unfavourable conditions for the issuer. The second requirement relates to instruments that will or may be settled in the issuer's own equity instruments and the terms on which such settlement will or may occur.

Decisions by shareholders, which is the focus of this article, mainly affect the application of the first requirement. The guidance in IAS 32 indicates that in circumstances where an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle an obligation, the obligation meets the definition of a financial liability. One should not only consider explicit obligations but also obligations established indirectly through the terms and conditions of the instrument. This complicates the assessment. The application guidance illustrates that an entity does not have a contractual obligation if the payment is at the discretion of the issuer.

If a payment depends on a decision(s) by a shareholder of the issuer, the question arises whether the shareholder makes that decision as a shareholder or in the course of management of the issuer entity. If the latter, one can argue that this forms part of the issuer exercising its discretion to make the payment.

IFRIC submission and agenda decision

The IFRIC considered a scenario that involved a special purpose acquisition company ('SPAC').At inception, the SPAC must still identify the acquisition target. Such an acquisition requires management and/or shareholder approval. Certain shareholders may request reimbursement of their shares upon identification of the target. If the SPAC fails to identify a target within a specific period, the SPAC must liquidate unless shareholders vote to extend its lifespan.

The submission essentially asked the IFRIC's guidance on the effect of decisions of shareholders, firstly, on the acquisition and possible reimbursement obligations and, secondly, the decision to extend the life of the SPAC which impacts whether the shareholders are entitled to liquidation distributions, on the classification.

The IFRIC acknowledged that the decisions by shareholders pose practical difficulties in classifying instruments. IAS 32 does not include any requirements on how to assess the nature of these decisions. Given the broader implications of the matter, they did not address the question. Instead, the committee indicated that this is one of the matters that the IASB considers as part of another project, Financial Instruments with Equity Characteristics.

Conclusion

The classification of an instrument invariably depends on the terms as well as specific facts and circumstances of the instrument. As illustrated in the scenario that the agenda decision considered, it may require significant judgement to determine the effect of some terms and conditions on the classification of an instrument. The classification decision ultimately depends on the basis of the substance of the instrument and all factors that affect this. Entities should disclose with information about the instruments and judgement exercised to assist users.

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