Shares issued: Are they debt or equity?

Although shares are often accounted for as equity, consistently with their legal form, this is not always the case. If shares contain terms that cause them to have debt features, the issuer could be required to account for them as a liability. This article provides an overview of some of terms that impact the classification of shares.

Intuitively, accountants tend to treat shares issued by a company as equity based on their legal form. The classification of the shares by the issuer in terms of IFRS, however, requires a more detailed analysis of their terms. Shares that, in substance, have the features of debt are accounted for as liabilities. This article discusses the guiding principles and some of the factors to consider in making this assessment.

Principle: Debt or equity

IAS 32 *Financial Instrument: Presentation* governs the classification of an instrument by its issuer as a financial liability or equity.

A critical distinction is the existence of a contractual obligation for the issuer of the shares to either deliver cash or another financial asset to the holder, or exchange financial assets or liabilities with another party under potentially unfavourable conditions. If the issuer has such an obligation, which it does not have an unconditional right to avoid, the obligation is a financial liability. At the other end of the spectrum is an equity instrument, where all payments to shareholders are fully at the issuer's discretion.

Factors that affect the assessment

IAS 32 provides guidance on various factors that could affect an issuer's obligations and the classification of an instrument. They include:

- The terms of the shares may contractually oblige the issuer to make certain payments. Examples include obligations to pay mandatory dividends or mandatorily redeem capital on specified dates. Conditionality or contingency, whether regulatory or otherwise, that affects this obligation often complicates this assessment.
- An unavoidable obligation may also exist if a shareholder holds the right to require the issuer to redeem the shares. In some instances, the capacity in which a shareholder acts requires further consideration. There is an exception for certain instruments that the holder may put to the issuer, which would ordinarily be classified as a liability, but that represent a residual claim to the issuer's net assets.
- IAS 32 prescribes specific rules to classify the instrument as a financial liability or equity if an issuer must or may settle an instrument in its own equity instruments.
- In some instances, the terms of an instrument may indirectly establish an obligation for the issuer. This is distinguishable for terms that economically encourage the issuer to make payments.

In conclusion

An instrument's classification for accounting purposes is often consistent with its form, but this is not always the case. Shares with complex terms, such as the ones considered in this article, require a detailed analysis to assess whether they should be accounted for as equity or are, in substance, liabilities for the issuer. Debts or loans may also have equity features and could be required to be accounted for as such, although this is less common in my experience.

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