IAS 32 *Financial Instruments: Presentation* (November 2006)

Classification of a financial instrument as liability or equity

At its meeting in March 2006, the IFRIC discussed a submission for a possible agenda item relating to the role of contractual obligations and economic compulsion in the classification of financial instruments. At that meeting and the following meeting in May, the IFRIC agreed not to take the item onto the agenda but did not agree on reasons to be given for that decision.

At the IFRIC meeting in July, the Chairman reported the Board's discussions on the issue at its meeting in June 2006. As stated in the June 2006 IASB *Update*, The Board discussed whether so-called economic compulsion should affect the classification of a financial instrument (or a component of a financial instrument) under IAS 32 *Financial Instruments: Presentation*. This issue had previously been debated at the IFRIC meetings in March and May 2006.

For a financial instrument (or a component of a financial instrument) to be classified as a financial liability under IAS 32, the issuer must have a contractual obligation either:

- to deliver cash or another financial asset to the holder of the instrument, or
- to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. (Different requirements apply to financial instruments that may or will be settled in the issuer's own equity instruments.) The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.

In view of the Board's discussion, the IFRIC believed that it could not achieve anything substantial by adding the issue onto the agenda. Instead, the IFRIC agreed to draw the Board's attention to comments raised by constituents and to ask the Board whether anything could be done to achieve even greater clarity on this point.