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IAS® Standard 32 Financial Instruments: Presentation

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CASE STUDY – IAS 32 FINANCIAL INSTRUMENTS: PRESENTATION

Introduction

Financial instruments used in today's economies can be quite complex and difficult to understand. Accounting, valuation, classification of financial instruments and making explanations about financial instruments is a very comprehensive subject. This comprehensive subject has been addressed with 3 different accounting standards. Classification of financial instruments in financial statements is within the scope of IAS 32.

In this case, it is aimed to explain how to classify financial instruments according to their characteristics under certain conditions.

The Case Information

Troy Company is a toy company founded in 1998. The company has become an important player in the market in a short time with its quality toys that are loved by children. In order to grow in this period, Troy company has taken care to establish strategic partnerships both on the supply side and on the sales and distribution side. Troy Enterprise signed an agreement with Rapid Plastics Company, a small chemical company, in 2016 as part of this strategic cooperation plan. Under this agreement, the Troy company would provide her with financing to support the growth of Rapid Plastics company. In this agreement, Troy Company presented two alternatives to Rapid Plastics Company.

In the first alternative, Troy Company would purchase some shares of Rapid Plastic Company for CU 200,000. Rapid Plastic Company would pay an annual dividend of CU10,000 over 10 years in exchange for these purchased shares. Ten years later, Troy Company would sell the shares it had bought back to Rapid Plastic Company for CU250,000.

In the second alternative, the Troy company would also lend CU200,000 to Rapid Plastic. According to the agreement, Rapid Plastic Company would be able to pay off this debt in two different ways after 5 years. In the first, Rapid Plastics Company would be able to pay off the debt by paying CU400,000 in cash. The second was that Rapid Plastic company would give 2,000 shares to Troy Company to cover the debt. However, the decision of which of these alternatives to be applied would be determined by the management of Troy Company.

Rapid Plastic Company executives, after the evaluations, decided that the first option would be more suitable for the entity. After the approval of both parties, an agreement was signed on December 29, 2016, and the sale of shares was realized. At the end of 2016, Troy Company classified the purchased shares as financial asset investments to be reported at Fair Value Through Profit and Loss. On the other hand, Rapid Plastic Company recognized this agreement as a share sale.

Discussion Questions

a. Is the way of the presentation of this agreement in the statement of financial position appropriate for both companies? Even if the business has legally sold shares, can it report it as a different transaction in its financial statements?

b. If the businesses had chosen the second alternative, how would this agreement affect the financial statements of the entities?

SOLUTION OF CASE STUDY – IAS 32 FINANCIAL INSTRUMENTS: PRESENTATION

a. There are two parties in this case: Troy Company and Rapid Plastic Company. For Troy Company, shares purchased under the given agreement are financial assets. According to IAS 32, an equity instrument of another entity is a financial asset. The classification of this financial asset will be determined according to the business model test and cash flow characteristics test specified in IFRS 9.

   Rapid Plastic Co, on the other hand, needs to decide whether this financial instrument is a financial debt or an equity instrument. Considering the legal framework of the agreement, the stocks to be given should be classified as equity instruments. The first critical question for classification is whether the relevant financial instrument contains contractual obligations. Analysing the deal, we understand that Rapid Plastic Company is issuing shares and sending them to Troy Company. However, Rapid Plastic Company is obliged to pay a fixed dividend to Troy Company for 10 years and undertakes to repurchase the shares at the end of 10 years by paying a predetermined price. This is a contractual obligation. Due to that Rapid Plastic should classify this as a financial liability.

b. The second alternative looks like a liability from a legal perspective. Troy Company extends a CU200,000 loan to Rapid Plastic Company and obliges Rapid Plastic Company to pay CU450,000 at the end of the fifth year, even though it does not charge periodic interest payments for 5 years. Up to this point, this transaction seems to be a financial liability in terms of IAS 32.

   However, in the agreement, Troy Company has the right to purchase 2,000 Rapid Plastic Company shares instead of receiving the CU450,000 repayment. The agreement includes a contractual obligation as well as an equity component. In this case, it should be considered as a compound instrument. Rapid Plastic Company management should first calculate the value of the portion to be classified as financial liability in relation to this compound instrument. Afterwards, it should find the equity instrument value by subtracting the financial liability amount from the total amount.