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Some Aspects of Loan and Capital Financial Instruments

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Financial Instruments are any contract that generates both the financial assets of one enterprise as well as the financial liability of the second enterprise or the equity instrument. In many cases, the contract does not clearly indicate what the enterprise has to do with financial liabilities or equity instruments. Emission and equity instruments are implemented in different conditions, which determine the actual economic content of the instrument. Their recognition, measurement and accounting procedures differ significantly, while their correct classification affects the financial indexes and the financial conclusions and decisions made by an user of the financial information. Thus, it is important to properly identify, measure and reflect in the financial statements all financial instruments.

Keywords: *Financial instruments; Loan instruments, Equity instruments; Difficult financial instruments, Option.*

JEL Codes: *G10, G18, G21*

Introduction

When preparing the financial statements, it is important to distinguish between loan and equity financial instruments. Their classification affects the company's financial indicators, namely, its agreements (covenants). The difficulty lies in the fact that many instruments can have characteristics of financial liabilities and equity instruments simultaneously (L.Sabauri, 2018). When it is difficult to find out what we are dealing with - equity or loan instrument, the principle of superiority of the economic content on a legal form, shall apply.

IAS 32 Financial instruments: Presentation - The main objective is to determine the principles of liabilities or equity of financial instruments as well

as the principles of financial assets and financial liabilities. Understanding the rules of classification of financial instruments and the effective use of these rules are important for a company leadership for the following reasons, at least (IASB, 2016):

• Classification of financial instruments as a capital or classification has a significant impact on the organization's indicators, namely on the covenants;

• Shareholders may accept negatively a classification of the financial instrument in a form of the equity instrument, if they consider that such instrument causes uncertainty of shares in the equity capital of the organization;

• Shareholders might not like to classify financial instruments as liabilities, since liabilities have normally the accrued interest that reduce profit, while decrease of the profit affects the company's ability to pay dividends on shares;

• The difference between loan and equity instruments is important when the organization makes financial instruments at the time of business / enterprise merger.

Prior to the classification of the financial instruments, it is necessary to find out what is meant under the financial obligation (debt instrument) and the capital instrument (equity instrument) in the standards (Stephen G. Ryan, 2012).

How to distinguish between loan and equity instruments

According to IAS 32 [1, p.11], a**a** financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

In connection to the last paragraph, an explanation is needed that the enterprise's own equity instruments for a fixed amount of any currency unit in the fixed amount of purchase rights, options and warrants – are the equity instruments, if the enterprise presents its own class of non-derivative equity instruments to all its holders, on a proportional basis (Mary E. Barth, Katherine Schipper, 2008).

At the same time, the items listed below does not belong to the entity's own equity instruments, for this purpose:

- Returnable financial instruments (with the right to redemption) [1, pp. 16a; 16 b]. Returns is a financial instrument that allows the owner to return the refund through the money transfer or other financial assets or automatically returns the issuer in the event of an uncertain event in the future or when the instrument holder dies or pension [1, p.11].
- Instruments that the enterprise undertakes to transfer to the other party the proportionate share of the net assets of the enterprise in case of liquidation and are classified as equity instruments [1, pp. 16, d];
- Acceptance or delivery agreements of the future enterprise of the enterprise;
- Exception: An instrument that meets a financial liability is classified as a equity instrument if it has all the features and meets all relevant conditions required by IAS 32.

The main feature of the loan instrument is to pay the issuer (the issuer) the money or the financial instrument to the holder of the instrument. Contract obligation may arise with the request of payment of principal, interest or dividends of the debt. Such a contract may be directly or indirectly based on the terms of the agreement. For example, the bond under which the issuer must pay interest and repurchase or repay it, classified as a liability (Sabauri L.2015).

In contrary to the obligations, the equity instrument is any agreement confirming ownership of shares remaining after the deduction of all its liabilities in enterprise assets [1, p. 11]. For example, classification of ordinary shares with which the payments are made only by the wishes of the issuer, the issuer is an equity instrument. An equity instrument may also be considered a financial instrument that can be covered or may be covered by equity instruments issued by the issuer. Thus, the privileged shares, which are subject to conversion, are fixed as fixed fixed quantity of ordinary shares or on the event of occurrence that will occur and also be classified as a equity instrument.

At the same time, the contract is not always recognized as an equity instrument in the registry of the issuer only because it is assumed to be accepted or transmitted by the issuer's equity instruments. In such a case, the classification of the contracts depends on whether the amounts of equity instruments, receivables or financial assets to be transferred are considered to be:

a. If the contract provides for the transfer or transfer of the distinctly fixed (fixed) quantity issued by the enterprise in exchange for a clearly defined (fixed) amount or other financial assets, such a contract shall be considered an equity instrument;

b. If there is any change in the transfer or acceptable amount or equity instruments, such a contract shall be deemed to be a financial asset or liability.

For example, if the enterprise shall transfer the equity instruments of its own emissions, the value of which is equivalent to the sum, the other side of the contract will be the only one who will receive the money or equity instruments whose value is equal to that amount. Therefore, such a contract is considered as a loan instrument (Kvatashidze Nadezhda, 2012).

In order to be considered as a loan instrument, the following should be established:

- Whether the issuer is obliged to buy their own instruments by force or contract;
- Redeeming instruments by the decision of the other party of the Treaty;
- The term of the instrument circulation is limited;
- Whether the instrumental redemption is due to the future unforeseen occurrence or in the absence of which the Contracting Parties can not influence;
- Does the issuer pay any kind of dividends if he / she can refuse to pay if such a decision is made by its shareholders?

Classification of a financial instrument as the liability or equity instrument should be based on the legal basis of the principle of economic substance. Some tools are structured to achieve certain goals related to taxation, financial accounting or regulatory requirements. In such a time it is difficult to reveal the economic content of the instrument. For example, privileged shares whose owner may require their redemption from the issuer, are treated as debt instruments, even if legally recognized as equity instruments.

The classification of the privileged shares shall be taken into consideration as to the specific funding of the instrument's funding and the contract relating to the income received from it. For instance, privileged shares in some states differ from the usual just by assuming that the precedent of dividends is precedent. In this case, privileged action can be considered as an equity instrument (Sabauri L. 2017). Legislation or release conditions in different countries oblige the issuer to redeem privileged shares - in this case they are classified as financial liabilities.

The enterprise must decide how to classify the instrument at initial recognition. The IAS 32 does not directly reflect the further change of such classification.

Exceptions are refundable instruments and instruments that oblige the enterprise to transfer the proportionate share of its net assets to the other party only during liquidation, cases related to reclassification [1, 16e, 16f].

The distinctive feature of the loan and equity instrument is that when the issuer does not have the unconditional right to prevent payment of money and other financial assets for the purpose of payment of liabilities. Such an obligation can be established directly or indirectly, but its basis shall be the terms of the financial instrument itself.

Economic necessity should not have a decisive impact on the classification of a financial instrument. For example, restrictions on the ability of the enterprise to perform such an obligation when it does not have a sufficient amount of distribution winnings, does not violate its contractual obligations.

When it is Difficult to Classify the Instrument

Sometimes dividing equity and loan instruments is not easy. For example, when shares or options are a way of settlement, and allowsa variable number of shares, or when a financial instrument allows to the owner to request a redemption. For example, the enterprise undertakes to repay a credit debt of 10 MIO CU through issuing after a year its own shares in a value of 12 MIO CU. In this case, the enterprise undertakes to transfer to the creditor not a fixed amount of shares nut the number of shares valued as 12 MIO CU. Since the market value of the shares is changeable, a different amount of shares may be issued on the day of repayment of the credit debt, and not the amount fixed as at the date of the contract. Such a contract is not an equity instrument, since the enterprise uses a variable equity instrument to cover the contractual obligation. Consequently, this Agreement does not guarantee ownership of the shares remaining after the deduction of all its liabilities in the enterprise assets and is classified as the financial liability [1, p. 21].

The contract, which is compensated by the company for a fixed quantity of its equity instruments (receiving or transferring), is a equity instrument in exchange for a fixed amount of cash or other financial asset.

The second situation - the stock option. The company has released its own stock options. The number of shares that the owner of the option can receive in exchange of payment of 1,0 MIO CU, depends on the volume of sales of the enterprise in the previous reporting period. On the one hand, the option for the stock issuer enterprise means the emission of its equity instruments in exchange for the money to be received. However, on the other hand, the issuer enterprise is obliged to transfer not the fixed number of shares but the variable amount which depends upon the volume of the sales. Accordingly, the enterprise should not classify the option as an equity instrument (Lopes P.T., Rodrigues L.L. 2006).

According to the financial instrument with the right to redemption, the issuer is obliged to redeem or cover the instrument for money or other financial assets at the time of sale of such right.

Classification of shares of the open-type equity funds is associated with certain difficulties. The open-type equity fund (OEF) is an investment fund the shares of which can be sold to the Fund managing company at any day, on the basis of of daily calculation of the net assets of this fund. Correspondingly,

the OEFs are the instruments with the redemption right. In general, the similar instruments are classified as the loan instruments because they include the redemption right, but, they cannot be classified as the equity instrument unless they hold all the features defined by Points 16a and 16b of IAS 32:

It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation.

The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument has no priority over other claims to the assets of the entity on liquidation, and does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments

All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features

Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity over the life of the instrument (excluding any effects of the instrument)

In addition to the above listed, to classify the instrument as the equity one, it is necessary that an issuer must not have any other financial instrument or contract that satisfies the two criteria simultaneously:

- Total cash flows based substantially on the profit or loss, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such instrument or contract) and
- The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in Paragraph 16a that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that

this condition is met, it shall not classify the puttable instrument as an equity instrument

Although such shares are classified according to IAS 32 as the equity instruments, they are not considered so for the purpose of use of IFRS 9 [2, p.5.7.5], since they do not meet the interpretation of equity from the very beginning (IASB, 2014).

Difficult Financial Instruments - Instruments with Capital and Liability Elements

Some financial instruments include both liability and equity elements. For example, bonds convertible to a strictly defined number of shares are: a financial obligation element is a part of the contract on cash transfer, and the equity instrument element is the holder's right to perform its conversion into a fixed quantity of ordinary shares of the enterprise. In this case the liability element is reflected separately from the capital element.

The real value of the paid or compensated amount shall be distributed between the part of the financial obligation and the component of the equity in time of the initial recognition of such instrument. The fair value of a financial liability is measured by the fair value of a similar liability which is not related to the right of conversion in the shares (option). While the fair value of the equity of the capital is determined as the difference between the actual value of the financial instrument and the real value of its composition as a financial liability (Steve Collings, 2012).

Conclusion:

- The classification of the right to acquire additional shares by the existing shareholders may be made as equity instruments, if the price is expressed in currency, which differs from the functional currency of the enterprise. The value of the right may be expressed in the currency, which differs from the functional currency of the enterprise if the enterprise securities are quoted in more than one jurisdiction or is required by the legislation. If a fixed price is expressed not in a functional currency, the condition is usually not fulfilled by a certain amount of shares on a certain amount of money. Nevertheless, according to IAS 32, such right to purchase additional shares is classified into the issuer's account as a equity tool for the following reasons:
- Besides, for this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata

to all of its existing owners of the same class of its own non-derivative equity instruments [1,IAS 32, p.11];

• The right to buy fixed quantity of ordinary shares with fixed amount expressed in any currencies (including currencies other than functional) are recognized as equity instruments if these rights are allotted to each owner of their own non-derivative equity instruments on a proportionate basis (IAS 32, p.16);

• Classification of the financial instruments as the loan and equity instruments, should be based on the definitions provided by IAS 32;

• When classifying the financial instruments as the loan and equity instruments, the principle of superiority of the economic content on a legal form, shall apply;

• Difficult financial instruments are classified as the liability and capital elements.

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ფინანსური ინსტრუმენტები არის ნებისმიერი ხელშეკრულება, რომელიც წარმოშობს როგორც ერთი საწარმოს ფინანსურ აქტივს, ასევე მეორე საწარმოს ფინანსურ ვალდებულებას ან წილობრივ ინსტრუმენტს. ხშირ შემთხვევაში ხელშეკრულებაში ნათლად არ ჩანს რასთან აქვს საწარმოს საქმე - ფინანსურ ვალდებულებასთან, თუ წილობრივ ინსტრუმენტთან. სასესხო და წილობრივი ინსტრუმენტების ემისია ხდება სხვადასხვა პირობებით, რაც განსაზღვრავს ინსტრუმენტის რეალურ ეკონომიკურ შინაარს. მათი აღიარების, შეფასების და აღრიცხვის წესი მნიშვნელოვნად განსხვავდება, ხოლო მათი სწორი კლასიფიკაცია გავლენას ახდენს ფინანსურ კოეფიციენტებზე და ფინანსური ინფორმაციის მომხმარებლების მიერ გაკეთებულ დასკვნებზე და მიღებულ გადაწყვეტილებებზე. ამდენად, მნიშვნელოვანია ყველა ფინანსური ინსტრუმენტების სწორად იდენტიფიცირება, შეფასება და ასახვა ფინანსურ ანგარიშგებაში.

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