Section 5—Definition of equity and distinction between liabilities and equity instruments

Introduction

5.1 This section discusses:

(a) the definition of equity, including the measurement and presentation of different classes of equity (see paragraphs 5.2–5.21); and

(b) whether the distinction between liabilities and equity instruments should be based solely on the definition of a liability (see paragraphs 5.22–5.59).

Definition of equity

5.2 The existing *Conceptual Framework* defines 'equity' as the residual interest in the assets of the entity after deducting all its liabilities.[40] The IASB's preliminary view is that it should not change that definition.

5.3 Total equity equals total assets, less total liabilities, as recognised and measured in the financial statements. It does not depict the value of the entity.

5.4 Total equity at the end of a period generally equals:

(a) total equity at the start of the period (restated, if applicable, for changes in accounting policies, and to correct previous errors); plus

(b) contributions to equity in the period; minus

(c) distributions of equity in the period; plus

(d) comprehensive income for the period; plus

(e) capital maintenance adjustments, if applicable (see Section 9).

5.5 Typically, entities divide total equity into various categories. IFRS does not generally prescribe which categories of equity an entity should present separately, because determining which categories are most relevant to users of financial statements may depend on local legislation and on the reporting entity's governing constitution. Similarly, IFRS does not generally specify the categories of equity in which an entity should present the effects of particular transactions, measurements or other events. IAS 1 *Presentation of Financial Statements* requires an entity to disclose a description of the nature and purpose of each reserve within equity.

5.6 In most cases, total equity is positive, though it can also be negative, depending on whether all assets and liabilities are recognised and on how recognised assets and liabilities are measured. Similarly, the individual categories of equity may be positive or negative.

5.7 This Discussion Paper uses the following terms for convenience, without defining them formally:

40 See paragraph 4.4(c) of the existing *Conceptual Framework*.

(a) *equity claim*: a present claim on the equity of an entity (ie a residual interest in the assets of the entity after deducting all its liabilities). For the purposes of this Discussion Paper, an equity claim is either a primary equity claim or a secondary equity claim.

(b) *primary equity claim*: a present right to share in distributions of equity during the life of the reporting entity or on liquidation.

(c) *secondary equity claim*: a present right or a present obligation to receive or deliver another equity claim.

(d) *equity instrument*: an issued financial instrument that creates equity claims and creates no liability.[41]

5.8 Examples of equity instruments include:

(a) equity instruments that create primary equity claims, including:

(i) ordinary shares;

(ii) other classes of shares (for example, some preferred shares, some deferred shares); and

(iii) non-controlling interests (NCI) in a subsidiary.

(b) equity instruments that create secondary equity claims, including:

(i) forward contracts to buy, sell or issue an entity's own shares; and

(ii) options to buy or sell an entity's own shares.

(c) an equity component of a financial instrument that contains both an equity component and a liability component, if an entity is required or permitted to separate those components. IAS 32 *Financial Instruments: Presentation* requires such separation in some cases. As noted in paragraph 5.54, identifying whether and when to permit, require or prohibit such separation would be a decision for the IASB to make when it develops or revises particular Standards, rather than for the *Conceptual Framework*.

5.9 Whether a financial instrument or other contract creates a liability depends not on the legal form of the contract, but on whether the contract creates a present obligation of the entity to transfer an economic resource as a result of a past event.

5.10 Paragraphs 5.11–5.21 discuss:

(a) classes of equity claim (see paragraphs 5.11–5.17);

(b) measuring equity claims (see paragraphs 5.18–5.20); and

(c) non-controlling interests (see paragraph 5.21).

41 IAS 32 *Financial Instruments: Presentation* defines an equity instrument as "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities".

Classes of equity claim

5.11 Existing and potential investors need information to help them assess the prospects for future net cash inflows to an entity.[42] In addition, information about priorities and payment requirements of existing claims helps users of financial statements to predict how future cash flows will be distributed among those with a claim against the entity.[43] In other words, existing and potential investors need information about both:

(a) the future net cash inflows to the entity (cash inflows less cash outflows); and

(b) the claims that determine how those net cash inflows will be distributed among holders of different claims.

5.12 To meet those needs, this Discussion Paper explores an approach in which an entity would provide the following:

(a) information to help investors assess the amount, timing and uncertainty of future net cash inflows to the entity: in the statements of financial position, profit or loss and other comprehensive income (OCI), and cash flows, and in the notes; and

(b) information about the claims on those net cash inflows: in the statement of financial position and the statement of changes in equity. These statements, with related notes, should be designed in a way to enable equity holders to understand:

(i) how their own equity claims are affected at the end of the period by other classes of equity claims; and

(ii) the changes during the period in the effect of those other classes of equity claims. Those changes are described in paragraph 5.13 as wealth transfers between different classes of equity claims.

5.13 This could be achieved by designing the statement of changes in equity in the following way:

(a) the statement of changes in equity would display a separate column for each class of equity claim. An entity would include equity claims within the same class if they have the same (or perhaps similar) rights.

(b) the column for each class of equity claim would be sub-divided (on the face of the statement or in the notes), if applicable, into categories on a basis consistent with legal and other requirements governing the entity. Depending on those requirements, examples of such categories might include share capital, retained earnings and reserves.

42 See paragraph OB3 of the existing *Conceptual Framework*.

43 See paragraph OB13 of the existing *Conceptual Framework*.

(c) an entity would, at the end of each period, update the measurement of each class of equity claim. This would update the allocation of total equity between the classes of equity claim, but would not affect total equity. Which measurements might be appropriate for this purpose is discussed in paragraphs 5.18–5.20.

(d) updating measurements of different classes of equity claim would result in transfers between the amounts of recognised net assets (assets less liabilities) attributed to those classes. These represent transfers of wealth between those classes. In other words, they show how each class of equity claim diluted the net assets attributable to other classes of equity claim during the period. Currently, financial statements do not necessarily provide this information.

5.14 The *Conceptual Framework* would not prescribe a specific format for the statement of changes in equity, and would not provide an illustration of a format. Example C2 in Appendix C illustrates a statement designed in this way, as does Example 5.1.

5.15 The following points are worth making about Example 5.1:

(a) the entity (Entity A) in the example has three classes of equity claim: existing shareholders of the parent, NCI and holders of an option written by Entity A.

(b) Entity A wrote the option on 17 January 20X2 in exchange for an option premium of CU5,000 paid in cash on that date. That amount was the fair value of the option at that date. If the holder exercises that option, Entity A must issue its own shares in exchange for a cash payment of CU1,500 by the holder.

(c) on 31 December 20X2, Entity A updates the measurement of the option to its fair value of CU4,000, recognising CU1,000 (CU5,000 – CU4,000) as a wealth transfer from option holders to existing shareholders of the parent. For illustration purposes, Example 5.1 assumes that the wealth transfers are recognised in retained earnings.

(d) the subtotal 'change in net assets' summarises the change in equity attributable to each class of equity shareholders as a result of comprehensive income for the year, together with wealth transfers to or from other classes of equity claim.

(e) immediately before exercise of the option on 15 December 20X3, its fair value has declined by a further CU800 to CU3,200. Entity A recognises a further wealth transfer of CU800 in 20X3 to depict this decline.

(f) when the option holder exercises the option, Entity A receives CU1,500 from the option holder and fulfils its obligation to the option holder by issuing new shares. For illustration purposes, Example 5.1 assumes that the new shares are recognised in share capital.

Example 5.1: statement of changes in equity

	Existing shareholders of parent		Non-controlling interests	Obligation to issue shares	Total
	Share capital	Retained earnings			
1 January 20X2	10,000	20,000	4,000	—	34,000
Written option issued on 17 January 20X2	—	—	—	5,000	5,000
Total profit/comprehensive income for 20X2	—	3,500	200	—	3,700
Change in fair value of written option	—	1,000	—	(1,000)	—
Change in net assets	—	4,500	200	(1,000)	3,700
31 December 20X2	10,000	24,500	4,200	4,000	42,700
Total profit/comprehensive income for 20X3	—	3,700	300	—	4,000
Change in fair value of written option	—	800	—	(800)	—
Change in net assets	—	4,500	300	(800)	4,000
New shares issued on 15 December 20X3	4,700	—	—	(3,200)	1,500
31 December 20X3	14,700	29,000	4,500	—	48,200

5.16 Many commentators have stated that IFRS does not currently update measures of items classified as equity instruments. However, that is only partly true:

(a) IFRS generally does not permit entities to update measures of equity instruments **through profit or loss**. There is no existing obstacle to updating those measures through equity (and reporting the resulting changes as transfers within the statement of changes in equity).

(b) IFRS requires entities to update measures of NCI for the NCI's share in profit or loss, in OCI and in other equity movements.

5.17 Standards do not currently contain a **requirement** to update measures of equity claims through the statement of changes in equity. Such a requirement would achieve two objectives:

(a) it would give equity holders a clearer and more systematic view of how other equity claims affect them; and

(b) as discussed in paragraphs 5.22–5.59, it would provide a way to resolve some liability/equity classification issues that have proved problematic over the years.

Measuring equity claims

5.18 If the IASB decided to introduce a requirement to measure equity claims, it would need to determine when it develops or revises particular Standards what measurement to use for particular classes of equity claim, considering how best to convey how the claims of that class affect the holders of other classes. For example, the IASB might decide:

(a) to use an allocation of the underlying net assets as the measurement of primary equity claims. As an example, this basis is currently used for NCI. If an entity has more than one class of equity claim, the allocation would reflect the relative priorities of their claims against the total equity that is attributable to holders of all primary equity claims. If those relative priorities would vary across different future circumstances, the allocation would need to consider those variations. An entity would not measure primary equity claims by reference to estimates of the cash flows that holders of those claims will receive because such measures would, in effect, require a measurement of the entity as a whole. As explained in paragraph OB7 of the existing *Conceptual Framework*, showing the value of the entity as a whole is not the objective of general purpose financial statements.

(b) to measure secondary equity claims in the same manner as an entity would measure a comparable financial liability, for example:

(i) to use amortised cost for a class of secondary equity claims if those claims confer a right to deliver or receive, at a fixed date, equity instruments that have a fixed total value; and

(ii) to use fair value for a class of secondary equity claims if those claims confer a right to deliver or receive equity instruments that have a total value that varies because of changes in a price, index or other variable (perhaps other than the price of the issuer's own equity instruments or its own financial liabilities).

5.19 Regardless of the method used to measure equity claims, updating the measurement of those claims would not change total equity, it would simply reallocate total equity between the classes of equity claim. Updating the amount allocated to one class of equity claim causes an offsetting change in the amount allocated to one or more other classes of equity claim.

5.20 This Discussion Paper uses the term 'wealth transfer' to describe the reallocations between different classes of equity claim in the statement of changes in equity. Those reallocations depict the change during the period in the allocation of total equity between different classes. That change arises because different classes have different types of interest in equity. Those wealth transfers are not income and expense. They do not change total equity, but are akin to contributions of equity by one or more classes and equal distributions of equity to other classes.

Non-controlling interests

5.21 The approach described in paragraphs 5.12–5.14 is largely consistent with, and an extension of, the way in which IFRS treats NCI in a subsidiary. NCI does not meet the existing or proposed definition of a liability, because the entity has no obligation to transfer economic resources. Consequently, IFRS treats NCI as part of equity, not as a liability. IAS 1 already requires entities to display prominently the NCI's share in equity, in profit or loss and in comprehensive income. An entity would display changes in NCI separately in the statement of changes in equity (for example, as a separate column). The treatment described in paragraphs 5.12–5.14 would extend that requirement for a prominent display to all other categories of equity instrument.

Distinguishing liabilities from equity instruments

5.22 This section discusses how to apply the definitions of a liability and of equity in distinguishing between liabilities and equity instruments. This distinction currently has several effects:

(a) the two categories are classified separately in the statement of financial position. If distinguished strictly in accordance with the definition of a liability in the existing *Conceptual Framework*, the classification would distinguish items that oblige the entity to deliver cash or other economic resources from items that create no such obligation.

(b) the statement(s) of profit or loss and OCI:

(i) include(s) income and expenses arising from liabilities (interest and, if applicable, remeasurement and gain or loss on settlement);

(ii) do(es) not report as income or expense the changes, if any, in the carrying amount of the entity's own equity instruments; and

(iii) include(s) expenses arising from the consumption of services acquired in exchange for financial liabilities or equity instruments (IFRS 2 *Share-based Payment*).

(c) in the statement of financial position:

(i) the carrying amount of many financial liabilities changes with the passage of time (and for other factors, if the liability is measured at fair value); and

(ii) the amount reported for particular classes of equity instruments typically does not, under current practice, change after initial recognition (except for NCI).

(d) the statement of changes in equity:

(i) includes comprehensive income and thus includes implicitly the related change in the carrying amount of assets less liabilities. Thus it shows, albeit implicitly, how those liabilities affect the returns to equity holders.

(ii) shows NCI's share of comprehensive income and NCI's interest in recognised net assets.

(iii) does not currently show how changes in the value of each class of equity claim (other than NCI) affect the value of, or possible returns to, more subordinated (lower-ranking) classes of equity. Thus, it does not currently show wealth transfers between different classes of equity holder.

5.23 The distinction between financial liabilities and equity instruments is currently governed by IAS 32 and IFRS 2. IAS 32 is supplemented by IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. In both IAS 32 and IFRS 2, the starting point is to determine whether the entity has an obligation to transfer economic resources, but there are exceptions to that basic principle. Table 5.1 is a highly condensed summary of the approaches.

5.24 As Table 5.1 shows, the distinction in IFRS 2 (between cash-settled and equity-settled share-based payment transactions) relies almost entirely on the existing definition of a liability in the *Conceptual Framework*. IFRS 2 makes one adjustment to that definition, to address transactions for which the obligation rests with another group entity or other related party. In contrast, IAS 32 overrides that definition with complex exceptions for:

(a) some obligations that require an entity to deliver its own equity instruments, or that permit an entity to elect to deliver its own equity instruments instead of delivering cash or other economic resources (see paragraphs 5.28–5.54);

(b) some puttable instruments (see paragraphs 5.55–5.59); and

(c) some obligations payable on liquidation. Section 3 suggests that no liability results from payments that would arise only on liquidation. It follows that relative priorities on liquidation of the reporting entity would play no role in determining whether instruments are classified as financial liabilities or as equity instruments. This conclusion applies even if the reporting entity has a predetermined limited life (or even if another party can compel liquidation). However, that conclusion may not be appropriate in consolidated financial statements for obligations that would become payable on liquidation of a consolidated subsidiary before liquidation of the parent.

Table 5.1 summary of classification under IAS 32 and IFRS 2

	IAS 32	**IFRS 2**
Liabilities	• obligation to deliver cash or another financial asset.[(a)] • obligation (in a derivative or non-derivative) to deliver a variable number of the entity's own equity instruments. • obligation (in a derivative only) that may or must be settled by exchanging a fixed number of the entity's own equity instruments for a variable amount of cash or other financial assets. • derivative obligation that allows either the holder or issuer to elect whether the holder is to settle in cash or in shares.	• obligation to transfer cash or other assets.
Equity	• no obligation to deliver cash or other financial assets (and none of the above features present). • some puttable instruments that entitle the holder to a pro rata share of net assets on liquidation, or earlier repurchase. • obligation to deliver a pro rata share of net assets only on liquidation of the entity. • derivative that must be settled by exchanging a fixed number of the entity's own equity instruments for a fixed amount of cash or other financial assets.	• no obligation to transfer cash or other assets. • no obligation for the entity at all because another group entity or other related party will settle the obligation.

(a) or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable.

5.25 In their joint project on financial instruments with characteristics of equity (FICE), which was suspended in 2010, the IASB and the US Financial Accounting Standards Board (FASB) had tentatively decided to use an approach that classifies, as IAS 32 does:

(a) some instruments as equity instruments, even though they create obligations to transfer economic resources; and

(b) some other instruments as financial liabilities, even though they create no obligations to transfer economic resources.

5.26 Thus, the approaches in both IAS 32 and the FICE project may be viewed as overriding the definition of a liability in the existing *Conceptual Framework* with several exceptions. Such approaches have significant disadvantages:

(a) the exceptions are complex, difficult to understand and difficult to apply, as evidenced by a stream of requests for Interpretations.

(b) inconsistency with the definitions in the *Conceptual Framework* makes financial statements less internally consistent and, as a result, less understandable and less comparable.

(c) inconsistencies in approach may create opportunities to structure transactions to achieve a more favourable accounting result without changing the economics of a transaction significantly.

(d) the approach is not fully consistent with the approach used for share-based payments in IFRS 2. This reduces comparability, creates further opportunities for structuring, and makes it more important to establish whether particular obligations are within the scope of IAS 32 or within the scope of IFRS 2.

(e) further inconsistencies arise because under IFRS 2, cash-settled transactions are remeasured but equity-settled transactions are not remeasured. This puts pressure on the distinction between those two types of settlement. It also means that investors receive different information about how those transactions affect their own investments, depending on the form of settlement.

5.27 Whether there is a conceptual basis for the exceptions developed in IAS 32 and the FICE project, and whether those exceptions indicate a need to amend the *Conceptual Framework*'s definitions of liability and equity, is discussed in paragraphs 5.28–5.59. Specifically, the paragraphs cover:

(a) obligations to deliver equity instruments (see paragraphs 5.28–5.44).

(b) other approaches considered (see paragraphs 5.45–5.52).

(c) other factors that would need to be considered in applying the concepts when developing or revising particular Standards (see paragraphs 5.53–5.54).

(d) whether the *Conceptual Framework* should indicate that an entity should treat some puttable instruments as equity, even though the issuer has an obligation to transfer cash or other economic resources if the holder so requests (see paragraphs 5.55–5.59).

Obligations to deliver equity instruments

5.28 An equity instrument is not an economic resource of the issuer. Accordingly, an obligation for an entity to deliver its own equity instruments is not an obligation to deliver economic resources. Hence, it does not meet the current or proposed definition of a liability. Such an obligation is one form of a 'secondary equity claim', as described in paragraph 5.7(c).

5.29 IAS 32 classifies some equity claims as liabilities and others as equity instruments. It classifies them as liabilities if an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (for example, a commodity price). The Basis for Conclusions on IAS 32 explains that the IASB adopted this approach for the following reasons:

(a) the entity has an obligation for a specified amount rather than a specified equity interest. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and it may not even know whether it will receive its own shares or deliver them.

(b) precluding equity treatment for such a contract limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. For example, the IASB believed that an entity should not obtain equity treatment for a transaction simply by including a share settlement clause when the contract is for a specified value, rather than for a specified equity interest.

5.30 This Discussion Paper identifies two approaches that could simplify the distinction between liabilities and equity: a narrow equity approach and a strict obligation approach. The narrow equity approach would:

(a) classify as equity only existing equity instruments in the most residual existing class of equity instrument issued by the parent. (Defining the most residual class might require detailed work when developing or revising particular Standards.)

(b) classify as liabilities all other instruments, such as:

  (i) instruments that create no obligation to transfer assets;

  (ii) NCI;[44] and

  (iii) forwards and options on those equity instruments that are classified as equity by the criterion in (a).

(c) recognise in profit or loss gains and losses (including, if applicable, interest expense) on all instruments classified as financial liabilities.

5.31 The thinking behind the narrow equity approach may underlie some of the exceptions in IAS 32. In addition, some regard the narrow equity approach as being consistent with the proprietary perspective on the reporting entity, and

44 A variant on the narrow equity approach might classify NCI as equity.

the strict obligation approach as being consistent with the entity perspective. Appendix B refers to these two perspectives in the context of the IASB's work on the reporting entity.

5.32 The narrow equity approach depicts the interests of holders of the most residual existing class of equity claim directly in only one step, by depicting the claims against the entity from the perspective of those investors. It does this by categorising all prior claims against the entity as fundamentally different from those residual claims. Not all of those prior claims create an obligation for the entity to deliver economic resources (ie to deliver assets). A narrow equity approach could be supplemented by a requirement to distinguish prominently those instruments that are classified as liabilities but that create no obligation to transfer economic resources.[45]

5.33 Unlike the narrow equity approach, the strict obligation approach depicts interests of holders of the most residual existing class of equity claim in two steps. The first step depicts the entity as a whole from a perspective common to all providers of capital. It does this by identifying economic resources, obligations to deliver economic resources (such as cash), and changes in those economic resources and obligations. The second step enhances that depiction from the perspective of the holders of each class of equity claim by identifying the effects on those holders of all other equity claims.

5.34 The strict obligation approach would:

(a) classify as liabilities only obligations to deliver economic resources. Thus, the statement of financial position would show the entity's economic resources and its obligations to deliver economic resources. The statement(s) of profit or loss and OCI would show changes in those economic resources and obligations.

(b) classify as equity all equity claims, in other words:

   (i) all claims that give the holder the right to receive a portion of any distributions of equity made to holders of that class of claim; and

   (ii) all obligations to deliver equity instruments.

(c) as suggested in paragraph 5.13, reallocate total equity by updating measures of all equity claims. Thus:

   (i) the equity section of the statement of financial position would show how all equity claims affect other equity claims; and

   (ii) the statement of changes in equity would show wealth transfers between different classes of equity claims.

5.35 Both the narrow equity approach and the strict obligation approach would account in the same way for goods or services acquired in exchange for issuing equity instruments: the goods or services received are an asset; when the entity consumes that asset, it recognises an expense. For many services, an entity

45 A narrow equity approach differs from the mezzanine approach mentioned in paragraph 5.51. The narrow equity approach classifies all claims as either liabilities or equity claims, without creating an intermediate category that is neither a liability nor an equity claim.

consumes that asset immediately; if so, the entity recognises the expense at the same time as it recognises the related contribution to equity.[46] However, the two approaches differ in how they account subsequently for any remaining obligation to issue equity instruments:

(a) the narrow equity approach would recognise and measure that obligation as a financial liability, and would report subsequent changes in its carrying amount in profit or loss (or perhaps in OCI, depending on the approach to profit or loss and OCI).

(b) the strict obligation approach would recognise that obligation within equity as an equity claim. It would report subsequent changes in its carrying amount as wealth transfers in the statement of changes in equity.

5.36 The main advantages of the narrow equity approach are that:

(a) it places less emphasis than the strict obligation approach does on the need for equity investors to read and understand the statement of changes in equity. In addition, some may feel that dilution and wealth transfers between different classes of equity holder can be reported simply and understandably only by showing those effects on the face of the statement(s) of profit or loss and OCI, rather than in the statement of changes in equity.

(b) it does not require an entity to assess whether a particular instrument creates an obligation for the entity to transfer economic resources. In contrast, the strict obligation does require such an assessment, which may sometimes require considerable judgement, especially for some instruments containing an option that permits the issuer to settle by using its own equity instruments, although settlement in cash is more likely. Paragraph 5.42 refers to some of the complexities that may exist.

(c) all entities that issue financial instruments would classify the most residual class of instruments as equity. This might remove the concerns that led to the exemption for some classes of puttable instruments, as discussed in paragraphs 5.55–5.59. This is an important issue for many co-operatives and mutuals.

5.37 However, in the IASB's preliminary view, the strict obligation approach is preferable to the narrow equity approach because:

(a) the strict obligation approach is consistent with the existing definition of a liability. As a result, it is also consistent with the existing treatment of non-controlling interest. Amending the definition of a liability to make it consistent with the narrow equity approach would make the definition more complex and less understandable.

(b) it would separate two important distinctions more clearly than the narrow equity approach does:

46 See paragraphs BC45–BC53 of IFRS 2.

(i) does the entity have an obligation to transfer cash or other economic resources? The answer to this question is important to lenders because such obligations can affect the likely returns to lenders. That answer is also important to investors because such obligations can threaten the entity's survival. The strict obligation approach answers this question by classifying an obligation as a liability if the obligation requires the entity to transfer cash or other economic resources.

(ii) does an instrument create a prior (higher-ranking) claim that will affect the returns to existing holders of other classes of equity claim? The strict obligation approach answers this question by reporting each class of equity claim separately in the statement of changes in equity. (In contrast, the narrow equity approach answers this question by classifying prior claims as liabilities.)

(c) measuring all equity claims will provide equity holders with clearer and more prominent information about the effects of other equity claims.

(d) if applied when developing new or revised Standards:

(i) it would eliminate the inconsistency between IAS 32 and IFRS 2.

(ii) it would require remeasurement for all share-based payments, thus removing one source of complexity from IFRS 2.

5.38 Paragraph 5.29(b) explains that the treatment in IAS 32 limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. It limits those incentives by using profit or loss to report prominently the effects that those transactions have on holders of existing equity claims. The strict obligation approach also reports those effects prominently, but uses the statement of changes in equity for this purpose.

5.39 Discussions on the distinction between liabilities and equity often concentrate on how best to depict leverage. Leverage can refer to two different, but related, conditions, which could be described informally as:

(a) cash leverage—the ratio of:

(i) financing obligations that must be settled by delivering cash (or other economic resources); to

(ii) equity financing.

(b) return leverage—the ratio of:

(i) financing obligations that do not share fully in the returns on the residual interest in an entity's assets less liabilities; to

(ii) obligations that do share in those residual returns.

5.40 Typical debt instruments contribute to both cash leverage and return leverage. In contrast, obligations that are settled in their entirety by issuing equity instruments contribute to return leverage but not to cash leverage. The strict obligation approach described in this paper uses the distinction between liabilities and equity to depict cash leverage, and it uses presentation in the statement of changes in equity to depict any additional return leverage that is not apparent from the depiction of cash leverage. On the other hand, the narrow equity approach uses the distinction between liabilities and equity to depict return leverage, and would need to rely on disclosure to depict cash leverage.

5.41 In paragraph 5.36 it is noted that the narrow equity approach shows on the face of the statement(s) of profit or loss and OCI all effects on equity investors of changes in the carrying amount of prior claims. In contrast, to see those effects under the strict obligation approach, equity investors would need to look beyond profit or loss or comprehensive income. However, the need to look further would not be new: equity investors already need to do so if they wish to reconcile profit or loss to the numerator used in calculating earnings per share.

5.42 The strict obligation approach requires an entity to assess whether an instrument creates an obligation to transfer an economic resource. That assessment may be complex if the instrument results in a transfer of an economic resource in some circumstances but not in others.

(a) An instrument may require the entity to transfer an economic resource when an event occurs that is beyond the control of both the holder and the issuer. As indicated in paragraphs 3.70–3.71, such a requirement creates an obligation to transfer an economic resource, hence a liability exists.

(b) An instrument may require the entity to transfer an economic resource if the counterparty takes some action, for example if it exercises an option. As indicated in paragraphs 3.70–3.71, such a requirement creates an obligation to transfer an economic resource, hence a liability exists.

(c) An instrument may require the entity to transfer an economic resource if the entity itself takes some action, for example if it fails to exercise an option. In paragraphs 3.72–3.89, there is a discussion of some factors that would be relevant in assessing whether the entity has a liability in such cases. In addition, paragraphs 3.98–3.102 discuss whether an entity has a liability if it appears to hold an option that enables it to avoid transferring an economic resource, but that option lacks commercial substance.

5.43 The informal description of a secondary equity claim in paragraph 5.7(c) includes both obligations to receive or deliver another equity claim and rights to receive or deliver another equity claim. Most of the discussion in this section has focused on equity claims that result in an obligation to deliver equity instruments. Similar considerations apply to rights for the entity to claim delivery of its own equity instruments, such as a purchased call option on its own shares or a forward repurchase of its own shares. Appendix E summarises the rights and obligations that arise under options and forwards on an entity's own shares.

5.44 This Discussion Paper contains several appendices to help readers understand some of the implications of different approaches. The IASB does not expect to include detailed appendices of this kind in the *Conceptual Framework*.

(a) Appendix C provides two examples to illustrate the approaches discussed in this section.

(b) Appendix D summarises how the strict obligation approach would treat different classes of instrument.

(c) Appendix E summarises the rights and obligations arising under options and forwards on an entity's own shares.

(d) Appendix F provides background information on three questions that the IASB might need to address, when revising particular Standards, on how to distinguish liabilities from equity instruments. These questions relate to the measurement of options written by an entity on its own equity and on NCI.

Other approaches considered

5.45 In previous work, the IASB considered some other approaches included by the FASB in 2007 in its Preliminary Views document *Financial Instruments with Characteristics of Equity* and discussed in 2008 in the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*. Those approaches were labelled as the 'basic ownership approach', the 'ownership-settlement approach' and the 'revised expected outcomes (REO) approach'.[47]

5.46 All three approaches refer to a basic ownership instrument, which is defined as an instrument for which the holder:

(a) has a claim to a share of the assets of the entity that is subordinate to all other claims if the issuer were to liquidate on the date that the classification decision is being made; and

(b) is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied.

5.47 The basic ownership approach would classify as equity only basic ownership instruments. It is a narrow equity approach. The advantages and disadvantages of the narrow equity approach are discussed in paragraphs 5.36–5.37.

5.48 The basic ownership approach is inconsistent with the existing and proposed conceptual definition of a liability. The FASB Preliminary Views document suggested that a definition similar to the following would be consistent with the basic ownership approach: "A liability is a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments." Appendix D of that document discusses possible definitions of liabilities and of equity for each of the three approaches discussed there. This Discussion Paper does not reproduce those definitions.

5.49 The ownership-settlement approach would classify as equity:

(a) basic ownership instruments;

47 The IASB's Discussion Paper and the FASB's Preliminary Views document are available at http://go.ifrs.org/FICE-Discussion-Papers

(b) other perpetual instruments and some derivative instruments that are indexed to, and settled with, the entity's basic ownership instruments; and

(c) a component of an instrument that has more than one outcome if one or more of those outcomes provides a return to the holder that has the same general profile as the return to the holder of a basic ownership instrument.

5.50 The REO approach would classify as equity:

(a) basic ownership instruments; and

(b) instruments (or components of instruments) whose fair value changes in the same direction as, or in an opposite direction to, the fair value of a basic ownership instrument.

5.51 The FASB Preliminary Views document briefly discussed three other approaches:

(a) a claims approach that does not distinguish liabilities from equity at all;

(b) a mezzanine approach that defines an additional element between liabilities and equity; and

(c) a loss absorption approach that classifies instruments (or components of instruments) as equity if the instrument's claim on net assets is reduced when the entity incurs a loss.

5.52 After reviewing responses to the FASB's Preliminary Views document and the IASB's Discussion Paper, both the IASB and the FASB decided not to pursue the ownership-settlement, REO, claims, mezzanine or loss absorption approaches. Reasons included complexity, lack of understandability and inconsistency with the conceptual definition of a liability. Accordingly, this Discussion Paper does not analyse these approaches.

Applying the concepts in Standards

5.53 As noted above, IAS 32, IFRS 2 and some related Interpretations provide the criteria for classifying instruments as financial liabilities or as equity instruments. If the IASB wishes at some future date to consider changing those criteria, the IASB would need to go through its normal due process for adding a project to its agenda, and for developing an Exposure Draft and then an amendment to IFRSs.

5.54 In deciding in particular Standards how to distinguish liabilities from equity instruments, the IASB might need to address some other questions not addressed in this Discussion Paper, including:

(a) whether and when to separate single instruments into two or more components, for example:

(i) whether to separate compound instruments into a liability component and an equity component, as IAS 32 requires in some cases.

(ii) whether to separate some derivatives on an entity's own shares into separate components in some cases when that would produce a different result. For example, a forward contract can be viewed as a combination of a purchased option and a written option. The forward contract might be viewed as creating an obligation to settle that does not exist in the case of the purchased option.

(iii) whether puttable shares should be separated into an equity host and an embedded put option. Such a separation might be one way to seek consistency between the treatments of puttable shares and stand-alone written put options. (IAS 32 achieves consistency in a different manner, by requiring a gross presentation for written put options, both free-standing and embedded.)

(b) similarly, whether to link two or more separate instruments into a single instrument for accounting purposes.

(c) whether some obligations within a subsidiary would be reclassified from liability to equity, or vice versa, on consolidation. For example, if an entity has an obligation to transfer economic resources only on liquidation, that obligation would not be a liability of that entity. However, in some circumstances, it might be appropriate to treat it as a liability of the group in the consolidated financial statements of the entity's parent, particularly if liquidation of the entity might occur before liquidation of the parent.

(d) whether any specific guidance is needed on contractual terms that have no commercial substance, for example an option that is deeply in the money or deeply out of the money, with no genuine possibility that this will change before expiry. Paragraphs 3.98–3.108 include a discussion of contractual options that lack commercial substance.

(e) three questions on which Appendix F provides more background:

(i) how to measure the rights and obligations that arise under a written put option on an entity's own shares;

(ii) whether changes in liabilities arising under a written put option result in income or expense, or in a distribution of equity or contribution to equity; and

(iii) how to measure the rights and obligations that arise under a written put option on NCI, and where to present changes in the measures of those rights and obligations.

Puttable instruments

5.55 IAS 32 requires an entity to classify some puttable instruments as equity instruments, even though they create an obligation to transfer assets, and thus meet the definition of a financial liability. To summarise some complex and detailed requirements, this applies to financial instruments that:

(a) give the holders a pro rata residual interest in the entity's net assets, after deducting all its liabilities; but also

(b) oblige the entity to deliver cash or other assets to the holders on liquidation, or on early redemption at an amount broadly equivalent to that pro rata share.

Examples of entities that issue such instruments are some co-operative and mutual organisations.

5.56 The Basis for Conclusions on IAS 32 identifies the following concerns that would have arisen from classifying these puttable instruments as liabilities:

(a) on an ongoing basis, the liability would be recognised at not less than the amount payable on demand. This could result in the entire market capitalisation of the entity being recognised as a liability, depending on the basis for calculating the redemption value of the financial instrument.

(b) changes in the carrying amount of the liability would be recognised in profit or loss. This would result in counterintuitive accounting (if the redemption value is linked to the performance of the entity) because:

   (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss would be recognised; and

   (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain would be recognised.

(c) it is possible, again depending on the basis for calculating the redemption value, that the entity would report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

(d) the statement of financial position would portray the entity as wholly, or mostly, debt-funded.

(e) distributions of profits to shareholders would be recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not of performance.

5.57 The exception in IAS 32 treats some puttable instruments as if they were equity instruments. The existing *Conceptual Framework* provides no basis for that exception. In the IASB's preliminary view, its reasons given in paragraph 5.56 for creating that exception are still valid and the *Conceptual Framework* should provide a concept that underlies the exception. To reflect that suggestion, the revised *Conceptual Framework* should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments. One consequence would be that changes in the carrying amount of those obligations would not be recognised in profit or loss. Arguably, this treatment might be appropriate if the obligations are the most subordinated (lowest ranking) class of instruments issued by an entity (such as some co-operatives or mutuals) that would otherwise report no equity. In such cases, no other class of instrument has a residual interest in the entity's assets less other liabilities. Thus, payments to holders of the most subordinated class of instruments might be regarded as akin to distributions of equity.

5.58 Identifying whether to use such an approach, and if so, when, would continue to be a decision that the IASB would make when developing or revising particular Standards. For example, the following topics might require analysis if the IASB were to undertake a project to amend IAS 32, IFRS 2 or another Standard:

(a) whether an obligation could be treated as if it were an equity claim if it would arise only on the liquidation of a subsidiary of the reporting entity; and

(b) whether some or all of these puttable instruments should be separated into an embedded put option (for which a liability would be recognised) and a host equity instrument.

5.59 The most subordinated class of instruments issued by an entity might qualify as equity instruments under the narrow equity approach mentioned in paragraph 5.30. Thus, the narrow equity approach might make it unnecessary to create an exception for puttable instruments in that class. In contrast, without such an exception, the strict obligation approach would not treat these instruments as equity.

Questions for respondents

Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB's preliminary view:

(a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.

(b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:

  (i) obligations to issue equity instruments are not liabilities; and

  (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).

(c) an entity should:

  (i) at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.

  (ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.

(d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Appendix C
Distinction between liabilities and equity instruments

C1 In Section 5 two approaches to distinguishing liabilities from equity instruments are discussed: a narrow equity approach and a strict obligation approach. This appendix illustrates how those approaches, as well as the existing approach in IAS 32 *Financial Instruments: Presentation*, would apply to two examples:

(a) Example C1: written put option, settlement net in cash.

(b) Example C2: written put option, settlement net in shares.

Example C1: written put option, settlement net in cash

C2 This example illustrates how the approaches described in this paper would treat a written put option that must be settled net in cash. For such an option, if the strike price exceeds the share price at expiry, the issuer must pay cash equal to that excess.

Fact pattern

C3 An entity issues a written put option on 1,000 of its own shares on 1 February 20X2. The issuer receives a premium of CU5,000 for the option.[85] The option is exercisable only on 31 January 20X3, in exchange for paying a strike price of CU98 per share (CU98,000 in total). The option will be settled net in cash. In other words, if the holder exercises the option, it will receive the fair value of 1,000 shares on the exercise date (31 January 20X3), less the total strike price of CU98,000.

C4 Further data:

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Fair value per share	CU100	CU95	CU95
Fair value of option	CU5,000	CU4,000	CU3,000

C5 On 31 January 20X3, the holder exercises the option, receiving cash of CU3,000 (ie CU98,000 − CU95,000).

IAS 32 approach, narrow equity approach and strict obligation approach

C6 The same treatment would apply under IAS 32, the narrow equity approach and the strict obligation approach. The issuer treats the contract as a derivative financial liability because the issuer has a present obligation that will require the issuer to deliver an economic resource (cash) if the holder exercises the option. The issuer would present the following information:

85 In this Discussion Paper, currency amounts are denominated in ‘currency units’ (CU).

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	2,000
Derivative liability	(5,000)	(4,000)	–
Net assets	–	1,000	2,000
Share capital	–	–	–
Retained earnings	–	1,000	2,000
Total equity	–	1,000	2,000

Statement(s) of profit or loss and OCI

	31 Dec 20X2	31 Jan 20X3
Change in fair value of derivatives	1,000	1,000
Profit/comprehensive income	1,000	1,000

Statement of changes in equity

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	–	–	–
Profit/comprehensive income for 20X2	–	1,000	1,000
31 December 20X2	–	1,000	1,000
Profit/comprehensive income for January 20X3	–	1,000	1,000
31 January 20X3	–	2,000	2,000

C7 In the statement of changes in equity, the right-hand column is labelled 'total existing shareholders' for ease of comparison with Example C2.

Example C2: written put option, settlement net in shares

Fact pattern

C8 The facts are as in Example C1, except that the option will be settled net in shares. In other words, if the holder exercises the option, the issuer will issue shares whose total fair value equals the amount of cash that would be paid in Example C1. Neither party pays cash when the option is exercised or expires.

C9 On 31 January 20X3, the holder exercises the option. The issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.[86]

IAS 32 approach

C10 Under IAS 32, the issuer treats the obligation to deliver a variable number of shares as a liability (because the issuer is, in effect, using its own shares as currency). The issuer accounts for the transactions as shown below. The

86 In these examples, fractional shares are assumed possible.

accounting at 1 February 20X2 and 31 December 20X2 is the same as in Example C1. The accounting differs at 31 January 20X3 because the issuer must settle by issuing shares, not by paying cash.

Statement of financial position

	1 Feb 20X2	**31 Dec 20X2**	**31 Jan 20X3**
Cash	5,000	5,000	5,000
Derivative liability	(5,000)	(4,000)	–
Net assets	–	1,000	5,000
Share capital	–	–	3,000
Retained earnings	–	1,000	2,000
Total equity	–	1,000	5,000

Statement(s) of profit or loss and OCI

	31 Dec 20X2	**31 Jan 20X3**
Change in fair value of derivatives	1,000	1,000
Profit/comprehensive income	1,000	1,000

Statement of changes in equity

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	–	–	–
Profit/comprehensive income for 20X2	–	1,000	1,000
31 December 20X2	–	1,000	1,000
Profit/comprehensive income for January 20X3	–	1,000	1,000
Shares issued	3,000	–	3,000
31 January 20X3	3,000	2,000	5,000

Narrow equity approach

C11 In this example the narrow equity approach would lead to the same results as IAS 32.

Strict obligation approach

C12 The obligation to issue shares is not an obligation to transfer economic resources. Consequently, applying the strict obligation approach, that obligation is an equity claim, not a liability.

C13 At inception (1 February 20X2), the issuer recognises:

(a) cash of CU5,000; and

(b) within equity, an equity claim of CU5,000. That equity claim consists of a present obligation that will require the issuer to issue its own shares if the holder exercises its option.

C14 At 31 December 20X2, the issuer remeasures the equity claim. For illustration purposes, this example assumes that the remeasurement is to fair value (see paragraphs 5.18–5.20 for a discussion of how to measure equity claims). At this date, the fair value of the equity claim is CU4,000, and the issuer recognises in the statement of changes in equity a wealth transfer of CU1,000 from the column labelled 'Obligation to issue shares' (which depicts the interest of option holders) to the section for existing shareholders. For illustration purposes, the example shows that wealth transfer as a transfer to retained earnings, but other classifications would be possible, provided that the statement of changes in equity identifies clearly which class of equity holder benefits from the transfer.[87]

C15 At 31 January 20X3:

(a) the issuer remeasures the equity claim to its new fair value of CU3,000, recognising in the statement of changes in equity a further wealth transfer of CU1,000 from the option holders to shareholders.

(b) the issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares. At this point, the issuer transfers CU3,000 from the column labelled 'Obligation to issue shares' to the section for existing shareholders. For illustration purposes, this example assumes that the entire amount of CU3,000 is transferred to share capital rather than to some other category attributable to existing shareholders.

(c) if the option expires unissued, the issuer transfers any remaining balance from the column labelled 'Obligation to issue shares' to some category within the section for existing shareholders.

87 IFRSs do not in general prescribe which categories of equity an entity should present separately, because determining which categories are most relevant to users of financial statements may depend on local legislation and on the reporting entity's governing constitution. IAS 1 *Presentation of Financial Statements* requires an entity to disclose a description of the nature and purpose of each reserve within equity.

C16 The issuer would present the amounts shown below:

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Net assets	5,000	5,000	5,000
Share capital	–	–	3,000
Retained earnings	–	1,000	2,000
Total existing shareholders	–	1,000	5,000
Obligation to issue shares	5,000	4,000	–
Total equity	5,000	5,000	5,000

Statement(s) of profit or loss and OCI

	31 Dec 20X2	31 Jan 20X3
Income	–	–
Expense	–	–
Profit/comprehensive income	–	–

Statement of changes in equity

	Share capital	Retained earnings	**Total existing shareholders**	**Obligation to issue shares**	**Total**
Opening 1 February 20X2	–	–	**–**	**–**	**–**
Profit/comprehensive income for 20X2	–	–	**–**	**–**	**–**
Change in fair value of option	–	1,000	**1,000**	**(1,000)**	**–**
Change in net assets	–	1,000	**1,000**	**(1,000)**	–
Written option issued	–	–	**–**	**5,000**	**5,000**
31 December 20X2	–	1,000	**1,000**	**4,000**	**5,000**
Profit/comprehensive income for January 20X3	–	–	**–**	**–**	**–**
Change in fair value of option	–	1,000	**1,000**	**(1,000)**	**–**
Change in net assets	–	1,000	**1,000**	**(1,000)**	**–**
New shares issued	3,000	–	**3,000**	**(3,000)**	**–**
31 January 20X3	3,000	2,000	**5,000**	**–**	**5,000**

C17 In the statement of changes in equity in Example C2:

(a) the column ‘Total existing shareholders’ shows the sum of share capital and retained earnings. In this example, these are entirely attributable to existing shareholders.

(b) the column ‘Obligation to issue shares’ shows the portion of total equity attributed to option holders. In this example, it is measured as the fair value of the written option.

(c) the row ‘Change in fair value of option’ show the wealth transfers between existing shareholders and option holders. In this example, it is measured as the change in fair value of the obligation to issue shares.

(d) the row ‘Change in net assets’ shows the subtotal of profit/comprehensive income and change in fair value of option.

Comparison of Examples C1 and C2

C18 The following comments can be made about Examples C1 and C2:

(a) the treatments under IAS 32 and under the narrow equity approach at 1 February 20X2 and 31 December 20X2 do not depict, in a faithful and understandable manner, the fact that these two examples will cause different effects on the economic resources of the issuer. In Example C1, the issuer suffers a cash outflow of CU3,000. In Example C2, no cash outflow can occur. In contrast, the strict obligation approach does depict that difference.

(b) all three approaches depict the fact that both examples cause the same degree of dilution to those remaining shareholders (ie the shareholders who do not hold the put options):

(i) IAS 32 and the narrow equity approach depict this similarity by generating the same profit or loss in both examples.

(ii) the strict obligation approach depicts this similarity in the statement of changes in equity in the line labelled ‘Change in net assets’, in the column labelled ‘Total existing shareholders’. For example, in both Examples C1 and C2, the ‘change in net assets’ for existing shareholders in 20X2 is an increase of CU1,000, because the obligation is remeasured to fair value in both cases. (In Example C1, the only component of that change in net assets is the comprehensive income for 20X2.)

Appendix D
Effect of strict obligation approach on different classes of instrument

D1 In Section 5 two approaches to distinguishing liabilities from equity instruments are discussed: a narrow equity approach and a strict obligation approach. Table D.1 compares the current treatment of various instruments under IAS 32 *Financial Instruments: Presentation* with how they would be treated under the strict obligation approach.

D2 In several cases, the treatment depends on whether the instrument would be settled by delivering a fixed number of the issuer's own equity instruments for a fixed amount of cash, or whether it would be settled in some other way. Table D.1 identifies those cases by the legend 'If not only fixed for fixed, then derivative'. For instruments labelled in this way, if they do not meet the 'fixed for fixed' criterion they are treated as derivatives and hence are classified as financial liabilities (or financial assets) measured at fair value through profit or loss.

D3 In paragraphs 5.18–5.20, the way to measure equity claims is discussed, but no specific proposals are provided. In Table D.1, it is assumed that equity claims are measured in the same way as otherwise comparable financial liabilities, unless otherwise stated in Table D.1.

Table D.1: comparison of the current treatment of various instruments under IAS 32 and the strict obligation approach

Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Obligation to deliver a variable number of shares, whose total fair value equals a fixed amount. The entity will receive no further cash in exchange for that obligation.	Liability, measured at amortised cost, with interest expense reported in profit or loss.	Equity claim, measured as if it were a financial liability: most likely at amortised cost, with interest expense reported in the statement of changes in equity (SCE) as a wealth transfer to the future shareholders from existing shareholders.
Obligation to deliver a variable number of shares, whose total fair value equals a specified amount indexed to the gold price. The entity will receive no further cash in exchange for that obligation.	Liability, measured at fair value (under the fair value option) or at amortised cost with separate measurement of an embedded derivative at fair value through profit or loss.	Equity claim, measured as if it were a financial liability that requires the issuer to pay the specified amount (ie measured at fair value). Changes in carrying amount reported in the SCE.
Forward contract to repurchase own shares, settled gross.	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss.	Liability at present value of gross redemption amount. To be determined: whether to recognise subsequent changes in that amount in profit or loss, or in SCE (see paragraphs F4–F5).
Written put option on own shares, settled gross.	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss.	Liability. To be determined: measurement and treatment of subsequent changes in carrying amount (see paragraphs F2–F10).

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Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Written put option on non-controlling interest (NCI put), settled gross for a cash payment equal to the fair value of the underlying non-controlling interest (NCI).	Liability at present value of the gross redemption amount (ie fair value of the underlying NCI). Subsequent changes in that amount in profit or loss.[(a)]	Liability. To be determined: measurement and treatment of subsequent changes in carrying amount (see paragraphs F2–F10).
Purchased call option to repurchase own shares, settled gross.	No asset or liability. Recognise in equity, initial measurement net at premium paid. No remeasurement. If not only fixed for fixed, then derivative.	No asset or liability. Equity claim: right to receive shares on request by electing to pay the strike price, initial measurement net at premium paid. Subsequent remeasurement (net) to fair value through SCE.
Forward sale of own shares, settled gross.	Do not recognise until settlement. If not only fixed for fixed, then derivative.	Asset at present value of gross sale proceeds. Subsequent measurement: same basis as for a financial asset that entitles the entity to receive the specified amount. To be determined: whether interest expense (and impairment loss on asset, if applicable) in profit or loss or in SCE. No liability. Equity claim: obligation to deliver own shares.
Purchased put on own shares, settled gross.	No asset or liability. Recognised in equity, initial measurement net at premium paid. No remeasurement. If not only fixed for fixed, then derivative.	Asset, initial measurement net at premium paid. Subsequent remeasurement (net) to fair value through SCE to show wealth transfers between different equity claimants.

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Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Written call on own shares, settled gross.	Equity claim, initial measurement net at proceeds received. No remeasurement. If not only fixed for fixed, then derivative.	Equity claim, initial measurement net at proceeds received. Subsequent remeasurement (net) to fair value through SCE.
All net cash-settled derivatives on own shares.	Derivative asset or liability measured net: fair value through profit or loss.	Derivative asset or liability measured net: fair value through profit or loss.
All derivatives on own shares if they must be settled by net delivery or net receipt of shares with no cash payment (net share settlement).	Derivative asset or liability: fair value through profit or loss. On settlement or expiry, derecognise the derivative asset or liability, with a corresponding decrease or increase in equity.	Equity claim measured net: fair value, remeasured through SCE.
Derivative obligation that permits the holder to elect whether the issuer will settle in cash or in shares.	Financial liability. Measure in accordance with IFRS 9 *Financial Instruments*.	Financial liability. Measure in accordance with IFRS 9.
Derivative obligation that permits the issuer to elect whether to settle in cash or in shares.	Financial liability. Measure in accordance with IFRS 9.	Equity claim (because the issuer is not obliged to deliver economic resources).[(b)] Measured as if it were a financial liability, with changes in the carrying amount reported in the SCE.
Cash-settled share-based payment.	Recognise as an expense and a liability. Remeasure the liability through profit or loss.	Recognise as an expense and a liability. Remeasure the liability through profit or loss.

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Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Equity-settled share-based payment.	Recognise as an expense and as an equity claim. Do not remeasure.	Recognise as an expense and as an equity claim. Remeasure the equity claim through SCE.

(a) See draft IFRIC Interpretation *Put Options Written on Non-controlling Interests* and further discussion in paragraphs F6–F10.
(b) As discussed in Section 3, if the entity's option to settle in shares has no commercial substance, the entity might have a financial liability.

Appendix E
Rights and obligations arising under options and forwards on an entity's own shares

Table E.1 analyses the rights and obligations that arise under options and forwards on an entity's own shares. Table E.1 applies the definitions discussed in Section 2 and the related guidance in Section 3 to assess whether those rights and obligations are assets, liabilities or equity claims. In all cases, it is assumed in Table E.1 that the entity ultimately settles the instruments by delivering or receiving the entity's own shares in exchange for receiving or paying cash.

Table E.1: analysis of the rights and obligations that arise under options and forwards on an entity's own shares

Type of option	Right of the entity	Obligation of the entity
Purchased call option.	To receive shares on request, by electing to pay the strike price. (An equity claim on the writer of the option, not an economic resource.)	None. (An obligation to pay the strike price will arise subsequently if the entity exercises the option.)
Written call option.	None. (A right to receive the strike price will arise subsequently if the holder exercises the option.)	To stand ready to issue shares, at the request of the holder, in exchange for the strike price. (An equity claim, not an obligation to transfer economic resources.)
Purchased put option.	To receive the strike price on request, by electing to issue or deliver shares. (An asset.)	None. (An obligation to issue or to deliver the shares will arise subsequently if the entity exercises the option. That obligation will be an equity claim, not a liability.)
Written put option.	None. (A right to receive the shares will arise subsequently if the holder exercises the option. That right will be an equity claim, not an asset.)	To stand ready to pay the strike price at the request of the holder. (An obligation to transfer economic resources, and hence a liability.)

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Type of option	**Right of the entity**	**Obligation of the entity**
Forward purchase for cash.	To receive shares. (An equity claim.)	To pay cash. (A liability.)
Forward sale for cash.	To receive cash. (An asset.)	To issue or deliver shares. (An equity claim.)

Appendix F
Written put options on own equity and on non-controlling interests

F1 Paragraph 5.54 identifies some questions that the IASB might need to address if it undertakes a project to amend its Standards on how to distinguish liabilities from equity instruments. This appendix provides background information on three of those questions:

(a) how to measure the rights and obligations that arise under a written put option on an entity's own shares (see paragraphs F2–F3);

(b) whether changes in liabilities arising under a written put option result in income or expense, or in a distribution of equity or contribution to equity (see paragraphs F4–F5); and

(c) how to measure the rights and obligations that arise under a written put option on non-controlling interests (NCI), and where to present changes in those rights and obligations (see paragraphs F6–F10).

Written put options on own shares

F2 Possible approaches for how an entity should measure written put options on its own shares are:

(a) the present value of the redemption amount, the existing requirement as set out in paragraph 23 of IAS 32 *Financial Instruments: Presentation*. This measure is simple, and conveys information about the possible outflow of economic resources, but it has the following disadvantages:

(i) it conveys no information about the likelihood of the transfer. It depicts the liability as if its exercise were certain, regardless of how certain or uncertain the exercise is.

(ii) if the strike price for the option is the fair value of the underlying shares, the liability is measured at fair value. Changes in its fair value are recognised in profit or loss, even if the fair value of such an option is minimal, and regardless of the likelihood of exercise.

(b) the fair value of the entire instrument. This would be consistent with the treatment of most other derivatives. On the other hand, it would appear inconsistent to measure an obligation to transfer an economic resource by factoring in both the resource that will be transferred and the underlying shares to be received, which are not a resource of the entity itself.

(c) the present value of the redemption amount, probability-weighted to reflect the estimated likelihood of the exercise. This would depict more faithfully whether the exercise is likely, however:

(i) until close to expiry, when the exercise becomes either highly likely or highly unlikely, that measure is likely to differ from the ultimate cash outflow. It is also likely to change over time.

(ii) this measure would require estimates of the probabilities, which would require subjective estimates or models, perhaps using the probabilities that are implied in a fair value measurement of the entire option. This approach has some similarities with the revised expected outcomes approach (the 'REO approach') described in paragraph 5.50. As noted in paragraph 5.52, the IASB and FASB rejected the REO approach, partly because they viewed it as too complex.

(d) an approach that measures the option at the present value of the strike price if some threshold is passed, and at zero if the threshold is not passed. This would be simpler than the expected value approach described in F2(c), but it would ignore the time value of the option (ie the possibility that the threshold might be passed in the future). The threshold might be, for example:

(i) when the option comes into the money. With this threshold, the measure of the option would equal its intrinsic value (ie zero if the option is out of the money, and the present value of the strike price if the option is in the money).

(ii) when the entity concludes that exercise is likely.

F3 This Discussion Paper does not conclude on how an entity should measure the obligation that arises under a written put option on its own shares.

Changes in the carrying amount of written put options on own shares

F4 There are two views on how to treat changes in the carrying amount of obligations arising under written put options on an entity's own shares:

(a) View A: those changes relate to a financial liability and should therefore be recognised in profit or loss.

(b) View B: the settlement of the obligation relates to a distribution of equity. Consequently, increases in the carrying amount of that obligation are distributions of equity and decreases in that carrying amount are contributions to equity.

F5 Arguably, deciding which view to adopt in particular cases is a matter for projects on particular Standards, not for the *Conceptual Framework*. Consequently, this Discussion Paper does not investigate this issue further. One topical case where this issue is relevant is for NCI puts, as discussed in paragraphs F6–F10.

Implications for NCI puts

F6 IAS 32 requires that the issuer of a written put on its own shares should recognise a liability for the present value of the redemption amount. One instrument subject to that requirement is a written put option that obliges a parent to purchase shares of its subsidiary that are held by an NCI shareholder on request by that shareholder (an NCI put). In May 2012 the IFRS Interpretations Committee (the 'Interpretations Committee') addressed NCI puts in a draft Interpretation *Put Options Written on Non-controlling Interests* (the 'draft Interpretation').

F7 Under the draft Interpretation, changes in the measurement of NCI puts would, in the parent's consolidated financial statements, be recognised in profit or loss. The Interpretations Committee reasoned that changes in the measurement of NCI puts do not change the relative interests of the parent and the NCI shareholder and are therefore not equity transactions (ie they are not transactions with owners in their capacity as owners). Moreover, the NCI put is a financial liability, and thus sits within the scope of IFRS 9 *Financial Instruments*. It follows that the gains and losses would be recognised in profit or loss. In other words, the Interpretations Committee adopted View A identified in paragraph F4. In addition, that conclusion ensures consistency with the treatment of written put options embedded in an equity instrument (ie redeemable equity instruments), for which changes in the carrying amount are also recognised in profit or loss.

F8 To some, the approach in IAS 32 seems particularly problematic for written put options on the issuer's own shares (and NCI puts) with a strike price equal to fair value (fair value puts). For these instruments, the requirement in IAS 32 means that:

(a) the strike price would be recognised as a liability and measured at fair value.

(b) changes in the fair value of the liability would be recognised in profit or loss. Part of those changes arises from changes in the value of unrecognised assets, such as goodwill. Some believe that this does not result in relevant or understandable information for users of financial statements.

(c) measurement of the liability is equal to the strike price, as if the exercise were certain to occur, even if the exercise is highly unlikely.

F9 In March 2013 the IASB discussed the feedback it had received on the draft Interpretation, and the Interpretations Committee's reactions to that feedback. The IASB decided to reconsider the requirements in IAS 32, including whether all or particular put options and forward contracts written on an entity's own equity should be measured on a net basis at fair value, consistently with derivatives that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9. The IASB will continue to discuss this issue.

F10 This paper does not conclude on whether changes in the carrying amount of NCI puts should be recognised in profit or loss or in equity.