Exposure Draft

ED 150
June 2006

Proposed Amendments to AASB 132 *Financial Instruments: Presentation* and AASB 101 *Presentation of Financial Statements*: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 22 September 2006. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 23 October 2006. Comments should be addressed to:

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A copy of all non-confidential submissions to the AASB will be placed on public record on the AASB website: www.aasb.com.au.

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PREFACE

Background

Australian Accounting Standards

The Australian Accounting Standards Board (AASB) makes Australian Accounting Standards to be applied by:

(a) entities required by the *Corporations Act 2001* to prepare financial reports;

(b) all reporting entities engaged in either for-profit, not-for-profit or public sectors; and

(c) any other entity that prepares general purpose financial reports.

Australian Accounting Standards that apply to annual reporting periods beginning on or after 1 January 2005 include Australian equivalents to International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB).

Although IFRSs are developed to apply to for-profit entities, the AASB has decided to continue to make transaction-neutral accounting standards as between for-profit, not-for-profit private and not-for-profit public sectors. Accordingly, Australian Accounting Standards (including Australian equivalents to IFRSs) generally require the same accounting treatment for similar transactions occurring in both for-profit and not-for-profit entities, including public sector entities. An Australian equivalent to an IFRS uses the corresponding IFRS as the “foundation” Standard to which the AASB adds material detailing its scope and applicability in the Australian environment. Additions are made, where necessary, to broaden the content of the Australian equivalent to an IFRS to cover domestic, regulatory or other issues. In addition to making accounting standards that are Australian equivalents to IFRSs, the AASB also continues to make other Australian Accounting Standards that are specific to the not-for-profit sector, including public sector entities, or that are purely of a domestic nature.

Exposure Drafts

The adoption of IFRSs is an ongoing process. Whenever the IASB issues new or amended IFRSs, the AASB must also consider making new or amended Australian equivalents to those IFRSs.

In developing a new or amended IFRS, the IASB releases an Exposure Draft (ED) of the proposed Standard or amendments for public comment. The AASB generally follows a similar due process prior to making or amending Australian Accounting Standards. In the case of changes proposed by the IASB to IFRSs, the AASB also releases an ED containing those proposed changes and specifically invites comments from Australian constituents on, among other things, whether the implementation of the proposals in an Australian equivalent to an IFRS may be affected by the Australian environment (including the legal and regulatory environment) and whether the proposals are in the best interests of the Australian economy.

Purpose of this Exposure Draft

The purpose of this ED is to invite comments from Australian constituents on proposed amendments to AASB 132 *Financial Instruments: Presentation* and AASB 101 *Presentation of Financial Statements*, which are the Australian equivalents to IAS 32 *Financial Instruments: Presentation*, and IAS 1 *Presentation of Financial Statements*, respectively.

These proposed amendments are contained in the IASB Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements*: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation, that was issued by the IASB in June 2006. If these amendments are approved by the IASB, and subsequently by the AASB, they are expected to be applicable from the time that the IASB amendments become effective. The IASB has not yet specified an effective date.

Structure of this Exposure Draft

The AASB has decided to reproduce the IASB Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements*: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation, without amendment as part of this ED, and seek constituents' views on the proposals.

Application

The proposals in the ED are intended to:

(a) amend some of the requirements of AASB 132 and AASB 101, issued on 15 July 2004; and

(b) consequentially amend a number of other Australian Accounting Standards. This ED identifies the consequential amendments to various IFRSs that would need to be made to corresponding Australian equivalents to IFRSs.

The existing requirements of these Standards remain operative until superseded by the proposals in this ED.

Application Date

The AASB intends to make the amended AASB 132, AASB 101 and the amendments to other Australian Accounting Standards applicable from the same date as the IASB. The IASB has not yet specified the application date. Earlier application is proposed to be permitted for annual reporting periods beginning on or after the date the amendments are made by the AASB.

Application and Materiality Paragraphs

The AASB intends to include the application and materiality paragraphs (as per the existing AASB 132 and AASB 101) in the amended AASB 132 and AASB 101.

For the amendments to other Australian Accounting Standards, the application and materiality paragraphs in those Standards will continue to apply.

Summary of Main Changes to AASB 132 and AASB 101

Refer to the IASB ED Features of this Exposure Draft for a description of the proposed changes to the current requirements of IAS 32 and IAS 1 and, by extension, to AASB 132 and AASB 101, respectively.

Background to the Main Changes

Paragraph 11 of the current AASB 132 defines a financial liability and an equity instrument as follows:

"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. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities."

Furthermore, paragraph 16 states that:

"When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no 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 issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument."

In short, in accordance with the current AASB 132, a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This treatment has given rise to a number of concerns among constituents relating to the application of AASB 132 in a number of cases. These concerns are outlined in paragraph BC5 of the IASB ED.

Some of the cases that are affected by this treatment include: shares puttable at fair value, limited life entities and partnerships. This treatment is illustrated as follows:

Shares Puttable at Fair Value

An entity such as a partnership, a co-operative, or other unlisted entity could issue a financial instrument that requires the entity to repurchase or redeem the instrument at fair value of a pro rata share of the net assets of the entity. For example, in many partnerships, a partner can resign from the partnership which terminates the partnership, and the partner interest is then paid out. In the case of some co-operatives, members may be entitled to put their shares back to the entity for a pro rata share of the entity's net assets[1]. Therefore, because these instruments can be put back to the entity for cash or another financial asset, under AASB 132, these instruments are currently classified as financial liabilities.

[1] Whilst the amendments in this ED would alter the classification of instruments issued by some co-operatives, for those co-operatives whose members are only entitled to put back their shares at the amount for which they were purchased, the classification would not change and these instruments would still be classified as financial liabilities.

Limited Life Entities

There are entities which have limited lives, for example, property trusts. Under Australian trust law, many property trusts have termination dates (some as long as 80 years) and as such trust managers may have to realise assets and distribute the proceeds to unitholders upon termination. Currently, the contingent settlement provisions of paragraph 25 of AASB 132 permit certain instruments to be classified as equity where the instruments can be redeemed only on the event of liquidation of the issuer. However, because liquidation of a limited life entity is not contingent, that is, it is a known future event, the instruments issued are classified as financial liabilities under the current AASB 132.

In the adoption of the Australian equivalents to IFRS, the AASB notes that a number of limited life entities in Australia, such as certain listed property trusts, have amended their constitutions to remove the finite termination dates. This has removed a barrier to the instruments being classified as equity instruments. However, there are other entities including certain unlisted trusts that still retain the termination dates in their constitutions, and therefore the proposed amendments in this Exposure Draft will be relevant to them.

Request for Comments

Comments are invited on any of the proposals in the ED, including the questions on the proposed amendments to IAS 32 and IAS 1 as listed in the Invitation to Comment section of the IASB ED.

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 22 September 2006. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 23 October 2006. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Specific Matters for Comment

In addition, the AASB would value comments on the following matters:

(a) any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

  (i) not-for-profit entities; and

  (ii) public sector entities; and

(b) whether the proposals are in the best interests of the Australian economy.

IASB Exposure Draft June 2006

Exposure Draft of Proposed

AMENDMENTS TO

IAS 32 FINANCIAL INSTRUMENTS: PRESENTATION

AND

IAS 1 PRESENTATION OF FINANCIAL STATEMENTS:

FINANCIAL INSTRUMENTS PUTTABLE AT FAIR VALUE AND OBLIGATIONS ARISING ON LIQUIDATION

Comments to be received by 23 October 2006

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This Exposure Draft of proposed Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements—*Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IAS 32 and IAS 1. Comments on the Exposure Draft and the Basis for Conclusions should be submitted in writing so as to be received by **23 October 2006**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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IASB Exposure Draft June 2006

Introduction

1 This Exposure Draft contains proposals by the International Accounting Standards Board to amend IAS 32 *Financial Instruments: Presentation* to classify as equity financial instruments puttable at the fair value of a pro rata share of the net assets of the entity (financial instruments puttable at fair value) and instruments with obligations for a pro rata share of the net assets of the entity on its liquidation (obligations arising on liquidation), provided specified criteria are met.

2 Under IAS 32, equity classification of a financial instrument depends upon specified conditions being met; one of those conditions is that the instrument does not include a contractual obligation to deliver cash or another financial asset to another entity. An instrument with such an obligation is a financial liability.

3 Some entities have issued financial instruments puttable at the fair value of a pro rata share of the net assets of the entity. After the revised IAS 32 was issued in 2003, constituents raised concerns about the consequences of applying IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement* to financial instruments puttable at fair value. For example, those standards require an entity to recognise such instruments as a liability and to measure them at an amount not less than the amount payable on demand, ie the fair value of the puttable instruments. This can result in the entire market capitalisation of an entity being recognised as a liability. Such an entity is likely to 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.

4 Issues similar to those raised by constituents relating to the classification of financial instruments puttable at fair value also apply to the classification of ordinary shares in a limited life entity. The entity is obliged to liquidate because it has a limited life. Therefore, IAS 32 requires these shares to be classified as financial liabilities because the entity has an obligation to transfer cash or another financial asset to the shareholders. Hence, a limited life entity would have no equity. Similar issues also apply to some partnerships that are required to liquidate upon the exit of a partner (eg on retirement or death).

5 The objective of this Exposure Draft is to develop a limited scope, short-term solution to improve the financial reporting of financial instruments puttable at fair value and instruments with obligations arising on liquidation that have characteristics similar to ordinary shares, pending the outcome of the Board's longer-term project on liabilities and equity.

Features of this Exposure Draft

6 The Exposure Draft proposes amendments that would require:

(a) a financial instrument puttable at fair value to be classified as equity, provided specified criteria are met;

(b) an instrument that imposes an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation to be classified as equity, provided specified criteria are met;

(c) disclosures about

  (i) financial instruments puttable at fair value classified as equity, including the fair values of these instruments; and

  (ii) the reclassification of financial instruments puttable at fair value and instruments with obligations arising on liquidation between financial liabilities and equity; and

(d) these amendments to be applied in annual periods beginning on or after a date to be determined after exposure, with early adoption encouraged. These amendments are to be applied retrospectively (with one exception permitted relating to compound instruments).

Acknowledgements

The Board thanks its partner standard-setter, the Financial Reporting Standards Board of the New Zealand Institute of Chartered Accountants (NZICA), for its assistance with this project, in particular, Joanna Yeoh (Senior Analyst—Accounting Standards) and Kimberley Crook (Technical Director—Accounting Standards), NZICA staff.

Invitation to Comment

The Board invites comments on the amendments to IAS 32 and IAS 1 proposed in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated;

(b) indicate the specific paragraph or group of paragraphs to which they relate;

(c) contain a clear rationale; and

(d) include any alternative the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional issues that, in their view, warrant consideration.

The Board is not requesting comments on matters in IAS 32 and IAS 1 not addressed in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than **23 October 2006**.

Question 1 – Financial instruments puttable at fair value

The Exposure Draft proposes that financial instruments puttable at fair value should be classified as equity, provided that specified criteria are met.

Do you agree that it is appropriate to classify as equity financial instruments puttable at fair value? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification of financial instruments puttable at fair value, why?

Question 2 – Obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation

The Exposure Draft proposes that an instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation should be classified as equity, provided that specified criteria are met (eg ordinary shares issued by a limited life entity).

Do you agree that it is appropriate to classify as equity these types of instruments? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification for these types of instruments, why?

Question 3 – Disclosures

The Exposure Draft proposes disclosures about financial instruments puttable at fair value classified as equity, including the fair values of these instruments, and the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity.

(a) Do you agree that it is appropriate to require additional information about financial instruments puttable at fair value classified as equity, including the fair values of these instruments? If so, do you agree that the fair value disclosures should be required at every reporting date? If not, why? What changes do you propose, and why?

(b) Do you agree that it is appropriate to require disclosure of information about the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity? If not, why? What changes do you propose, and why?

Question 4 – Effective date and transition

The proposed changes would be required to be applied retrospectively, from a date to be determined by the Board after exposure (with one exception permitted relating to compound instruments). Earlier application would be encouraged.

Are the transition provisions appropriate? If not, what do you propose, and why?

Proposed Amendments to IAS 32 *Financial Instruments: Presentation*

In the Introduction to IAS 32, the footnote to paragraph IN1 and paragraphs IN6, IN7 and IN10 are amended (new text is underlined and deleted text is struck through). Paragraphs IN1–IN5, IN8, IN9 and IN11 are included here for convenience but are not amended.

Introduction

Reasons for revising IAS 32

IN1 International Accounting Standard 32 *Financial Instruments: Disclosure and Presentation* (IAS 32)[2] replaces IAS 32 *Financial Instruments: Disclosure and Presentation* (revised in 2000), and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is permitted. The Standard also replaces the following Interpretations and draft Interpretation:

- SIC-5 *Classification of Financial Instruments—Contingent Settlement Provisions*;
- SIC-16 *Share Capital—Reacquired Own Equity Instruments (Treasury Shares)*;
- SIC-17 *Equity—Costs of an Equity Transaction*; and
- draft SIC-D34 *Financial Instruments—Instruments or Rights Redeemable by the Holder*.

[2] This Introduction refers to IAS 32 as revised in December 2003. In August 2005 the IASB amended IAS 32 by relocating all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*. Also, in [month and year to be inserted], the IASB amended IAS 32 by requiring particular types of financial instruments (eg financial instruments puttable at fair value) to be classified as equity, provided that specified conditions are met.

IN2 The International Accounting Standards Board developed this revised IAS 32 as part of its project to improve IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*. The objective of the project was to reduce complexity by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance published by the Implementation Guidance Committee (IGC).

IN3 For IAS 32, the Board's main objective was a limited revision to provide additional guidance on selected matters—such as the measurement of the components of a compound financial instrument on initial recognition, and the classification of derivatives based on an entity's own shares—and to locate all disclosures relating to financial instruments in one Standard.[3] The Board did not reconsider the fundamental approach to the presentation and disclosure of financial instruments contained in IAS 32.

The main changes

IN4 The main changes from the previous version of IAS 32 are described below.

Scope

IN5 The scope of IAS 32 has, where appropriate, been conformed to the scope of IAS 39.

Principle

IN6 In summary, when an issuer determines whether a financial instrument is a financial liability or an equity instrument, the instrument is an equity instrument if, and only if, both conditions (a) and (b) are met.

(a) The instrument includes no contractual obligation either~~:~~

[3] In August 2005 the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

~~(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 issuer~~;~~. For this purpose, a contractual obligation does not include:

(i) an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, provided that all financial instruments (or components of financial instruments) in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation; or

(ii) an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity are financial instruments puttable at fair value.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, the issuer's own equity instruments do not include financial instruments puttable at fair value, instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, or instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

IN7 In addition, when an issuer has an obligation to purchase its own shares for cash or another financial asset, there is a liability for the amount that the issuer is obliged to pay (except when that obligation is excluded from the definition of a financial liability).

IN8 The definitions of a financial asset and a financial liability, and the description of an equity instrument, are amended consistently with this principle.

Classification of contracts settled in an entity's own equity instruments

IN9 The classification of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments has been clarified consistently with the principle in paragraph IN6 above. In particular, when 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 (eg a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability.

Puttable instruments

IN10 IAS 32 incorporates the guidance previously proposed in draft SIC Interpretation 34 *Financial Instruments—Instruments or Rights Redeemable by the Holder*. Consequently, a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability of the issuer (with one exception, which relates to financial instruments puttable at fair value). In response to comments received on the Exposure Draft, the Standard provides additional guidance and illustrative examples for entities that, because of this requirement, have no equity or whose share capital is not equity as defined in IAS 32.

Contingent settlement provisions

IN11 IAS 32 incorporates the conclusion previously in SIC-5 *Classification of Financial Instruments—Contingent Settlement Provisions* that a financial instrument is a financial liability when the manner of settlement depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder. Contingent settlement provisions are ignored when they apply only in the event of liquidation of the issuer or are not genuine.

In the Standard, paragraph 11 is amended (new text is underlined and deleted text is struck through). In paragraph 11, the definitions of a financial asset and a financial liability are amended, and two new definitions are added immediately after the definition of fair value. The definitions of a financial instrument, an equity instrument and fair value are included here for convenience but are not amended.

International Accounting Standard 32 *Financial Instruments: Presentation*

Definitions (see also paragraphs AG3–AG24)

11 **The following terms are used in this Standard with the meanings specified:**

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

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

(d) 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 receive 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. For this purpose the entity's own equity instruments do not include financial instruments puttable at fair value, instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that ~~is:~~ meets either of the following conditions.

(a) It is a contractual obligation~~:~~ either

~~(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~~;~~. For this purpose, a contractual obligation does not include:

(i) an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, provided that all financial instruments (or components of financial instruments) in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation; or

(ii) an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the most subordinated class

of instruments with a claim to the assets of the entity are financial instruments puttable at fair value. ~~**or**~~

(b) It is **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. For this purpose the entity's own equity instruments do not include financial instruments puttable at fair value, instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.**

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

***Fair value* is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

A *financial instrument puttable at fair value* has all of the following features:

(a) **its issue price is the fair value of the instrument holder's entitlement to a pro rata share of the net assets of the entity;**

(b) **it entitles the holder to require the entity to repurchase or redeem the instrument for the fair value of a pro rata share of the net assets of the entity;**

(c) **it entitles the holder to a pro rata share of the net assets of the entity in the event of the liquidation of the entity; and**

(d) **other than a contractual obligation that arises from the entitlement set out in (b) and a contractual obligation that may arise from the entitlement set out in (c), it does not contain a 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 unfavourable 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.**

A financial instrument that entitles the holder to a *pro rata share of the net assets of the entity* has all of the following features:

(a) **the financial instrument is in the most subordinated class of financial instruments with a claim to the assets of the entity. The claims of a financial instrument with this entitlement have no priority over other claims to the assets of the entity, in terms of either the calculation of the amount due on liquidation or the timing of payment of that amount. A financial instrument that must be converted into another instrument to be in the most subordinated class of financial instruments does not possess this feature.**

(b) **the financial instrument is entitled to a proportionate share of the residual interest in the assets of the entity that remains after deducting all other claims to the assets of the entity. A proportionate share is one that is determined by:**

- **(i)** **dividing the total amount of the residual interest in the assets of the entity into units of equal amount; and**

- **(ii)** **multiplying that unit amount by the ratio of the number of the units held by the financial instrument holder to the total number of units.**

(c) **the financial instrument does not contain any preferential right upon liquidation of the entity.**

(d) **the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, to any extent, before or at liquidation, through the terms and**

conditions of either (i) the instrument, (ii) another financial instrument issued by the entity (to either the instrument holder or another party), or (iii) a related contract between the entity and the instrument holder.

Paragraph 16 is amended (new text is underlined and deleted text is struck through). After paragraph 16, paragraph 16A is inserted. Paragraph 15 is included here for convenience but is not amended.

Presentation

Liabilities and equity (see also paragraphs AG25–AG29)

15 **The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.**

16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation~~:~~ either

~~(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 issuer. For this purpose, a contractual obligation does not include:

(i) an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, provided that all financial instruments (or components of financial instruments) in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation; or

(ii) an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity are financial instruments puttable at fair value.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments specified in paragraph 16A, or instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

16A A financial instrument puttable at fair value and a financial instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation are classified as equity when these instruments meet the specified criteria for exclusion from the definition of a financial liability (see subparagraphs (a)(i) and (ii) of the definition of a financial liability in paragraph 11).

Paragraphs 17–19 are amended (new text is underlined and deleted text is struck through). After paragraph 17, paragraph 17A is inserted. Paragraph 20 is included here for convenience but is not amended.

No contractual obligation to deliver cash or another financial asset (paragraph 16(a))

17 Except as stated in paragraph 17A, a~~A~~ critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

17A However, for the purposes of this Standard, a 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 unfavourable to the entity) does not include those specifically excluded from the definition of a financial liability (see subparagraphs (a)(i) and (ii) of the definition of a financial liability in paragraph 11).

18 The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

(a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require

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the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

(b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability (except as stated in paragraph 16A). This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease~~, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer~~. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability (except as stated in paragraph 16A). For example, open-ended mutual funds, unit trusts, partnerships and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash ~~equal to their proportionate share of the asset value of the issuer~~, which results in the unitholders' or members' interests being classified as financial liabilities (except as stated in paragraph 16A). However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no contributed equity (such as some mutual funds and unit trusts, see Illustrative Example 7) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not (see Illustrative Example 8).

19 If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability (except as stated in paragraph 17A). For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

20 A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21).

Paragraphs 22 and 23 are amended (new text is underlined and deleted text is struck through). After paragraph 22, paragraph 22A is inserted. Paragraphs 21 and 24 are included here for convenience but are not amended.

Settlement in the entity's own equity instruments (paragraph 16(b))

21 A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100,[4] and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

22 <u>Except as stated in paragraph 22A, a</u>~~A~~ contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

22A If the entity's own equity instruments to be (received or) delivered by the entity upon settlement of a derivative are financial instruments puttable at fair value, or instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, the derivative is a (financial asset or) financial liability. This includes a derivative that will be settled by the entity (receiving or) delivering a fixed number of such equity instruments in exchange for a fixed amount of cash or another financial asset.

[4] In this Standard, monetary amounts are denominated in 'currency units' (CU).

23 Except as stated in paragraph 16A, a~~A~~ contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under IAS 39, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with IAS 39. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

24 A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold.

After paragraph 25, a heading and paragraph 25A are added. Paragraph 25 is included for convenience but is not amended.

Contingent settlement provisions

25 A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or

otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

Settlement on liquidation of the entity

25A Typically, a financial instrument that entitles the holder to a pro rata share of the net assets of the entity on liquidation of the entity does not impose an obligation on the entity to deliver cash or another financial asset of the entity (or otherwise to settle it in such a way that it would be a financial liability) because the entity is not obliged to liquidate. However, in some cases, an entity may be obliged to liquidate (eg the entity may be required to liquidate at the end of a fixed period or the instrument holder may have the ability to require the entity to liquidate). Instruments, or components of instruments, in the most subordinated class of instruments issued by an entity that must be liquidated at the end of a fixed period are not precluded from being classified as equity solely because the entity has an obligation to pay the holders of those instruments a pro rata share of its net assets on liquidation. Similarly, instruments, or components of instruments, are not precluded from being classified as equity solely because the holder, in common with all other holders of financial instruments in the most subordinated class of instruments with a claim to the assets of the entity, can require the entity to liquidate and pay the holder a pro rata share of the net assets of the entity (see paragraph 16A).

After paragraph 96, paragraph 96A is inserted and after paragraph 97, paragraph 97A is inserted. Paragraph 97 is included here for reference but is not amended.

96A ***Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*** **(Amendments to IAS 32 and IAS 1), issued in [date to be inserted after exposure], amended the definition of a financial liability**

and a financial asset, and included new definitions for a financial instrument puttable at fair value and a financial instrument that entitles the holder to a pro rata share of the net assets of the entity in paragraph 11, amended paragraphs 16, 17–19, 22, 23, AG13, AG14 and AG27, and inserted paragraphs 16A, 17A, 22A, 25A, 97A, AG14A–AG14G and AG29A. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to IAS 1, IAS 39 and IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* at the same time.

97 This Standard shall be applied retrospectively.

97A When applying the amendments described in paragraph 96A, an entity is required to split a compound financial instrument with an obligation for a pro rata share of the net assets of the entity upon its liquidation into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of those amendments to IAS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, an entity need not separate these two portions if the liability component is no longer outstanding at the date of application of the amendments.

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In the Appendix *Application Guidance*, paragraphs AG13 and AG14 are amended (new text is underlined). After paragraph AG14, a heading, paragraphs AG14A–AG14C, another heading and paragraphs AG14D–AG14G are added.

Appendix
Application Guidance

Definitions (paragraphs 11–14)

Equity instruments

AG13 Examples of equity instruments include non-puttable ordinary shares, some types of preference shares (see paragraphs AG25 and AG26), some financial instruments puttable at fair value (see paragraph 16A) and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. An entity's obligation to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity (except as stated in paragraph 22A). However, if such a contract contains an obligation for the entity to pay cash or another financial asset (other than a contractual obligation of the type that is excluded from the definition of a financial liability), it also gives rise to a liability for the present value of the redemption amount (see paragraph AG27(a)). An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

AG14 A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is

not a financial asset of the entity (except as stated in paragraph 22A). Instead, any consideration paid for such a contract is deducted from equity.

Financial instruments puttable at fair value

AG14A For a financial instrument to be a financial instrument puttable at fair value, the issue price received, or the redemption or repurchase price paid by the entity for the financial instrument is its fair value, determined in accordance with the requirements of IAS 39 paragraph 48A and paragraphs AG69–AG82. However, entities that

(a) have not filed, or are not in the process of filing, their financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or

(b) do not hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity,

are permitted to use a formula to determine the fair value of financial instruments puttable at fair value on their issue, redemption or repurchase, provided that the formula is intended to approximate the fair value of the financial instruments. The instrument's pro rata share of the book value of the net assets of the entity is a formula that would approximate the fair value of the instrument only when there is no material difference between the book value of the entity's net assets and the fair value of its net assets (both recognised and unrecognised). An entity may change the basis of determining the fair value of financial instruments puttable at fair value if, and only if, the change results in an estimate that is more representative of the fair value of the financial instruments puttable at fair value in the circumstances.

AG14B One feature of a financial instrument puttable at fair value is that its issue price must be the fair value of its pro rata share of the net assets of the entity. Financial instruments puttable at fair value are issued at fair value only if the fair value of the consideration received equals the fair value of the instruments issued. For example, an entity may issue a convertible bond, which is convertible into the entity's ordinary shares that are puttable at fair value. Upon conversion, the fair value of the convertible bond tendered in exchange for the puttable shares will reflect both the fair value of the option and the fair value of the bond. Hence, typically the fair value of the convertible bond will equal the fair value of the puttable shares. If so, the puttable shares are issued at fair value for the purposes of determining whether those shares meet the definition of a financial instrument puttable at fair value.

AG14C In the case of the convertible bond described in paragraph AG14B, IAS 32 requires the option embedded in the bond to be recognised separately from the host instrument (bond). Typically, the option embedded in a convertible bond would be accounted for as an equity instrument and not remeasured. However, in the case of an option on a financial instrument puttable at fair value, the embedded option is a derivative and, consistently with the treatment of all derivatives on financial instruments puttable at fair value, is classified as a financial liability. Therefore, the option shall be measured at fair value at each balance sheet date and on the date of conversion in accordance with IAS 39.

Financial instruments that entitle the holders to a pro rata share of the net assets of the entity

AG14D One feature of a financial instrument that entitles the holder to a pro rata share of the net assets of the entity is that the financial instrument is in the most subordinated class of instruments with a claim to the assets of the entity. A financial instrument is in the most subordinated class of financial instruments if, and only if, on liquidation the amount due to the holders of the financial instruments is calculated after deducting all other claims to the assets of the entity and the instrument holders are paid out last, after payments are made to all other claimants to the assets of the entity.

AG14E When determining whether an instrument is in the most subordinated class, an instrument's claim on liquidation is evaluated as if the entity were to liquidate on the date the classification decision for the instrument in question is made (the assessment date). The classification decision shall be reassessed if there is a change in circumstances relevant to the classification of the financial instrument. For example, if the entity issues or redeems another financial instrument, this may affect whether the instrument in question is in the most subordinated class.

AG14F An instrument that has a preferential right on liquidation of the entity is not an instrument with an entitlement to a pro rata share of the net assets of the entity. For example, an instrument has a preferential right on liquidation if it entitles the holder to a fixed dividend on liquidation, in addition to a share of the net assets of the entity, when other instruments in the most subordinated class with a right to a pro rata share of the net assets of the entity do not have the same right on liquidation.

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AG14G For an instrument to have an entitlement to a pro rata share of the net assets of the entity, the terms and conditions of the instrument shall not, to any extent, have the effect of providing the instrument holder with an entitlement to a pro rata share of the entity's net assets that:

(a) is a fixed or specified amount;

(b) changes over time, so as to provide the instrument holder with a fixed or specified amount; or

(c) is unaffected by changes in the value of the net assets of the entity.

Similarly, if terms and conditions that have these effects are included in another instrument issued by the entity (either to the instrument holder or another party), or in a related contract between the entity and the instrument holder, the instrument does not have an entitlement to a pro rata share of the net assets of the entity.

Paragraph AG27 is amended (new text is underlined) and after paragraph AG29, paragraph AG29A is added. Paragraphs AG25, AG26, AG28 and AG29 are included here for convenience but are not amended.

Presentation

Liabilities and equity (paragraphs 15–27)

No contractual obligation to deliver cash or another financial asset (paragraphs 17–20)

AG25 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

AG26 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity

instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Settlement in the entity's own equity instruments (paragraphs 21–24)

AG27 The following examples illustrate how to classify different types of contracts on an entity's own equity instruments:

(a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity <u>(except as stated in paragraph 22A)</u>. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount <u>(except as stated in paragraph 16A)</u>. One example is an entity's obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.

(b) An entity's obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem <u>(except as stated in paragraph 16A)</u>. One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.

(c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity <u>(except as stated in paragraph 16A)</u>. One example is a net cash-settled share option.

(d) A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent settlement provisions (paragraph 25)

AG28 Paragraph 25 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares

may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Treatment in consolidated financial statements

AG29 In consolidated financial statements, an entity presents minority interests—ie the interests of other parties in the equity and income of its subsidiaries—in accordance with IAS 1 *Presentation of Financial Statements* and IAS 27 *Consolidated and Separate Financial Statements*. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

AG29A The definition of a financial liability excludes some contractual obligations (provided the specified conditions are met) that oblige the entity to deliver to another party a pro rata share of the net assets of the entity upon its liquidation (or upon redemption or repurchase of a financial instrument puttable at fair value). One of the features of a financial instrument that entitles the holder to a pro rata share of the net assets of the entity is that the instrument is in the most subordinated class of financial instruments with a claim to the assets of the entity. In the consolidated financial statements, the financial instruments held by minority interests are not in the group's most subordinated class of instruments. This is because, if the group were to liquidate, the claims of minority interest holders to the net assets of the subsidiary have to be satisfied before the parent's share of the net assets of the subsidiary can be distributed to claimants to the assets of the parent.

Therefore, in all cases, a contractual obligation of the group to deliver cash or another financial asset to a minority interest holder (or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the group) is classified as a financial liability in the consolidated financial statements.

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In the Illustrative Examples, paragraph IE1 is amended (new text is underlined).

Illustrative Examples

Accounting for contracts on equity instruments of an entity

IE1 The following examples[5] illustrate the application of paragraphs 15–27 and IAS 39 to the accounting for contracts on an entity's own equity instruments <u>(other than the financial instruments specified in paragraph 16A)</u>.

In Example 8, paragraph IE33 is amended (new text is underlined).

Example 8: Entities with some equity

IE33 The following example illustrates an income statement and balance sheet format that may be used by entities whose share capital is not equity as defined in IAS 32 because the entity has an obligation to repay the share capital on demand <u>at a fixed price</u>. Other formats are possible.

[5] In these examples, monetary amounts are denominated in 'currency units' (CU).

Income statement for the year ended 31 December 20X1

	20X1	20X0
	CU	CU
Revenue	472	498
Expenses (classified by nature or function)	(367)	(396)
Profit from operating activities	105	102
Finance costs		
– other finance costs	(4)	(4)
– distributions to members	(50)	(50)
Change in net assets attributable to members	51	48

Balance sheet at 31 December 20X1

		20X1		20X0
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IAS 1)	908		830	
Total non-current assets		908		830
Current assets (classified in accordance with IAS 1)	383		350	
Total current assets		383		350
Total assets		1,291		1,180
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		717		681
Non-current liabilities (classified in accordance with IAS 1)	187		196	
		(187)		(196)

RESERVES[(a)]				
Reserves eg revaluation reserve, retained earnings etc	530		485	
		530		485
		717		681

MEMORANDUM NOTE – Total members' interests

Share capital repayable on demand	202	161
Reserves	530	485
	732	646

(a) In this example, the entity has no obligation to deliver a share of its reserves to its members.

Proposed Amendments to IAS 1 *Presentation of Financial Statements*

In the Standard, after paragraph 11, paragraph 11A is inserted as follows:

11A The following terms are defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation* and are used in this Standard with the meaning specified in IAS 32:

- financial instrument puttable at fair value
- a financial instrument that entitles the holder to a pro rata share of the net assets of the entity.

After paragraph 75, paragraph 75A is inserted as follows:

75A If an entity has reclassified:

(a) a financial instrument puttable at fair value; or

(b) an instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation;

between financial liabilities and equity, it shall disclose the amount reclassified into and out of each category (financial liabilities or equity), and the timing and reason for that reclassification.

After paragraph 124C, a new heading and paragraphs 124D and 124E are inserted as follows. Paragraph 126 is amended (new text is underlined and deleted text is struck through). Paragraph 125 is not amended but is included here for convenience.

Financial instruments puttable at fair value

124D For financial instruments puttable at fair value classified as equity, an entity shall disclose (to the extent not disclosed elsewhere):

(a) summary quantitative data about the amount classified as equity;

(b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

(c) the fair value of that class of financial instruments in a way that permits it to be compared with its carrying amount; and

(d) information about how fair value was determined, consistently with the requirements of IFRS 7 *Financial Instruments: Disclosures* paragraph 27(a)–(c), to the extent applicable.

124E If an entity uses a formula to determine the price received or paid by the entity upon issue, redemption or repurchase of financial instruments puttable at fair value that are classified as equity (as permitted by paragraph AG14A of IAS 32), it shall:

(a) disclose that fact; and

(b) use that formula, and disclose information about the formula, for the purposes of complying with paragraph 124D(c) and (d).

Other disclosures

125 An entity shall disclose in the notes:

(a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to equity holders during the period, and the related amount per share; and

(b) the amount of any cumulative preference dividends not recognised.

126 An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

(a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);

(b) a description of the nature of the entity's operations and its principal activities; ~~and~~

(c) the name of the parent and the ultimate parent of the group~~.~~; and

(d) if it is a limited life entity, information regarding the length of its life.

After paragraph 127B, paragraph 127C is inserted as follows:

127C *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* (Amendments to IAS 32 and IAS 1), issued in [date to be inserted after exposure], amended paragraph 126 and inserted paragraphs 11A, 75A, 124D and 124E. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to IAS 32, IAS 39 and IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* at the same time.

Appendix
Amendments to other IFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies the [draft] amendments to IAS 32 and IAS 1 for an earlier period, these amendments shall be applied for that earlier period. In the amended paragraphs, new text is underlined and deleted text is struck through.

1 IAS 39 *Financial Instruments: Recognition and Measurement* is amended as described below.

Paragraph 2 is amended as follows:

Scope

2 This Standard shall be applied by all entities to all types of financial instruments except:

…

(d) financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options ~~and~~, warrants and the instruments specified in paragraph 16A of IAS 32). However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.

…

2 IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* is amended as described below.

The footnote (to the reference to 'IAS 32 *Financial Instrument: Disclosure and Presentation* (as revised in 2003)') is amended as follows:

[1]In August 2005, IAS 32 was amended as IAS 32 *Financial Instruments: Presentation*. Also, in [month and year to be inserted], the IASB amended IAS 32 by requiring particular types of financial instruments (eg financial instruments puttable at fair value) to be classified as equity, provided that specified conditions are met.

Paragraphs 6 and 9 are amended as follows. Paragraphs 7 and 8 are included here for convenience but are not amended.

6 Members' shares that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 7 and 8 is present or if the members' shares are financial instruments puttable at fair value that are classified as equity in accordance with paragraph 16A of IAS 32. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

7 Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

8 Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.

9 An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7 or if the members' shares are financial instruments puttable at fair value that are classified as equity in accordance with paragraph 16A of IAS 32. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.

After paragraph 14, paragraph 14A is inserted as follows:

14A An entity shall apply the amendments in paragraphs 6, 9, A1 and A12 for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* (Amendments to IAS 32 and IAS 1), issued in [date to be inserted after exposure], for an earlier period, those amendments shall be applied to that earlier period.

In the Appendix (Examples of the application of the consensus), paragraphs A1 and A12 are amended as follows:

A1 This appendix sets out seven examples of the application of the IFRIC consensus. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability and that the financial instruments are not financial instruments puttable at fair value that are classified as equity in accordance with paragraph 16A of IAS 32.

Classification

A12 In this case, CU750,000 would be classified as equity and CU150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 18(b) of IAS 32 states in part:

> …a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability (except as stated in paragraph 16A). This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease~~, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer~~. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability (except as stated in paragraph 16A).

In the Basis for Conclusions, paragraph BC7 is amended as follows:

BC7 In many jurisdictions, local law or regulations state that members' shares are equity of the entity. However, paragraph 17 of IAS 32 states:

> Except as stated in paragraph 17A, a~~A~~ critical feature in differentiating a financial liability from an equity instrument is *the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder)* or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party. [Emphasis added]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not a part of, the draft amendments to IAS 32 and IAS 1.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements—*Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation.* Individual Board members gave greater weight to some factors than to others.

Background

BC2 IAS 32 *Financial Instruments: Presentation* requires a financial instrument to be classified as equity if specified conditions are met. One condition is that the instrument includes no contractual obligation to deliver cash or another financial asset to another entity.

BC3 When an issuer has an obligation to purchase its own shares for cash or another financial asset, IAS 32 paragraph 23 requires the issuer to recognise a financial liability for the present value of the amount that it is obliged to pay for the financial instruments. Therefore, a financial instrument puttable at fair value is recognised as a financial liability at the fair value of the financial instrument.

BC4 IAS 32, in some cases, requires an instrument to be classified as equity even though the entity has an obligation to deliver cash or another financial asset to another entity upon its liquidation. In accordance with paragraph 25 of IAS 32, such an instrument is classified as equity if liquidation of the entity is a contingent event that is beyond the control of both the entity and the holder of the instrument. Therefore, IAS 32 requires an instrument containing an obligation to transfer cash or another financial asset on liquidation of the entity to be classified as a financial liability when liquidation is:

(a) certain to occur and outside the control of the entity; or

(b) uncertain to occur, but the holder of the instrument can require the entity to liquidate (liquidation at the option of the holder).

The proposed amendments

Financial instruments puttable at fair value

BC5 Some entities, such as some co-operatives, mutual funds, partnerships and private (unlisted) entities, issue financial instruments that require the entity to repurchase or redeem the instrument at the fair value of a pro rata share of the net assets of the entity (financial instruments puttable at fair value). Constituents raised the following concerns about the application of IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement* to financial instruments puttable at fair value.

(a) On an ongoing basis, the liability is recognised at not less than the amount payable on demand, ie the instrument's fair value. This results in the entire market capitalisation of the entity being recognised as a liability because the instruments are the equivalent of the entity's ordinary shares.

(b) The changes in the fair value of the liability are recognised in profit or loss. When the entity performs well and the fair value of the liabilities increases, a loss is recognised. When the entity performs poorly and the fair value of the liability decreases, a gain is recognised.

(c) It is likely that the entity will 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 issuing entity's balance sheet portrays the entity as wholly, or mostly, debt funded.

(e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that net income is a function of the distribution policy, not performance.

Furthermore, constituents considered that additional disclosures and adapting the format of the income statement and balance sheet did not resolve these concerns.

BC6 The Board noted that financial instruments puttable at fair value have characteristics similar to ordinary shares, in that the instruments give the holder a residual interest in the net assets of the entity. Moreover, financial instruments puttable at fair value would meet the definition of equity instruments in accordance with IAS 32 but for the holder's right to put the instruments back to the issuer at their fair value. The Board noted that additional disclosures and adapting the format of the entity's financial statements, supplementing the treatment of these instruments in accordance with IAS 32 and IAS 39, did not resolve the problem of the lack of relevance and understandability of that current accounting treatment.

BC7 The Board considered the following ways to improve the financial reporting of financial instruments puttable at fair value:

(a) continue to classify these instruments as financial liabilities, but amend their measurement so that changes in their fair value would not be recognised;

(b) amend IAS 32 to require separation of all puttable instruments into a put option and a host instrument; or

(c) amend IAS 32 to provide a limited exception so that financial instruments puttable at fair value would be classified as equity, if specified conditions were met.

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Amend the measurement of financial instruments puttable at fair value so that changes in their fair value would not be recognised

BC8 The Board decided against this approach because:

(a) it is inconsistent with the principle in IAS 32 and IAS 39 that only equity instruments are not remeasured after their initial recognition;

(b) it retains the disadvantage that entities whose shares are all puttable at fair value would have no equity instruments; and

(c) it introduces a new category of financial liabilities to IAS 39, and thus increases IAS 39's complexity.

Separate all puttable instruments into a put option and a host instrument

BC9 The Board concluded that conducting further research into an approach that splits a puttable share into an equity component and a written put option component (financial liability) would duplicate efforts of the Board's longer-term project on liabilities and equity. Consequently, the Board decided not to proceed with a project at this stage to determine whether a puttable share should be split into an equity component and a written put option component.

Classify as equity financial instruments puttable at fair value with characteristics similar to ordinary shares

BC10 The Board decided to proceed with proposals to amend IAS 32 to require financial instruments puttable at fair value with characteristics similar to ordinary shares to be classified as equity provided specified conditions are met, as a short-term solution, pending the outcome of the longer-term project on liabilities and equity. The Board acknowledges that this approach is a pragmatic solution to improve the financial reporting of financial instruments puttable at fair value, because it involves amending IAS 32 to

require equity classification of a particular type of financial instrument in specific circumstances, rather than comprehensively reviewing the distinction between liabilities and equity. Such a review would take a substantial amount of time to complete and therefore is part of the longer-term project. In the meantime, the Board concluded that the lack of relevance and understandability of the information produced from the current financial reporting treatment was such that it should proceed with a pragmatic, short-term solution.

BC11 The Board proposes the following conditions for classifying as equity a financial instrument puttable at fair value:

(a) the instrument entitles the holder to require the entity to repurchase or redeem the instrument for the fair value of a pro rata share of the net assets of the entity and would, but for this entitlement, have met the definition of an equity instrument;

(b) the instrument entitles the holder to a pro rata share of the net assets of the entity in the event of the entity's liquidation;

(c) the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, either before or at liquidation;

(d) the instrument is in the most subordinated class of instruments with a claim to the entity's net assets;

(e) the instrument's issue price is the fair value of a pro rata share of the net assets of the entity at the time of issue; and

(f) the instruments in the most subordinated class are all financial instruments puttable at fair value.

BC12 The Board decided on these conditions for the following reasons:

(a) to ensure that the affected instruments are equivalent to ordinary shares, except for the right to put at fair value;

(b) to ensure that the proposed amendments are consistent with the limited scope of the project; and

(c) to reduce structuring opportunities that may arise as a result of the proposed amendments.

BC13 To apply the proposed amendments, an entity would normally determine the fair value of financial instruments puttable at fair value in accordance with relevant IAS 39 guidance (paragraphs 48A and AG69–AG82). To reduce costs, some partnerships and non-public entities use a formula, as a proxy, to calculate the fair value of the issue price or redemption price of puttable instruments. For entities whose securities are not publicly traded or that do not hold assets in a fiduciary capacity for a broad group of outsiders, the Board decided not to increase their costs in complying with the proposed amendments by agreeing that a formula can be used to determine the amount at which the financial instruments puttable at fair value are issued, repurchased or redeemed, provided that the formula is intended to approximate fair value.

BC14 The Board also decided that warrants (and other derivatives) to be settled by the issue of financial instruments puttable at fair value should be precluded from equity classification under the proposed amendments; these derivatives would continue to be classified as financial liabilities. The Board noted that a warrant (and other similar derivatives) over a puttable instrument has the same characteristics as a cash-settled share appreciation right, which is classified as a financial liability. Moreover, as discussed above, the objective of the project is to improve the financial reporting of financial instruments puttable at fair value (and instruments that entitle the holder to a pro rata share of the net assets of the entity upon liquidation) that have characteristics similar to ordinary shares. The Board noted that warrants do not have the characteristics of the instruments to be affected by the proposed amendments. Therefore, in keeping with the limited scope of the project, the Board concluded that any warrants or other derivatives that are currently classified as financial liabilities should continue to be so classified.

Obligations arising on liquidation

BC15 Issues similar to those raised by constituents relating to the classification of financial instruments puttable at fair value (set out in paragraph BC5) apply to the classification of ordinary shares (or equivalent instruments) in a limited life entity. Liquidation of the entity is certain because it has a limited life. Therefore, IAS 32 at present requires those shares to be classified as financial liabilities because the entity has an obligation to transfer cash or

another financial asset to the shareholders. Hence, a limited life entity would have no equity. Similar issues also arise in respect of some partnerships that are required to liquidate upon exit of a partner (eg on retirement or death).

BC16 The Board decided to propose an amendment to exclude from the definition of a financial liability a contractual obligation that entitles the holder to a pro rata share of the net assets of the entity upon liquidation of the entity. This amendment would result in equity classification of instruments, or components of instruments, that entitle the holder to a pro rata share of the net assets of the entity upon liquidation, including when liquidation is:

(a) certain to occur and outside the control of the entity (affects limited life entities); or

(b) uncertain to occur and liquidation is at the option of the holder (affects partnership interests).

BC17 However, for the instruments referred to in (b) of the paragraph above, the Board decided that equity classification should be conditional upon all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity having the right to require liquidation of the entity. This condition is similar to the condition applying to the classification of financial instruments puttable at fair value, whereby all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity are puttable at fair value. In both cases, equity classification of an instrument that imposes on the entity an obligation to transfer cash or another financial asset to the instrument holder is conditional upon all instruments in the most subordinated class of instruments with a claim to the assets of the entity imposing such an obligation. This circumstance already applies to shares issued by a limited life entity, because all such shares impose on the entity an obligation to transfer cash or another financial asset to the instrument holder.

BC18 The Board also considered the classification of warrants (and other derivatives) to be settled by an exchange of a fixed amount of cash for a fixed number of financial instruments with a contractual obligation that entitles the holder to a pro rata share of the net assets of the entity upon liquidation of the entity (eg warrants over shares in a limited life entity). The Board decided that the classification of such warrants should be consistent with its earlier decision in respect of warrants over financial instruments puttable at fair value (as explained in paragraph BC14). The Board noted that these warrants do not have the characteristics of the instruments to be affected by the proposed amendments. Therefore, the Board concluded that these warrants should continue to be classified as financial liabilities.

Minority interests

BC19 The Board also discussed the classification of minority interests under the proposed amendments. Any minority interests that are currently classified as equity would be unaffected by the proposed amendments. The Board discussed minority interests that are, at present, classified as financial liabilities in the group's consolidated financial statements because they are puttable at fair value or represent obligations arising on liquidation of a subsidiary when liquidation is certain or at the option of the minority interest holder. The Board concluded that in the subsidiary's individual financial statements these types of minority interests should be classified as equity in accordance with the proposed amendments, if the relevant conditions were satisfied. However, they would not be classified as equity in the group's consolidated financial statements because minority interests are not in the most subordinated class of instruments from the perspective of the group. This is because, if the group were to liquidate, the claims of minority interests to the net assets of the subsidiary have to be satisfied first, before the parent's share of the net assets of the subsidiary could be distributed to the claimants to the assets of the parent. Therefore, those types of minority interests would continue to be classified as financial liabilities in the consolidated financial statements. The Board also noted that continuing to classify minority interests puttable at fair value and minority interests that impose an obligation arising on liquidation of a subsidiary as financial liabilities in the consolidated financial statements would limit the financial structuring opportunities arising from the proposed amendments. Finally, the Board noted that, if a parent has financial instruments puttable at fair value or financial instruments that impose an obligation arising on liquidation that meet the specified criteria for classification as equity in the parent's separate financial statements, the presence of minority interests does not preclude these shares from being classified as equity in the group's consolidated financial statements.

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Disclosures

BC20 The Board also considered disclosures for the instruments affected by the proposed amendments. The Board decided to require disclosure of information about the reclassification of the affected instruments between financial liabilities and equity. This disclosure will enhance the transparency of the financial statements, because the classification of these instruments determines their measurement, and will enhance the understandability of the financial statements when changes in classification occur.

BC21 The Board also concluded that entities with financial instruments puttable at fair value classified as equity should be required to disclose additional information to allow users to assess any risks arising from the ability of the holder to put these instruments to the issuer at any time. It is unusual for holders of equity instruments to have such an entitlement. Therefore, the Board concluded that additional disclosures are needed in these circumstances. In particular, the Board concluded that entities should disclose the fair value of financial instruments puttable at fair value that are classified as equity, because that represents the amount at which these instruments could be redeemed. The Board noted that, in effect, this resulted in the continuation of a disclosure requirement, because those instruments are classified as financial liabilities in accordance with IAS 32 at present and, therefore, their fair values are required to be disclosed in accordance with IFRS 7 *Financial Instruments: Disclosures.* The Board noted that the cost of disclosing the fair value of financial instruments puttable at fair value is mitigated for entities whose securities are not publicly traded or that do not hold assets in a fiduciary capacity for a broad group of outsiders because these entities are allowed to use a formula that approximates fair value in complying with this disclosure requirement.

Analysis of costs and benefits

Proposed changes to the classification of an instrument as a financial liability or equity in IAS 32

BC22 The Board acknowledges that the proposals are not consistent with the definition of a liability in the *Framework*, or with the underlying principle of IAS 32, which is based on that definition. Consequently, making these changes adds complexity to IAS 32 and introduces the need for several rules. However, the Board also notes that IAS 32 contains other exceptions to its principle (and the definition of a liability in the *Framework*) that require instruments to be classified as liabilities that otherwise would be treated as equity. This situation clearly identifies the need for a comprehensive reconsideration of the classification of instruments as liabilities or equity which the Board will undertake in its longer-term project with the FASB.

BC23 In the interim, the Board concluded that classifying the specified instruments as equity would improve the comparability of information provided to the users of financial statements by requiring more consistent classification of financial instruments that are largely equivalent to ordinary shares across different entity structures (eg partnerships, limited life entities and some co-operatives). The specified instruments differ from ordinary shares in one respect, being the obligation to deliver cash (or another financial asset). However, in the Board's view the other characteristics of the specified instruments are sufficiently similar to ordinary shares for the instruments to be classified as equity. (Some of these characteristics are set out in the definition of a financial instrument that entitles the holder to a pro rata share of the net assets of the entity.) Consequently, in the Board's view, the proposed amendments will result in financial reporting that is more understandable and relevant to the holders of the affected instruments and other users of the financial statements. Historically, these instruments have typically been treated as equity by issuers, and this treatment has reflected the perception that the instrument holders are the entity's owners.

BC24 Furthermore, in developing the proposed amendments, the Board considered the costs to entities of obtaining any new information necessary to complete

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a new analysis to determine the classification of financial instruments in accordance with the proposed amendments to IAS 32. The Board believes that the costs of obtaining any new information necessary to determine whether financial instruments meet the specified criteria for equity classification would be slight because all of the information needed should be readily available. The Board notes that costs of complying with the conditions for equity classification for financial instruments puttable at fair value are reduced for entities whose securities are not publicly traded or that do not hold assets in a fiduciary capacity for a broad group of outsiders because the Board has permitted these entities to use a formula (that is intended to approximate fair value) to determine the issue, redemption or repurchase price of these instruments.

BC25 The Board also considered that a cost or risk in introducing exceptions to the definition of a financial liability is the financial structuring opportunities that may result from the proposed amendments. The Board concluded that financial structuring opportunities are mitigated by the strict criteria required for equity classification and the disclosures required (both proposed and currently in IFRSs).

BC26 Consequently, the Board believes that the benefits outweigh the costs of the proposed amendments to IAS 32.

BC27 The Board took the view that, in most cases, entities should be able to apply the changes to IAS 32 retrospectively. There might be cases in which it is impracticable to determine the original issue price of the affected instruments, which is necessary to reverse the effects of remeasuring the instruments to be classified as equity. The Board notes that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides relief when it is impracticable to apply a change in accounting policy retrospectively as a result of a new requirement. The Board believes that the costs outweigh the benefits of separating a compound instrument with an obligation arising on liquidation at inception when the liability component is no longer outstanding on the date of application of the proposed amendments. Hence, the proposed transitional provision permitting entities not to separate those compound instruments (based on IFRS 1 *First–time Adoption of International Financial Reporting Standards* paragraph 23) reduces the costs of applying the proposed amendments retrospectively.

Proposed additional disclosures as amendments to IAS 1

BC28 The Board regards the costs arising from the proposed disclosures as the costs of preparing the information needed. The most costly disclosures are the fair value disclosures for financial instruments puttable at fair value. However, the Board notes that this is not an additional cost as these instruments are currently measured at fair value and subject to those fair value disclosures. The Board notes that costs of those fair value disclosures are reduced for entities whose securities are not publicly traded or that do not hold assets in a fiduciary capacity for a broad group of outsiders because the Board has permitted these entities to use a formula (that is intended to approximate fair value) to calculate the fair value of financial instruments puttable at fair value.

BC29 Information necessary to prepare the other proposed disclosures should be readily available and therefore only slightly increases the cost to preparers. The Board believes that the proposed disclosures can be included without difficulty in the comparatives of the annual period when the proposed amendments are first applied.

BC30 The Board considers that the proposed disclosures will result in more transparent information and will be useful for assessing the risks attached to the affected instruments. Therefore, the Board believes that the benefits outweigh the costs of the proposed disclosures.

Alternative View on Proposed Amendments to IAS 32 and IAS 1—*Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*

AV1 Two Board members voted against the publication of the Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements—*Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation.* The members' alternative view is set out below.

AV2 These Board members believe that the decision to permit entities to classify as equity financial instruments puttable at fair value and financial instruments that entitle the holder to a pro rata share of the net assets of the entity upon liquidation is inconsistent with the *Framework*. The contractual provisions attached to these shares give the holders the right to put the shares to the entity and demand cash. Key to the *Framework* definition of a liability is that it is a present obligation of the entity, the settlement of which would result in an outflow of resources of the entity. Thus, a share puttable at fair value clearly meets the definition of a liability in the *Framework*.

AV3 These Board members do not agree with the Board that an exception to the *Framework* is justified in this situation. First, the Board has an active project on the *Framework*, which will revisit the definition of a liability. Although these Board members agree that standards projects can precede decisions in the *Framework* project, the discussions to date in the *Framework* project do not make it clear that the Board will modify the existing elements definitions in such a way that these instruments would be equity. Second, the proposed amendments would require disclosure of the fair value of the obligation. These disclosures mirror those for financial liabilities; existing standards do not require disclosure of fair values of equity instruments. The Board's proposal to require these disclosures reveals its implicit view that these instruments are, in fact, liabilities. Yet, the *Framework* is clear that disclosure is not a substitute for recognition. Third, these Board members see no cost-benefit or practical reasons for making this exception. The amendments require the same information to be obtained and disclosed as would be the case if these obligations were classified as liabilities. Existing standards offer presentation alternatives for entities that have no equity under the *Framework* definitions.

AV4 These Board members also do not agree with the Board that there are two benefits to issuing these amendments. First, paragraph BC23 in the Basis for Conclusions states that the amendments will result in more relevant and understandable financial reporting. However, as noted above, these Board members do not believe that presenting as equity items that meet the *Framework* definition of a liability results in relevant information. Also as noted above, existing standards offer presentation alternatives that result in understandable financial reporting. Second, paragraph BC23 states that the amendments would increase comparability by requiring classification of these instruments that is more consistent with ordinary shares. However, ordinary shares are not comparable to these instruments. These instruments obligate the entity to transfer its economic resources; ordinary shares do not. Also, shares puttable at fair value and shares that entitle the holder to a pro rata share of the net assets of the entity upon liquidation will be classified as equity by some entities and as liabilities by other entities, depending on whether the other criteria specified in these amendments are met. Thus, these amendments account similarly for economically different instruments, which decreases comparability, not increases it.

AV5 Finally, these Board members do not believe that the amendments are based on a clear principle. Rather, they comprise several paragraphs of detailed rules crafted to achieve a desired accounting result. Although the Board attempted to craft these rules to minimise structuring opportunities, the lack of a clear principle leaves open the possibility that economically similar situations will be accounted for differently and economically different situations will be accounted for similarly. Both of these outcomes result in lack of comparability.

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