

Liability or equity?



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Introduction

Liability or equity?

When an entity issues a financial instrument, it must determine its classification either as a liability (debt) or as equity. That determination has an immediate and significant effect on the entity's reported results and financial position. Liability classification affects an entity's gearing ratios and typically results in any payments being treated as interest and charged to earnings. Equity classification avoids these impacts but may be perceived negatively by investors if it is seen as diluting their existing equity interests. Understanding the classification process and its effects is therefore a critical issue for management and must be kept in mind when evaluating alternative financing options.

IAS 32 'Financial Instruments: Presentation' (IAS 32) addresses this classification process. Although IAS 32's approach is founded upon principles, its outcomes can sometime seem surprising. This is partly because, unlike previous practice in many jurisdictions around the world, IAS 32 does not look to the legal form of an instrument. Instead, it focuses on the instrument's contractual obligations. Identifying the substance of the relevant obligations can itself be challenging, reflecting the huge variety of instruments issued by different types of entities around the world. Moreover, these principles sometime result in instruments that intuitively seem like equity being accounted for as liabilities. As a result, the IASB has made some amendments to the Standard which depart from its core principles, further complicating the classification process.

Fortunately the member firms within Grant Thornton International – one of the world's leading organisations of independently owned and managed accounting and consulting firms – have gained extensive insights into the more problematic aspects of debt and equity classification under IAS 32. Grant Thornton International, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality, consistent application of IFRS. We are pleased to share these insights by publishing the second edition of 'Liability or equity? A practical guide to the classification of financial instruments under IAS 32' (the Guide). The Guide reflects the collective experience of Grant Thornton International's IFRS team and member firm IFRS experts. It addresses IAS 32's key application issues and includes interpretational guidance in certain problematic areas. The second edition of the Guide reflects amendments that have been made to IAS 32 since the Guide was first published and our latest thinking on some of the more problematic areas of interpretation.

Sections of the Guide

The Guide is organised as follows:

- **Section A** gives an overview of the Guide
- **Section B** considers the basic principle of financial liability classification. It discusses contractual obligations, how they arise and their effects
- **Section C** looks at those financial instruments which can be settled in an entity's own equity instruments and considers whether they should be classified as liabilities or as equity
- **Section D** addresses the 2008 amendments to IAS 32 relating to puttable instruments and obligations arising on liquidation
- **Section E** discusses compound financial instruments – instruments which possess both liability and equity components
- **Section F** considers briefly the IASB's potential plans for the development of a new model for liability and equity classification.

Appendices A and B set out the full definitions of 'financial liability' and 'equity' respectively. Appendices C and D discuss certain specific issues raised in the main body of the Guide in further detail.

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A. Overview of the Guide

Summary of requirements

- IAS 32 addresses the equity or liability classification of financial instruments. Certain financial instruments are scoped out of IAS 32
- classification as a financial liability or as equity depends on the substance of a financial instrument rather than its legal form. The substance depends on the instrument's contractual rights and obligations
- a basic principle of liability classification is that a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset to the instrument holder is a financial liability
- exceptions to the basic principle of classification were introduced in 2008 by the 'Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation'
- instruments which may or will be settled in an entity's own equity instruments are classified according to specific criteria – the 'fixed' test for non-derivatives and the 'fixed for fixed' test for derivatives
- instruments possessing the characteristics of both equity and liability classification are compound instruments. The equity and liability components are accounted for separately.

1 Purpose of the Guide

'Liability or equity? A practical guide to the classification of financial instruments under IAS 32' (the Guide) explains the principles for determining whether the issuer of a financial instrument should classify the instrument as a liability, equity or a compound instrument.

The Guide sets out the classification process in IAS 32 'Financial Instruments: Presentation' (IAS 32) and draws out a number of practical application problems that are often encountered.

2 The importance of classification as liability or equity

Whether an instrument is classified as either a financial liability or as equity is important as it has a direct effect on an entity's reported results and financial position.

Liability classification typically results in any payments on the instrument being treated as interest and charged to earnings. This may in turn affect the entity's ability to pay dividends on its equity shares (depending upon the requirements of local law).

Equity classification avoids the negative impact that liability classification has on reported earnings and gearing ratios. It also results in the instrument falling outside the scope of IAS 39 'Financial Instruments: Recognition and Measurement', thereby avoiding the complicated ongoing measurement requirements of that Standard.

3 Overview of IAS 32 and its classification process

To determine whether a financial instrument should be classified as debt or equity, IAS 32 uses principles-based definitions of a financial liability and of equity. In contrast to the requirements of generally accepted accounting practice in many jurisdictions around the world, IAS 32 does not classify a financial instrument between equity and financial liability on the basis of its legal form. Instead, it considers the substance of the financial instrument, applying the definitions to the instrument's contractual rights and obligations.

Classification of financial instruments is often a challenging issue in practice. This in part reflects the many variations in the rights and obligations of instruments that are found in different types of entities and in different parts of the world. Moreover, some instruments have been structured with the intention of achieving particular tax, accounting or regulatory outcomes with the effect that their substance can be difficult to evaluate.

3.1 Financial instruments within the scope of IAS 32

IAS 32 and its classification principles apply only to financial instruments. As a result, the Standard does not deal with the classification of items within equity which are not financial instruments, such as retained earnings and revaluation reserves. Nor does it deal with the classification of non-financial liabilities.

A 'financial instrument' is defined under IAS 32 as:

“any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.”

Further, not all financial instruments fall within the scope of IAS 32. The Standard contains detailed scoping paragraphs which, in summary, exclude the following financial instruments from its requirements:

- interests in subsidiaries, associates and joint ventures
- employers' rights and obligations under employee benefit plans
- insurance contracts as defined in IFRS 4 'Insurance Contracts'
- financial instruments that are within the scope of IFRS 4 because they contain a discretionary participation feature
- financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 'Share-based Payment' applies.

3.2 The basics of IAS 32's classification process

Under IAS 32, a financial instrument can be classified as a liability, as equity or as a compound instrument (an instrument which exhibits elements of both equity and liability classification, which must be accounted for separately).

An equity instrument is defined as **“any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”**. Determining whether an instrument is classified as equity is therefore dependent on whether it meets the definition of a financial liability.

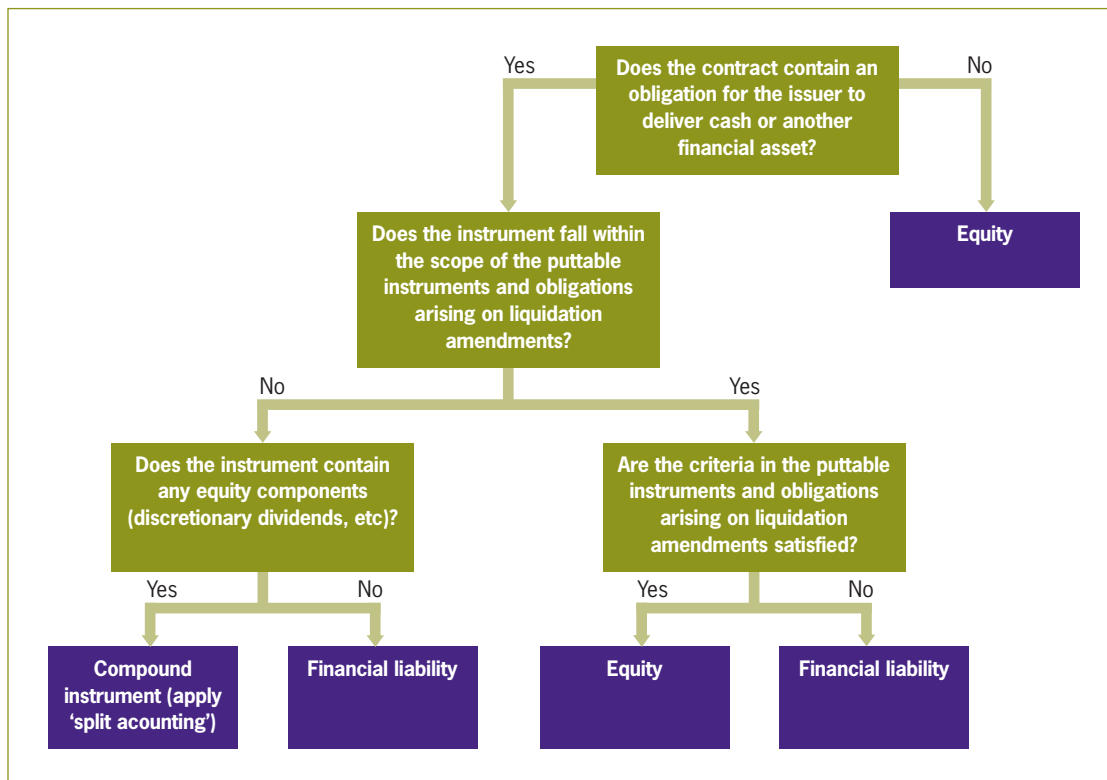
3.2.1 Obligations to deliver cash or another financial asset are financial liabilities

The basic principle of liability classification is that a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset to the instrument holder is a financial liability. This principle is reflected in the first part of the definition of a financial liability (the full definition is set out in Appendix A) and is discussed in Section B.

3.2.2 Exceptions: Puttable instruments and obligations arising on liquidation

Exceptions to this basic principle were however introduced in 2008 by the 'Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation'. The application of these Amendments results in equity classification for instruments which would otherwise be classified as financial liabilities in some narrowly defined cases. Section D discusses these exceptions.

Diagrammatic illustration of the classification of a financial instrument containing an obligation for the issuer to deliver cash or another financial asset

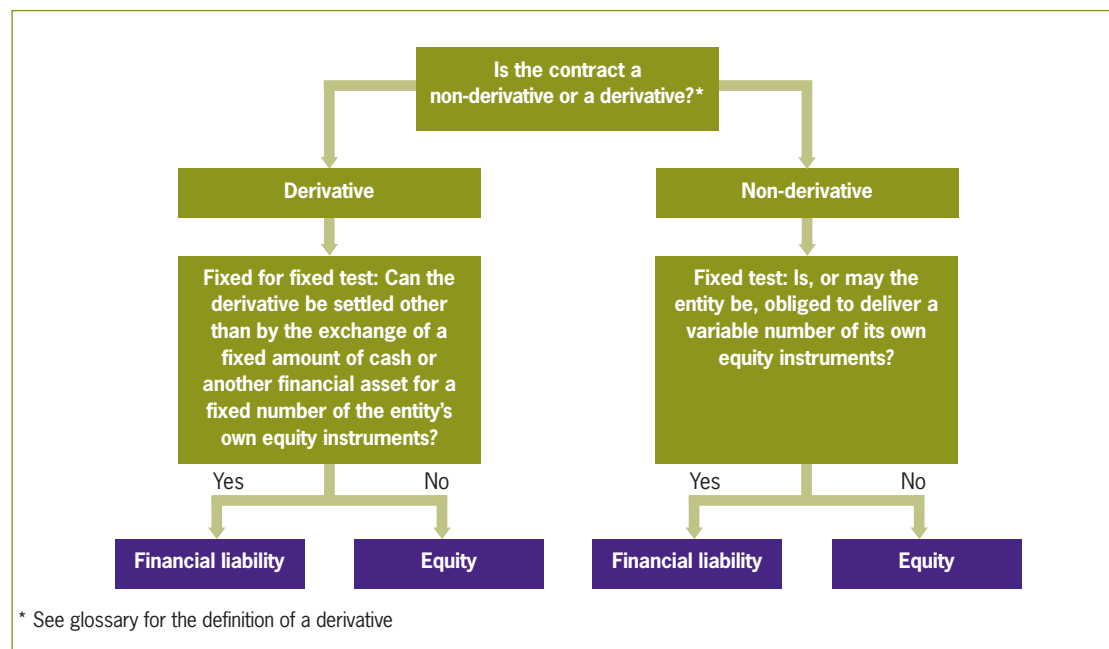


3.2.3 Instruments settled in an entity's own equity instruments

Applying the basic principle of liability classification to instruments which may or will be settled in an entity's own equity instruments is more complicated. Classification of these instruments is governed by the so-called 'fixed' test for non-derivatives, and the 'fixed for fixed' test for derivatives.

Under the fixed test, a non-derivative contract will qualify for equity classification only where there is no contractual obligation for the issuer to deliver a variable number of its own equity instruments. Under the fixed for fixed test, a derivative will qualify for equity classification only where it 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. The application of these rules is discussed in Section C.

Diagrammatic illustration of the classification of a financial instrument that will be settled by issue of the entity's own equity instruments



3.2.4 Compound instruments

Finally, some financial instruments contain both equity and liability components. These are referred to as compound instruments. IAS 32 separates a compound instrument into its equity and liability components on initial recognition, a process sometimes referred to as ‘split accounting’. The accounting for compound instruments is discussed in Section E.

For completeness, Section F of the Guide discusses possible future developments in the approach to distinguishing between financial liabilities and equity. Appendices A and B set out the current definitions of a financial liability and of equity in full.

3.3 Implications of classification as either liability or as equity

Liability classification	Equity classification
<ul style="list-style-type: none"> instrument is within the scope of IAS 39 and is therefore measured in accordance with that Standard in future periods 	<ul style="list-style-type: none"> instrument is outside the scope of IAS 39 and is not generally remeasured
<ul style="list-style-type: none"> interest, dividends, losses and gains on a financial instrument classified as a financial liability are recognised as income or expense in profit or loss 	<ul style="list-style-type: none"> distributions to holders of an equity instrument are debited by the entity directly to equity, net of any related income tax benefit
<ul style="list-style-type: none"> under IAS 39, any transaction costs are included in the calculation of the effective interest rate and amortised over the expected life of the instrument (or a shorter period where that is the period to which the transaction costs relate) 	<ul style="list-style-type: none"> transaction costs are accounted for as a deduction from equity, net of any related income tax benefit
<ul style="list-style-type: none"> presented as a liability in the Statement of Financial Position and increases the entity's debt-equity ratio 	<ul style="list-style-type: none"> reduces the entity's debt-equity ratio but may dilute existing owners' equity interests

B. What is a contractual obligation to pay cash or another financial asset?

Summary of requirements

- a basic principle of liability classification is that a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset to the instrument holder is a financial liability
- a contractual obligation may not be explicit but may be established indirectly through the terms and conditions of the instrument
- economic compulsion on its own is not enough to establish a contractual obligation. The obligation must be established through the terms and conditions of the financial instrument
- a financial instrument containing a contingent settlement provision, under which the instrument would be classified as a financial liability on the occurrence or non-occurrence of some uncertain future event beyond the control of both the issuer and the holder, will usually be classified as a financial liability unless the part of the contingent settlement provision that indicates liability classification is not genuine; or the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer
- exceptions to the basic principle of liability classification were introduced in 2008 by the 'Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation'. The application of these Amendments may result in equity classification for instruments which would otherwise be classified as financial liabilities.

1 Section overview

A basic principle of IAS 32 is that a financial instrument is a liability if it contains a contractual obligation for the issuer to deliver either cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder (see box).

A **financial liability** is defined under IAS 32.11 as:

“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) ...

As an exception,...”

By way of contrast, both the payment of dividends and the repayment of capital are discretionary.

Section B answers the question ‘What is a contractual obligation to deliver cash or another financial asset?’. It starts by giving common examples of ‘basic’ contractual obligations that result in liability classification. The Section goes on to consider more complex instruments such as members’ shares in co-operative entities and situations where the contractual obligation is not itself explicit.

Section B also considers the more problematic areas of:

- economic compulsion
- contingent settlement provisions
- ‘dividend pushers’ and ‘dividend blockers’
- guarantees within a group.

Exceptions to the general principle that a contractual obligation to deliver cash or another financial asset results in the instrument concerned being classified as a liability are discussed in Section D.

2 Contractual obligation

IAS 32’s classification requirements look to an instrument’s contractual rights and obligations. It is therefore necessary to consider what is meant by a contract. IAS 32.13 explains that:

“ ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.”

Liabilities or assets that are not contractual are not financial liabilities or financial assets. For example, income tax liabilities that arise from statutory requirements imposed by governments are not within the scope of IAS 32 (but are accounted for under IAS 12 ‘Income Taxes’). Similarly, constructive obligations, as defined in IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, do not arise from contracts and are not financial liabilities.

2.1 Examples of contractual obligations to pay cash or another financial asset

The following sub-sections discuss common types of contractual obligation that give rise to financial liability classification under IAS 32.

Examples of contractual obligations to deliver cash or another financial asset to the holder of an instrument	See Section
<ul style="list-style-type: none"> • redeemable shares – a fixed redemption date or redemption at the holder’s discretion typically results in liability classification (exceptions exist – see Section D) 	2.1.1
<ul style="list-style-type: none"> • mandatory dividends – a contractual obligation exists where distributions on an instrument are not at the issuer’s discretion 	2.1.2
<ul style="list-style-type: none"> • distributions of a specified percentage of profits – distributions are not at the issuer’s discretion where the terms and conditions of an instrument contain a formula under which a specified percentage of profits must be paid to the holder 	2.1.3

2.1.1 Redeemable shares

The basic principle of IAS 32 has the effect that shares which have a fixed date for redemption, or which give the holder an option to redeem the shares at some point in time, are classified as financial liabilities¹. This is because the entity is not able to avoid the obligation to pay cash upon the redemption of the shares².

¹ Exceptions to this basic principle were however introduced by the publication in 2008 of ‘Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation’ (see Section D).

² For members’ shares in co-operative entities and similar instruments, the application of this basic principle is more complicated – see Section 2.2 for details.

Example: Shares redeemable at the holder's option

Entity A issues 1,000 shares with a par value of Currency Unit (CU) 100 each. The holder of the shares has the option to require Entity A to redeem the shares at par at any given time.

These shares are classified as liabilities. This is because Entity A does not have the ability to avoid the obligation to redeem the shares for cash should the holder exercise his option to redeem the shares.

If the option to redeem the entity's shares had instead been at the discretion of the issuer, the shares would have been classified as equity. In this situation, the issuer has a right to pay cash to buy back the shares but no obligation to do so.

2.1.2 Shares with mandatory dividend payments

Where shares are non-redeemable, classification will depend on the other rights attaching to them.

It will often be clear from the terms and conditions attaching to an ordinary share that there is no obligation to pay cash or other financial assets, and that it should therefore be classified as equity.

The classification of preference shares may be less straightforward. IAS 32.AG26 contains specific guidance on non-redeemable preference shares. It clarifies that when preference shares are non-redeemable, the classification depends on a careful analysis of the other rights attaching to them. For instance, if distributions to holders of the preference shares (whether cumulative or non-cumulative) are at the discretion of the issuer, the shares are equity instruments. If distributions are mandatory the shares will be classified as financial liabilities.

Example: Mandatory dividend payments of a fixed percentage

An entity issues preference shares with a par value of CU 100 each. The preference shares are non-redeemable but require the entity to make annual dividend payments equal to a rate of 8% on the par amount. There are no equity components such as the possibility of further discretionary dividends.

The preference shares will be classified as financial liabilities, as the entity has a contractual obligation to make a stream of fixed dividend payments in the future. This means that the 'dividends' will be treated as interest payments and included as an expense in the Statement of Comprehensive Income.

2.1.2.1 Perpetual debt instruments

The non-redeemable preference shares in the above example are one type of 'perpetual' debt instrument. Other forms of perpetual debt instrument include some bonds, debentures and capital notes. Perpetual debt instruments normally provide the holder with the contractual right to receive payments of interest at fixed dates extending indefinitely. Holders normally have no right to receive a return of principal (although sometimes, in specified circumstances, they may).

A perpetual debt instrument which has mandatory interest payments (but no equity components) is a liability in its entirety. The value of the instrument is wholly derived from the mandatory interest payments.

2.1.3 Financial instruments with payments based on profits of the issuer

Financial instruments that include contractual obligations to make payments linked to the financial performance of the issuer are quite common. An example of such an instrument is a share that pays a specified percentage of profits of the issuer each period. The terms of the instrument usually include a definition of "profit" for this purpose. The instrument might be either redeemable or perpetual.

An obligation to pay a specified percentage of the profits of the issuer is a contractual obligation to deliver cash. Such an obligation therefore meets the definition of a financial liability (IAS 32.11(a)(i)). This is the case even if the issuer has not yet earned sufficient profits to pay any interest or dividend (see Section B.2.1.4). IAS 32 also makes clear that the ability of the issuer to influence its profits does not alter this classification (IAS 32.25 & IAS 32.AG26(f)).

Statutory dividend obligations

IAS 32.AG12 makes it clear that liabilities or assets that are not contractual (such as income taxes arising from statutory requirements) are not financial liabilities or financial assets.

In some countries entities may be required under national legislation to pay a dividend equal to a certain percentage of their profits or a certain proportion of their share capital. This is an example of a situation in which the overall obligations conveyed by an instrument are affected by the relevant governing law of the jurisdiction of the issuer.

Application of IAS 32 in this situation requires the issuer to consider whether the statutory imposition is part of the contractual terms of the instrument, or should alternatively be viewed as a separate, non-contractual obligation that is outside IAS 32's scope. This is a point of interpretation. Our preferred view is that the statutory imposition should be viewed as a contractual term if the issuer and the counter-party entered into the arrangement with the knowledge and expectation that the instrument's cash flows would be affected by the applicable law.

In some cases, the law may create incentives to pay dividends but does not impose an obligation. For example, an entity may be required under statute to pay a dividend equal to a certain percentage of profits in order to retain a particular tax status. In this case, a contractual obligation does not exist. This reflects the fact that the company is not obliged to pay a dividend even though the tax benefits may be so advantageous as to make it very likely that it will do so in practice.

2.1.4 Restrictions on ability to satisfy contractual obligation

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.

Example: Lack of distributable profits to pay a dividend

An entity issues preference shares with a mandatory redemption date and a fixed dividend rate. Under local company law, the dividends can only be paid and the shares redeemed if there are sufficient distributable profits to do so. The entity currently has no distributable profits.

The lack of distributable profits has no impact on the classification of the shares, which should be accounted for as liabilities (IAS 32.AG26(d)).

Conversely, where payment is at the issuer's discretion, equity classification should not be affected by an issuer's expectation of a profit or loss for a period, its intention to make distributions or a past history of making distributions (IAS 32.AG26(a) & (b)).

2.2 Members' shares in co-operative entities and similar instruments

2.2.1 Background

IFRIC Interpretation 2 'Members' Shares in Co-operative Entities and Similar Instruments' (IFRIC 2) clarifies how the requirements of IAS 32 relating to debt/equity classification should be applied to co-operative entities.

A co-operative entity is typically defined by national law along the lines of a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in such entities are often referred to as 'members' shares'.

Under the version of IAS 32 prior to the amendments relating to 'Puttable Financial Instruments and Obligations Arising on Liquidation' (see Section D), all instruments which gave the holder the right to demand redemption were classified as liabilities.

Many financial instruments issued by co-operative entities, including members' shares, have characteristics of equity, including voting rights and rights to participate in dividend distributions. However, some such instruments also give the holder the right to redeem them for cash or another financial asset. The co-operative entity's governing charter, local law or other applicable regulation may in turn set limits on the extent to which the instruments may be redeemed.

IFRIC 2 was issued to address how the principles of IAS 32 should be applied to such redemption terms in determining whether the financial instruments should be classified as liabilities or equity.

2.2.2 Conditions required for equity classification

IFRIC 2 clarifies that where members' shares in a co-operative would be classified as equity were it not for the ability of members to request redemption of their shares, it is still possible to achieve equity classification of those shares if:

- either of the two conditions described below are present or
- the members' shares have all the features and meet the conditions relating to the exceptions for puttable instruments and obligations arising on liquidation discussed in Section D.

2.2.2.1 The two conditions

The conditions are as follows:

- 1) members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares
- 2) members' shares are equity if redemption is unconditionally prohibited by local law, regulation or the entity's governing charter.

With regard to the second condition, it should be noted that there may be circumstances in which redemption is unconditional only where certain circumstances exist. For example, redemption might be prohibited only as a result of the co-operative failing to meet liquidity constraints set by regulators. This is not an 'unconditional prohibition' and, accordingly, the members' shares are classified as liabilities.

An unconditional prohibition may also apply to only some of the issued shares. For example, redemption may be prohibited only if it would cause the number of members' shares or the amount of paid-in capital to fall below a specified level. In this situation, members' shares that are redeemable without breaching the specified limit are liabilities (assuming the co-operative entity has no other unconditional right to refuse redemption, and that the shares do not meet the puttable instruments criteria discussed in Section D).

Example: Redemption prohibited by local law

In Country A, local law prohibits co-operative entities from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 80% of the original paid-in-capital from members' shares. The original paid-in capital is CU 800,000.

This is an example of an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares. While each member's share may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than upon the liquidation of the entity.

Accordingly CU 640,000 will be classified as equity and CU 160,000 as financial liabilities*.

* It is assumed that the shares do not meet the criteria required for equity classification under either the puttable instruments exception or the obligations arising on liquidation exemptions discussed in Section D.

Example: Liquidity requirements under local law

The example is the same as above, except that liquidity requirements imposed in the local jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the end of the reporting period is to prevent the co-operative from paying more than CU 100,000 to redeem the members' shares.

As in the example above, the entity classifies CU 640,000 as equity and CU 160,000 as financial liabilities*. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met.

* Again it is assumed that the shares do not meet the criteria required for equity classification under either the puttable instruments exception or the obligations arising on liquidation exemptions discussed in Section D.

2.2.3 Measurement

Where a financial liability is recognised, IFRIC 2 requires the financial liability to be measured on initial recognition at its fair value. It notes that the fair value of the financial liability for redemption should be measured at no less than the maximum amount payable under the redemption provisions, discounted from the first date that the amount could be required to be paid.

Where the amount subject to a partial redemption prohibition changes for whatever reason over the course of time, this will cause there to be a transfer between financial liabilities and equity.

Example: Redemption prohibited by governing charter

The charter of a co-operative states that cumulative redemptions of member shares cannot exceed 20% of the highest number of its member shares ever outstanding. The co-operative entity has issued 100,000 shares at CU 10 each and 50,000 shares at CU 20 each, giving a total at the period end of CU 2,000,000. The shares are redeemable on the holder's demand.

In such a situation, members' shares in excess of the prohibition against redemption are financial liabilities* and are measured at fair value on initial recognition. As the shares are redeemable on demand, the fair value of the liability is not less than the amount payable on demand.

This results in the co-operative classifying CU 400,000 as financial liabilities and CU 1,600,000 as equity. Should the co-operative subsequently amend its charter so that cumulative redemptions cannot exceed 25% of member shares outstanding, then it will need to transfer CU 100,000 from equity to liabilities.

* It is assumed that the shares do not meet the criteria required for equity classification under either the puttable instruments exception or the obligations arising on liquidation exemptions discussed in Section D.

2.2.4 Interaction with the puttable instruments and obligations arising on liquidation amendments

Shares in co-operative entities are often redeemable at the option of the holder. If so, the share meets the definition of a puttable instrument in the 'Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation' ('the Amendments') published in 2008 (see Section D.2.1).

As a result, a co-operative with member shares that meet the conditions for equity classification under the Amendments need not consider IFRIC 2.

Example: Interaction with the Amendments to IAS 32 for puttable financial instruments

As in the earlier example, local law prohibits co-operative entities from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 80% of the paid-in-capital from members' shares. At the end of the period, the balance of paid-in capital is CU 800,000.

If the members' shares meet all of the conditions set out in the Amendments to IAS 32 for equity classification of puttable instruments, they will all be classified as equity. Accordingly, there is no need to consider how IFRIC 2 would otherwise require only a proportion of them to be classified as equity.

Section D explains the Amendments in more detail.

2.3 Contractual obligation that is not explicit

A contractual obligation need not be explicit. It may instead be established indirectly through the terms and conditions of the financial instrument. IAS 32.20 provides two examples of this:

"(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."

Example: Indirect obligation to pay dividends

A financial instrument might contain a condition that the issuer has to transfer a property to the holder of the instrument if it fails to make dividend payments on the instrument. This creates an indirect obligation to make the dividend payments, and the instrument is therefore classified as a liability.

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

- ii) cash or another financial asset; or**
- iii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.”**

This second example makes it clear that liability classification is not avoided by a share settlement alternative that is uneconomic in comparison to the cash obligation (for the issuer).

Example: Own share alternative substantially exceeding cash settlement option

Entity A has in issue two classes of shares: A shares and B shares. The A shares are correctly classified as equity. The B shares have a nominal value of CU 1 each and are redeemable in 5 years time at the option of the issuer.

Under the terms of the redemption agreement, Entity A has a choice as to the method of redemption. It may either redeem the shares for their nominal value or it may issue 100 A shares. An A share currently has a value of CU 20 and has never traded at a price below CU 10.

The B shares will be classified as a liability. This is because the value of the own share settlement alternative substantially exceeds that of the cash settlement option, meaning that Entity A is implicitly obliged to redeem the option for a cash amount of CU 1 (IAS 32.20(b)).

3 Economic compulsion

As discussed above, a contractual obligation can be explicitly established in an instrument's contractual terms or could be indirectly established. In relation to this latter issue, IFRIC was asked to consider whether the concept of being economically compelled to pay dividends or to redeem a financial instrument would give rise to a financial liability.

IFRIC noted in their March 2006 meeting that an obligation must be established through the terms and conditions of the financial instrument. Economic compulsion, by itself, does not result in a financial instrument being classified as a liability. IFRIC noted that IAS 32 restricted the role of 'substance' to consideration of the contractual terms of an instrument. Anything outside the contractual terms is not therefore relevant to the classification process under IAS 32.

Example: Step-up clause

Entity X has two classes of shares: Class A and Class B shares. The Class A shares are Entity X's ordinary shares and qualify for equity classification. The Class B shares are not mandatorily redeemable shares but contain a call option allowing Entity X to repurchase them.

Dividends are payable on the Class B shares if and only if dividends have been paid on the Class A ordinary shares. Under the terms and conditions of the Class B shares, dividends are initially payable at a rate equal to that on the Class A ordinary shares. However, the class B shares also contain a 'step-up' dividend clause that will increase the (linked) dividend in three years time to a punitive rate of 25% unless Entity X exercises its call option before then.

Does the 'step-up' dividend clause mean that the instrument should be classified as a financial liability?

No. The instrument should be classified as equity as there is no contractual obligation to pay the dividends or to call the instrument.

4 Contingent settlement provisions

A financial instrument may require an entity to deliver cash or another financial asset, or settle it in some other way that would require it to be classified as a financial liability, but only in the event of the occurrence or non-occurrence of some uncertain future event. The ‘event’ may be within the control of the issuer or of the holder, or beyond the control of both. These types of contractual arrangements are referred to as ‘contingent settlement provisions’.

If the issuer is able to control the outcome of the event that would otherwise trigger a payment obligation, it is able to avoid payment. Accordingly, no liability arises. Conversely, if the holder can control the outcome, the holder is effectively able to demand payment and the instrument is classified as a liability. In many instruments, however, neither party controls the ‘event’ in question. Examples of such provisions are payments triggered by:

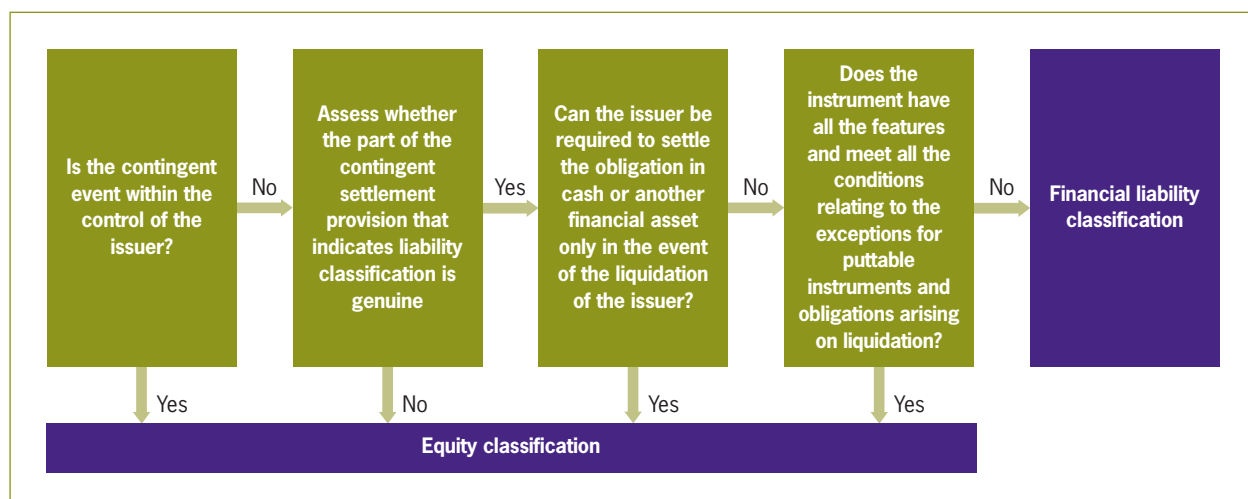
- changes in a stock market or other index
- changes in specified interest rate indices
- taxation requirements
- the financial results of the issuer (such as future revenues or net income).

Where a financial instrument contains such a provision, the issuer of the instrument does not have the unconditional right to avoid delivering cash or another financial asset. Therefore the contingent settlement provision results in a financial liability unless one of the following applies:

- the part of the contingent settlement provision that indicates liability classification is ‘not genuine’ (see Section B.4.1)
- the issuer can be required to settle the obligation in cash or another financial asset (or such other way that would cause it to be a financial liability) only in the event of liquidation of the issuer
- (in relatively rare circumstances) the instrument has all the features and meets the conditions relating to the exceptions for puttable instruments and obligations arising on liquidation (see Section D).

Illustration of classification process for contingent settlement provisions

Classification process for an instrument containing an obligation arising only on the occurrence or non-occurrence of uncertain future events



Example: Ordinary shares redeemable in event of stock exchange listing

Entity A issues shares that are redeemable at par in the event of Entity A listing on a stock exchange.

The possibility of Entity A listing on a stock exchange is a contingent settlement provision. However, it is not clear-cut whether this 'event' is within Entity A's control.

Our view is that there is a reasonable argument that an entity is able to avoid listing on a stock exchange if it so chooses (the converse is perhaps more debatable, as obtaining a listing requires the involvement and approval of third parties such as exchange regulators). Under this view, the event in question is within Entity A's control (and not the holder's control). Hence the shares would be classified as equity instruments.

Note that the same analysis would not apply if redemption in the example was instead contingent on the sale of the company (via current shareholders selling their shares). Normally the sale of the company would be within the holders' control meaning the shares would be classified as financial liabilities. However, if redemption was only on the sale of the company's assets, then this may be an event within the company's control (and hence the shares would not be classified as financial liabilities).

What is within the control of the entity?

The examples above indicate some of the complexities involved in 'drawing the line' between what is within the control of the entity and what is not. Differing views exist however on where to draw this line in practice. A common practical issue concerns 'obligations' where payments must be approved by the shareholders in general meeting. The question is whether the shareholders are regarded as an extension of the entity in this situation. If so, the shareholders' rights to approve or reject payments being made amount to a discretion of the entity to refuse payment.

Some commentators hold the view that the shareholders are not part of the entity even when voting as a collective body in general meeting. This view regards the shareholders as acting in their personal capacity as individuals when voting.

Other commentators make a distinction between actions of shareholders as a body under an entity's governing charter and other individual actions of the shareholders such as selling their shares.

In summary, there is no clear consensus on this issue and judgement will need to be applied in evaluating each particular situation in practice.

4.1 Settlement terms not genuine

IAS 32 does not directly address when contingent settlement terms are not considered to be genuine.

However IAS 32's Application Guidance notes that:

"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." (IAS 32.AG28)

It is apparent from this guidance then that 'not genuine' implies much more than the possibility of settlement being remote.

This is consistent with the Basis for Conclusions section in the Standard, where it is noted that **"The Board concluded that it is not consistent with the definitions of financial liabilities and equity instruments to classify an obligation to deliver cash or another financial asset as a financial liability only when settlement in cash is probable." (IAS 32.BC17)**

Example: Changes in a stock market index

A financial instrument which must be repaid in the event of a specified change in the level of a stock market index is an example of an uncertain future event that is beyond the control of both the issuer and the holder of the financial instrument, and which would normally result in classification of the instrument as a financial liability.

It is possible however, that the change required in the level of the stock market could be set at such a high level as to be 'not genuine'. For example, a five-fold increase in the stock market index in a six month period may be historically unprecedented and therefore sufficiently unlikely to be considered 'not genuine'.

Regulatory change clauses

There has been some debate as to whether 'regulatory change' clauses, found in the terms of some instruments issued by financial institutions, contain 'genuine' contingent settlement obligations.

Financial institutions are generally required by regulators to maintain certain minimum levels of regulatory capital (equity and some forms of highly subordinated debt). The regulatory capital essentially forms a safeguard to absorb losses to reduce the risk of losses for depositors.

A regulatory change clause will typically require an instrument which, at the date of issue, is classified as regulatory capital to be repaid in the event that it ceases to be so classified. As discussed above, if such a contingent settlement condition is genuine it will result in the instrument being classified as a financial liability.

In many jurisdictions, however, industry regulators have a history of applying changes in the rules regarding regulatory capital prospectively. This means that any existing instruments continue to be regarded as regulatory capital even though they do not meet the new rules, and are not therefore repayable.

In some circumstances, it can then be questioned whether the contingent settlement provision in these instruments is genuine. This requires careful consideration based on each individual set of facts and circumstances.

5 'Linked' instruments

IFRIC addressed the subject of 'linked' instruments in its March 2006 meeting.

It noted that where a financial instrument (the 'base' instrument) contains a clause whereby dividends must be paid if dividends are paid on another instrument (the 'linked' instrument), and that instrument itself contains a contractual payment obligation, then an indirect contractual obligation is created to pay dividends on the base instrument. Accordingly, the base instrument is classified as a liability under IAS 32.

This principle is often relevant to situations where a 'dividend pusher' or 'dividend blocker' exists, and is discussed in Section B.5.1.

5.1 Dividend pushers and dividend blockers

The term 'dividend pusher' denotes a clause in the terms of a financial instrument under which the holder becomes automatically entitled to receive a distribution when a distribution is made on another separate financial instrument.

The term 'dividend blocker' is used to denote the converse situation, which is where a distribution cannot be made on a financial instrument unless a distribution has been made on another financial instrument.

Such clauses are sometimes found within an individual entity where the entity has issued more than one type of financial instrument.

Example: Dividend blocker

Entity X has issued two classes of instruments, Class A instruments and Class B instruments. Class A instruments are correctly classified as equity shares. The terms of the Class B instruments are identical to those of Class A other than that they contain a 'dividend blocker' under which a dividend cannot be paid on the B instruments unless one has been paid on the A instruments.

In this situation, Entity X has discretion over whether dividends are paid on both the A instruments and the B instruments, and both will therefore be classified as equity.

Dividend pushers and blockers can also be encountered within groups of companies. For instance, an entity within a group may be prohibited from paying a dividend on the financial instruments that it has issued unless a dividend has been declared on a financial instrument issued by another entity within the group. The effect of such clauses may result in the classification of an instrument differing between the consolidated financial statements and the separate financial statements of the entity that has issued the instrument.

Example: Dividend pusher within a group of companies

Group A consists of Parent A and Subsidiary B. Parent A has issued one class of shares which have been correctly classified as equity instruments. Subsidiary B has also issued one class of financial instruments. The terms of the financial instruments issued by Subsidiary B are identical to those issued by Parent A except that they include a 'dividend pusher' clause, under which Subsidiary B is obliged to declare a dividend whenever Parent A declares a dividend on its instruments.

In this example, the dividend pusher means that Subsidiary B has no discretion over whether dividends are paid on the instruments it has issued (that decision being taken by the parent). Consequently, should Subsidiary B prepare financial statements, the instruments will be classified as financial liabilities in those statements.

In the consolidated financial statements, however, Subsidiary B's instruments will be classified as equity (to the extent of any non-controlling interests – the instruments held by parent A will be eliminated on consolidation). This is because Parent A has discretion over whether dividends are paid on its own financial instruments and also, by virtue of the dividend pusher clause, on those of Subsidiary B.

6 Guarantees within a group

The issue of guarantees within a group can result in the classification of a financial instrument differing between the consolidated financial statements and the separate financial statements of the company that has issued the instrument.

Such a situation often arises where one company within a group issues an instrument, and another group company guarantees the instrument by agreeing additional terms directly with the holder of the instrument.

At consolidated financial statement level, all the terms and conditions agreed between the holders of the instrument and all the companies within the group must be considered when deciding whether the group has an obligation to deliver cash or another financial asset or to settle it in a way that causes it to be classified as a financial liability (IAS 32.AG29). The effect of the guarantee is that there is a potential obligation for the group as a whole to transfer cash or other assets on unfavourable terms. The instrument will therefore be classified as a financial liability rather than equity in the consolidated financial statements.

In contrast, the company that has issued the instrument does not consider the additional terms and conditions relating to the guarantee given by the other group company. This means that the instrument may be classified as equity in the separate financial statements of the company that issued it.

C. Instruments settled in an entity's own equity instruments

Summary of requirements

- specific rules determine whether instruments that may or will be settled in an entity's own equity instruments are classified as financial liabilities or as equity
- for a non-derivative financial instrument, equity classification is required if and only if the 'fixed' test is met. Where an instrument can be settled using a variable number of an entity's own equity instruments, it is classified as a liability
- for a derivative financial instrument, equity classification is required if and only if the 'fixed for fixed' test is met. If it is possible to settle the derivative other than by exchanging a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments the instrument is classified as a liability
- instruments classified as equity are outside the scope of IAS 39 'Financial Instruments: Recognition and Measurement'. Subsequent changes in the value of the instrument are not recognised in the financial statements.

1 Section overview

Equity is defined as "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities" (IAS 32.11). Only those instruments which fail the definition of a financial liability can be classified as equity.

The expanded definition of equity in IAS 32.16 states that, as well as including no contractual obligation to deliver cash or another financial asset, an instrument that will or may be settled in the issuer's own equity instruments will only be classified as equity if "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."

Exceptions to the rules for equity classification are discussed in Section C.4.1.1 below and in Section D.

An instrument that will be settled by an entity issuing its own equity instruments does not contain an obligation for the issuer to deliver cash or another financial asset. In the absence of this expanded definition, such an instrument would be classified as equity. However, the IASB concluded that such an outcome would not reflect the substance of some of these instruments. IAS 32 therefore includes specific rules to govern their classification. Section C discusses these rules, namely the application of:

- the 'fixed test' for non-derivatives that may be settled in an entity's own equity instruments
- the 'fixed for fixed test' for derivatives that may be settled in an entity's own equity instruments.

Where equity classification is met, any consideration received is added directly to equity while any consideration paid is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

Where equity classification is not met, the contract will be accounted for either as a non-derivative financial liability, or as a derivative asset or liability, depending on the nature of the contract.

Classification process for instruments settled in an entity's own equity instruments



2 The 'fixed' test

For a non-derivative financial instrument that will or may be settled by an entity issuing its own equity instruments, equity classification is required if and only if the so-called 'fixed test' in IAS 32 is met.

The 'fixed' test

IAS 32.11(d) states that a financial liability is any liability that is:

"(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 deliver a variable number of the entity's own equity instruments; or
- ii) ..."

This part of the definition is sometimes referred to as the fixed test. By fixing upfront the number of shares to be received or delivered on settlement of the instrument in concern, the holder is exposed to the upside and downside risk of movements in the entity's share price.

A contractual right or obligation to receive or deliver anything other than a fixed number of the entity's own shares will result in liability classification of the instrument in concern.

The logic behind this test is that using a variable number of own equity instruments to settle a contract can be similar to using own shares as 'currency' to settle what in substance is a financial liability. Such a contract does not evidence a residual interest in the entity's net assets. Equity classification is therefore inappropriate.

IAS 32 contains two examples of contracts where the number of own equity instruments to be received or delivered varies so that their fair value equals the amount of the contractual right or obligation:

- 1) A contract to deliver a variable number of own equity instruments equal in value to a fixed monetary amount on the settlement date is classified as a financial liability.

Example: Shares used as currency

Entity A issues an instrument for which it receives CU 100,000. Under the terms of the issue, Entity A will repay the debt in 3 years time by delivering ordinary shares to the value of CU 115,000.

Entity A is using its own shares as currency, and the instrument should therefore be classified as a financial liability.

- 2) 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 a commodity results in liability classification of the instrument.

Example: Shares to the value of a commodity

Entity B issues preference shares for CU 1,000. The shares pay no interest and will be settled in three years time by Entity B delivering a number of its own ordinary shares (which are correctly classified as equity) as are equal to the value of 100 ounces of gold. Can the preference shares be classified as equity under the fixed for fixed test?

No. The shares must be classified as financial liabilities as the delivery of ordinary shares to the value of 100 ounces of gold represents 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.

Even though both of the contracts in these examples are settled by the entity delivering its own equity instruments, the contracts are not equity themselves. In both cases the entity uses a variable number of its own equity instruments to settle them. They are therefore classified as financial liabilities.

3 The 'fixed for fixed' test

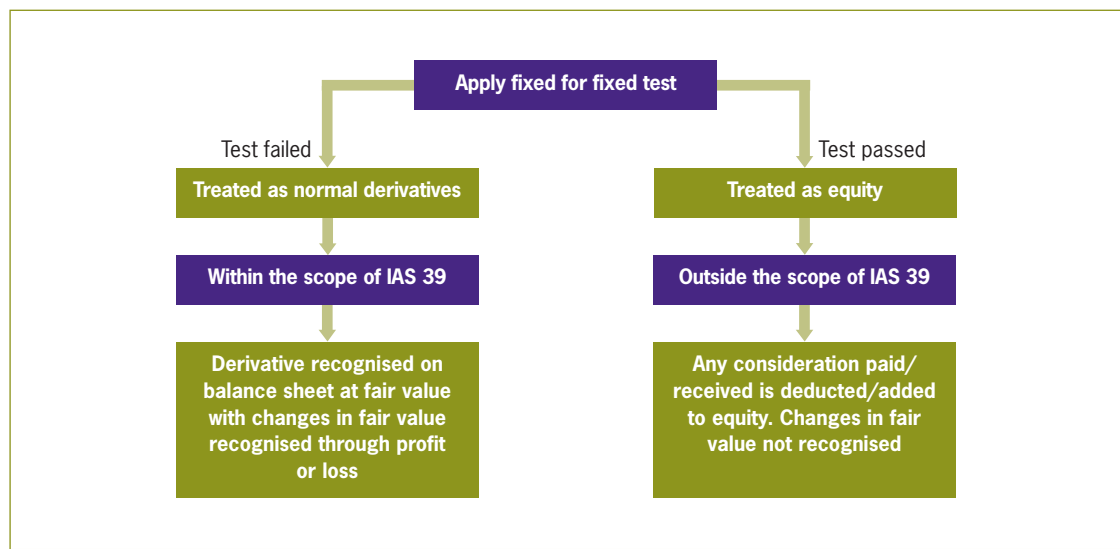
In the case of a derivative financial instrument which is to be settled by an entity issuing its own equity instruments, equity classification is required if and only if the so-called 'fixed for fixed' test in IAS 32 is met. This test is based on similar logic to the 'fixed' test discussed in Section C.2 above.

The 'fixed for fixed' test

IAS 32.11(d) states that a financial liability is any liability that is:
 "(d) a contract that will or may be settled in the entity's own equity instruments and is:
 i) ...
 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..."

This part of the definition of a liability is often referred to as the 'fixed for fixed' rule, as a fixed number of shares must be exchanged for a fixed amount of cash in order for an instrument to avoid classification as a financial liability.

Significance of the fixed for fixed test



If the fixed for fixed test is met, the derivative is classified as equity and falls outside the scope of IAS 39. Subsequent changes in fair value are not recognised in the financial statements. Note however that special rules apply to derivative contracts which include an obligation for the issuer to purchase its own equity instruments (a written put option) – see Section C.3.2 below.

The fixed for fixed test is therefore typically crucial when an entity issues (i) a convertible bond or (ii) share warrants or options.

Example: Call share option that meets the definition of equity

An issued share option that gives the counterparty a right to buy a fixed number of an entity's shares for a fixed amount of functional currency is an example of an instrument that meets the fixed for fixed test. Note however that equity classification applies only if the contract can be settled only by 'gross physical settlement' – in other words by actual issuance of shares for cash.

For the entity that has issued the option, the contract is an equity instrument as it will settle it by issuing a fixed number of its own equity instruments in return for a fixed amount of cash.

Example: Call share option that fails the definition of equity

An entity issues a share option that gives the counterparty a right to buy a number of shares for a fixed price. Under the terms of the option agreement, however, the number of shares that the counterparty obtains by paying the exercise price varies according to the level of sales that the entity achieves.

The option fails the fixed for fixed test as it is over a variable number of the entity's shares. The definition of equity is not met, and the option will therefore be accounted for as a derivative in accordance with the requirements of IAS 39.

It should be noted however that if share options are issued in exchange for goods or services, then IFRS 2 'Share-based Payment' would apply. The fixed for fixed test is not then relevant.

3.1 Own equity instruments

For the purpose of applying the fixed for fixed test, 'own equity instruments' do not include instruments classified as equity under the 'Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation' (see Section D).

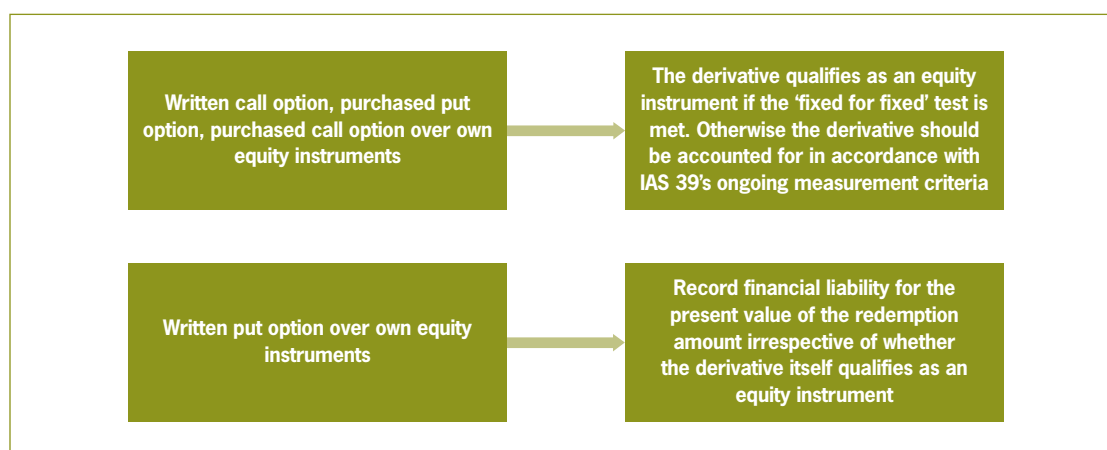
Nor do 'own equity instruments' include instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

3.2 Obligations to purchase own equity instruments for cash

A contract that contains an obligation for the 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 (the forward repurchase price, option exercise price or other specified redemption amount) (IAS 32.23). This is the case even for derivatives over equity instruments that meet the fixed for fixed test and would be equity in the absence of the rule in IAS 32.23.

IAS 32.23 also notes that a contractual obligation for an entity to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation is conditional on the counterparty exercising a right to redeem.

Treatment of options over own equity instruments (settled gross by receipt or delivery of own equity instruments)



Example: Written put option

On 1 January 20X1, Entity A writes a put option over 1,000 of its own (equity) shares for which it receives a premium of CU 5,000. Entity A's year end is 31 December 20X1.

Under the terms of the option, Entity A may be obliged to take delivery of 1,000 of its own shares in one year's time and to pay the option exercise price of CU 210,000. The option can only be settled through physical delivery of the shares (gross physical settlement).

Although the derivative involves Entity A taking delivery of a fixed number of equity shares for a fixed amount of cash, Entity A has an obligation to deliver cash which it cannot avoid (note that this is irrespective of the fact that the obligation for Entity A to purchase its own equity shares for CU 210,000 is conditional on the holder of the option exercising the option). On entering into the instrument on 1 January 20X1, the following entries are therefore required to record the premium received and the obligation to deliver CU 210,000 at its present value of CU 200,000 (discounted using an appropriate interest rate).

	Debit CU	Credit CU
Cash	5,000	
Equity		5,000
Equity	200,000	
Liability		200,000

At the year end (31 December 20X1), interest will be recognised in order to unwind the discount that was recorded when the liability was recorded at its present value on its initial recognition.

	Debit CU	Credit CU
Interest expense	10,000	
Liability		10,000

Assuming that the option holder exercises the option, the following entries will be made on 1 January 20X2 to record the derecognition of the liability

	Debit CU	Credit CU
Liability	210,000	
Cash		210,000

If the option holder does not exercise the option by the end of the stated option period, then the liability will be derecognised with a corresponding entry being made to equity.

3.3 Put and call options over non-controlling interests

It is common for a parent entity to hold a controlling interest in a subsidiary in which there are also non-controlling shareholders and to enter into arrangements that:

- grant the non-controlling interest shareholders an option to sell their shares to the parent entity (a “non-controlling interest written put option”) and/or
- grant the parent an option to acquire the shares held by the non-controlling interest shareholders (a “non-controlling interest purchased call option”).

³ Note that such arrangements are sometimes entered into as a result of a business combination and may represent contingent consideration, in which case additional considerations may arise from the application of IFRS 3 'Business Combinations'.

The accounting for put and call options relating to shares in a subsidiary held by non-controlling interest shareholders is not specifically addressed in IAS 32. The following sub-sections describe some of the application issues that arise as a result.

3.3.1 Written put options over non-controlling interests

IFRIC considered the classification of written put options entered into by parents over the shares of subsidiaries in its November 2006 meeting.

In the context of consolidated financial statements, non-controlling interests are regarded as own equity instruments unless the terms and conditions which have been agreed between the members of the group and the holders of the instruments mean that 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 (IAS 32.AG29).

In relation to a written put option entered into by a parent over the shares of a subsidiary IFRIC confirmed that IAS 32.23 applies and such an option is therefore not itself an equity instrument. This is because it contains an obligation to transfer cash on purchase of the non-controlling interests' shares (this is the case regardless of the fact that the transfer of cash is dependent on the holder of the option exercising it). Consequently, when a non-controlling interest put option is initially issued, a liability should be recorded for the present value of the redemption amount (which should be estimated if it is not contractually fixed). In our view, this liability should subsequently be accounted for in accordance with IAS 39.

IFRIC did not however address where in equity the corresponding debit to the liability should be recognised.

Where does the debit go?

Written put options entered into by a parent over non-controlling interests in a subsidiary are accounted for differently to most other derivatives in that they are reported at a gross liability amount with a corresponding debit to equity. This 'gross' approach contrasts with the usual method of accounting for derivatives at their (net) fair value (the different approach stems from the fact that IFRS does not regard own shares as an asset).

While IAS 32 is clear that the debit entry on initial recognition is to equity, there is no guidance on which component of equity should be debited.

Some commentators take the view that the non-controlling interest associated with shares subject to such a written put option should be derecognised when the put is written. This is an acceptable approach when the overall terms of the arrangement indicate that the risks and rewards of ownership of the non-controlling interest shares have in substance transferred to the parent when the put is written.

In cases when the risks and rewards of ownership remain with the non-controlling shareholders, however, this approach does not in our view reflect the true economic position as the non-controlling interest continues to exist until the option is actually exercised. Adopting the other approach would also create difficulties should the option lapse unexercised.

We therefore believe that in such circumstances, the debit entry should be made to a component of equity other than non-controlling interest (with disclosure of the element relating to the put option where material) and the non-controlling interest component of equity should continue to be recognised until the put option is exercised.

Example: Written put option

Parent P holds a 70% controlling interest in Subsidiary S. The remaining 30% is held by Entity Z. On 1.1.X1 P writes an option to Z which grants Z the right to sell its shares to Parent P on 31.12.X2 for CU 1,000. Parent P receives a payment of CU 100 for the option.

The applicable discount rate for the put liability is determined to be 6%.

Analysis

On 1.1.X1 the present value of the (estimated) exercise price is CU 890 (CU 1,000 discounted over 2 years at 6%). The respective entries in Parent P's consolidated financial statements on 1.1.X1 are:

	Debit CU	Credit CU
Cash	100	
Financial liability – put option		890
Equity – other (balancing entry)	790	

The liability will subsequently be accounted for in accordance with the ongoing measurement requirements of IAS 39.

Future developments

In May 2012, IFRIC published draft Interpretation DI/2012/2 'Put Options Written on Non-controlling Interests'. The draft Interpretation would apply to a put option written by a parent on the shares of its subsidiary held by a non-controlling interest shareholder that, if exercised, obliges the parent to purchase those shares.

The consensus reached in the draft Interpretation over how to account for changes in the measurement of the financial liability for a put option written on non-controlling interests is consistent with the approach advocated in our Guide. The draft Interpretation has however been the subject of some controversy. As a result, IFRIC has referred the matter to the IASB, who will now make the decision on whether to proceed with the draft Interpretation or to explore another route forward. Readers are advised to monitor developments in this area.

3.3.2 Purchased call option over non-controlling interests

In contrast to a written put option, a purchased call option entered into by a parent over shares of a subsidiary held by non-controlling interests contains no obligation for the parent entity to transfer cash. Accordingly, such a contract is capable of meeting the definition of an equity instrument. Equity classification is by no means automatic, however, as it is quite common for the exercise price of the option to be variable (eg the exercise price might be determined using a formula linked to the profitability of the subsidiary). A call option over non-controlling interests will only meet the definition of an equity instrument if its terms are 'fixed for fixed' (see Section C.3) ie it can only be settled by exchanging a fixed amount of cash for a fixed number of shares.

The cost of acquiring a call option over non-controlling interests that meets the definition of an equity instrument is debited to equity, with no further accounting entries being made for changes in the option's value or on its expiry. Conversely if the call option failed the fixed for fixed test then it would be accounted for as a derivative asset.

Note that options that may or will be net cash-settled are accounted for as normal derivatives, at fair value through profit or loss.

3.4 Settlement options

Where a derivative financial instrument gives one party a choice between alternative settlement options, for instance where the holder can choose to have the instrument settled net in cash or by exchanging shares for cash, it will be a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

Example: Option allowing cash settlement

A share option that the issuer can decide to settle either by exchanging its own shares for cash or by settling net in cash will be classified as a financial liability.

4 Problems affecting application of the 'fixed' and 'fixed for fixed' tests

Whilst the above examples are relatively straightforward, in practice a number of problems emerge when applying these rules.

One of the main problems is determining what exactly is a 'fixed' amount of cash or a 'fixed' number of equity instruments. Three situations which create particular problems in relation to this are contracts to be settled by a fixed number of own equity instruments in exchange for a fixed amount of foreign currency, changes to the conversion ratio in relation to convertible debt, and contingent conversion or exercise. We discuss these situations below.

4.1 Contracts to be settled by a fixed number of own equity instruments in exchange for a fixed amount of foreign currency

The question of what exactly is a fixed amount of cash was asked of IFRIC in 2005, in relation to contracts that will be settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency.

IFRIC concluded that such contracts, which would for example include a conversion option in a foreign currency denominated convertible bond, are liabilities. They did however decide to recommend that the IASB consider amending IAS 32 so that, for classification purposes only, a fixed amount of foreign currency would be treated as a fixed amount of cash. To date no such amendment has been made (although a more limited amendment relating to the classification of rights issues denominated in a foreign currency was issued in October 2009, see Section C.4.1.1 below). Accordingly, a derivative contract which involves an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency fails the 'fixed for fixed' test and will be classified as a liability.

4.1.1 Classification of rights issues

In October 2009, the IASB issued 'Classification of Rights Issues (Amendments to IAS 32)', making a narrow, targeted amendment to the requirements of IAS 32.

The amendment alters IAS 32 so that rights issues, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights pro rata to all of its existing shareholders.

Prior to the amendment, rights issues denominated in a foreign currency were considered not to result in the issuing entity receiving a fixed amount of cash for a fixed number of equity instruments due to the possibility of exchange rate fluctuations (see Section C.4.1 above). This resulted in such rights being treated as derivative liabilities and re-measured through profit or loss until exercise or expiry.

Many commentators questioned whether this reflected the substance of such transactions, given that rights are issued only to existing shareholders on the basis of their existing shareholdings. The IASB agreed and therefore decided that a pro rata issue of rights, options or warrants to all existing shareholders to buy additional shares is a transaction with an entity's owners in their capacity as owners and should be classified as equity. A narrow, targeted amendment to the requirements of IAS 32 was therefore made. In practice, rights issues denominated in a foreign currency are relatively rare.

4.2 Changes to the conversion ratio

Another area that frequently raises problems in deciding whether the fixed for fixed test relates to contractual features that cause the conversion price or ratio in convertible debt to change in particular circumstances. The same issues also arise in standalone options and warrants that will be settled in the issuer's own shares.

Many convertible bonds include conversion options in which the number of ordinary shares received in exchange for each bond (or conversion price) varies in some circumstances. Common types of variation provision include adjustments in the event of:

- a share split, share consolidation, bonus issue or rights issue
- dividend payments in excess of a certain level
- a change of control of the issuer.

A very narrow or mechanical reading of the fixed for fixed requirement would imply that any such adjustment would result in the conversion option failing the definition of equity. In our view, however, the fixed for fixed test should be applied based on the substance of the arrangement. If the conversion ratio varies in certain circumstances, the fixed for fixed requirement may be breached. However the factors that cause the conversion ratio to vary should be analysed.

Adjustments to conversion price that preserve the rights of bondholders

In our view, adjustments to the conversion ratio whose effect is simply to preserve the rights of the bondholders relative to the entity's other equity shareholders do not breach the fixed for fixed requirement.

An adjustment to the conversion ratio will preserve the rights of the bondholders relative to other equity shareholders if its effect is to ensure that all classes of equity interest are treated equally. Such types of adjustment are often referred to as 'anti-dilutive' and do not underwrite the value of the conversion option. Rather they preserve the value of the option relative to the other ordinary shares in specified circumstances. Caution must always be exercised, however, as a clause headed 'anti-dilutive' in a legal document may in reality go further than pure anti-dilution and so could cause the fixed for fixed test to be failed.

Other adjustments, for example those that link the number or value of the shares to be received on exercise to the entity's share price or some other price or index, will breach the fixed for fixed requirement. These conversion options are not equity components although they do represent embedded derivatives within the scope of IAS 39. The embedded conversion option must be accounted for as a derivative at fair value through profit or loss although problems of separating the embedded derivative can be avoided by designating the entire instrument at fair value through profit or loss.

In practice, the terms of convertible bonds will need to be analysed carefully to determine the substance of the conversion feature. Judgement will be required to decide whether a conversion option is fixed in economic terms.

4.2.1 Examples

Appendix D sets out various detailed scenarios in which the conversion feature in a convertible bond is affected by a change of conversion price clause. The appendix sets out our interpretation of whether or not the fixed for fixed test is met in these situations, ie whether the specific contract terms create an equity instrument / component or not. The underlying technical analysis applies equally to embedded conversion options and to standalone options and warrants.

4.3 Contingent conversion or exercise

Another area which leads to questions of how to interpret the fixed for fixed test is where an option or forward contract over own shares can be exercised or converted only in particular circumstances (in other words, the instrument is contingently convertible or exercisable).

In our view the fact that conversion or exercise can only occur in certain situations does not in itself cause an option to fail the definition of equity. For example, a purchased option to issue a fixed number of shares for a fixed amount of cash that is exercisable only if the issuer achieves a stated milestone (such as an IPO) is in our view an equity instrument. However, contracts with more than one possible outcome and multiple contingencies can raise further questions over what is considered to be a fixed number of own equity instruments under IAS 32.16(b)(ii).

Consider for example, a call option written by Entity A that gives the counterparty the right to buy a certain number of Entity A's shares for CU 100 per share in a year's time. The number of shares that may be purchased is contingent on Entity A achieving stated milestones or targets, for example:

- 100 shares if Target 1 is met
- 200 shares if Target 2 is met
- 300 shares if Target 3 is met.

Different views can be taken over whether such an arrangement meets the fixed for fixed test. Some might view the arrangement as failing the fixed for fixed test on the grounds that there are four possible outcomes in terms of the absolute amount of cash to be paid and the absolute amount of shares to be issued. Others might view the arrangement as meeting the requirements of the fixed for fixed test on the basis that the amount to be paid per share is always fixed.

Our view is that it depends on whether the individual milestones, targets or other contingencies are discrete outcomes that can be achieved independently of one another or, by contrast, are significantly interdependent. If they are discrete outcomes, we believe the arrangement can be considered as being in effect three separate contracts for the purpose of the fixed for fixed test, meaning that (in this example) the test is met. If the outcomes are interdependent, however, we believe that the fixed for fixed test is failed.

Example 1

Entity B enters into a written call option that gives the counterparty the right to buy equity of Entity B for CU 100 per share as follows:

- 1,000 shares if Entity B achieves Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) of CU 20m in year 1
- 2,000 shares if Entity B achieves EBITDA of CU 60m in year 2
- 3,000 shares if Entity B achieves EBITDA of CU 100m in year 3.

Analysis

In this case the three EBITDA targets can be viewed as discrete because the achievement of each target can occur independently of the other targets (as they relate to financial performance in different periods). The arrangement can therefore be considered to be economically equivalent to three separate contracts. The price per share and the amount of shares to be issued is fixed in each of these three discrete periods, with each target relating to a different year and therefore a separate risk. The fixed for fixed test is therefore met.

Example 2

Entity C enters into a written call option that gives the counterparty the right to buy equity of Entity C for CU 100 per share in a year's time as follows:

- 1,000 shares if Entity C achieves EBITDA of CU 45m for the year
- 2,000 shares if Entity C achieves EBITDA of CU 95m for the year
- 3,000 shares if Entity C achieves EBITDA of CU 150m for the year.

Analysis

The three EBITDA targets are interdependent because the second target cannot be met without also meeting the first target, and the third target cannot be met unless the first two are met. Although it might be possible to achieve the same outcome using three separate contracts, those contracts would need to be structured specifically to achieve that outcome with the likely effect that they would need to be assessed as linked agreements in any case. Our view is therefore that this contract should be treated as a single instrument when applying the fixed for fixed test. The test is then failed because both the number of shares and the amount of cash to be exchanged are variable.

D. Puttable instruments and obligations arising on liquidation

Summary of requirements

- exceptions to IAS 32's basic principle of liability and equity classification were introduced in 2008 by the 'Amendments to IAS 32 and IAS 1: Puttable Financial Instruments and Obligations Arising on Liquidation'
- the Amendments introduce a set of criteria which, if met, require some instruments which would otherwise have been classified as liabilities to be classified as equity. These criteria are intentionally rule-based and narrow in their focus.

1 Section overview

Under the basic definition of a financial liability in Section B, instruments containing an obligation for the issuer to transfer cash are classified as liabilities.

Some types of entity, however, commonly issue shares which give the holder the right to redeem the instrument for cash in certain situations but otherwise give an equity-like return. Examples of these types of entity include partnerships, co-operatives and collective investment vehicles.

Applying the basic definition of a liability led to many instruments issued by such entities being classified as liabilities because the entity has an obligation to transfer cash that it cannot avoid. As a result, the financial statements of some types of partnerships and co-operative organisations showed no equity.

This led in some circumstances to counter-intuitive results. For example, strong financial performance by an issuer would often increase the value of the underlying entity and therefore the value of the instrument in concern, with the consequent effect that reported liabilities and finance costs would also increase.

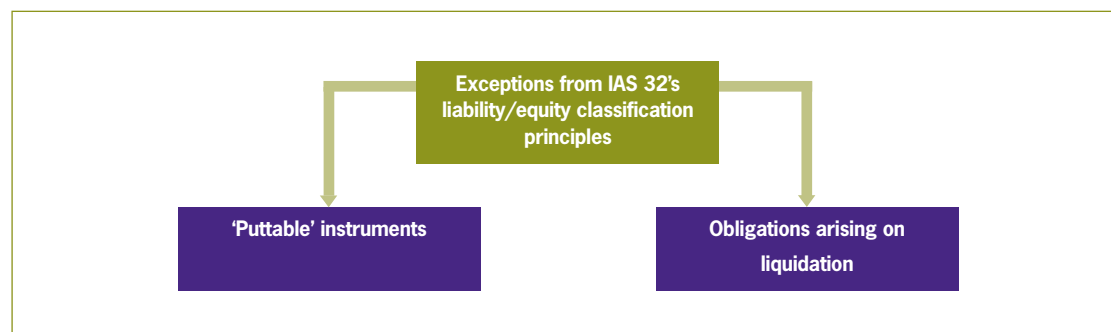
To address such problems, the IASB published 'Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements: Puttable Financial Instruments and Obligations Arising on Liquidation' ('the Amendments') in 2008.

The Amendments are effective for annual periods beginning on or after 1 January 2009, with early adoption permitted. Adoption of the Amendments is retrospective.

The Amendments have introduced a set of criteria which, if met, require some instruments which would otherwise have been classified as liabilities to be classified (or, if applicable, reclassified) as equity. The criteria set are stringent such that the Amendments will only alter classification in some narrowly defined cases. As the name suggests, they cover two types of financial instruments:

- puttable instruments
- instruments with obligations arising on liquidation.

Exceptions to IAS 32's liability classification principles



Section D discusses the criteria that must be met in order to achieve equity classification under the Amendments and illustrates some of the issues that arise when applying them. The Section starts by looking at the part of the Amendments that addresses 'puttable' financial instruments before considering financial instruments with obligations arising on liquidation.

2 The puttable instruments exception

2.1 What is a puttable instrument?

A puttable instrument is defined under the Amendments as:

“a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.”

It should be noted that this definition does not therefore capture instruments that are mandatorily redeemable on a set date or instruments that are redeemable on an event that is certain to happen. (Note, however, that in certain situations, the obligations arising on liquidation amendments discussed in Section D.3 may be relevant to such instruments.)

The Amendments introduce rules-based exceptions to the general principles behind liability or equity classification. Their effect is that if (and only if) certain strict conditions are met, puttable instruments are classified as equity. The conditions to be met to achieve equity classification are discussed in Section D.2.2.

Example: Partnership shares

Partnership A is an incorporated partnership that provides legal services. Under the terms of the partnership agreement, new partners are required to pay capital into the partnership. When a partner leaves or retires from the partnership, the capital that he or she initially paid in is repayable at fair value.

Before the publication of the Amendments, partners' capital was always presented as a liability in the partnership accounts because the partnership was obliged to pay cash to a partner leaving the firm or retiring from it.

Following the publication of the Amendments, however, the partners' capital meets the definition of a puttable instrument. This means that it will be presented as equity if all of the conditions in the Amendments are met.

Examples of instruments that do and do not meet the definition of a puttable instrument under the Amendments

Puttable instruments	Not puttable instruments
<ul style="list-style-type: none"> • instruments giving holder option to redeem 	<ul style="list-style-type: none"> • instruments with a mandatory fixed redemption date
<ul style="list-style-type: none"> • instruments automatically put back to the issuer on <ul style="list-style-type: none"> – occurrence of an uncertain future event (eg change of control) – death of the holder – retirement of the holder 	<ul style="list-style-type: none"> • instruments giving the issuer an option to redeem • instruments redeemable on an event that is certain to happen

2.2 The conditions to be met to achieve equity classification under the Amendments

The conditions which must be met to achieve equity classification can be briefly summarised as follows:

- 1) the instrument entitles the holder to a pro rata share of the entity's net assets on liquidation
- 2) the instrument is part of a class of instruments that is subordinate to all other classes of instruments
- 3) all financial instruments in this most subordinate class have identical features
- 4) apart from the put feature, the instrument must not include any other contractual obligation to deliver cash or another financial asset to another entity
- 5) the total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument
- 6) the issuer must have no other financial instrument or contract that has (a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and (b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

The full text of each of the conditions is set out below, together with a discussion of the application issues that arise from them.

2.2.1 The Instrument entitles the holder to a pro rata share of the entity's net assets on liquidation

The first of the criteria that must be met for a puttable instrument to be classified as equity in accordance with the Amendments is:

“(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

- i) dividing the entity's net assets on liquidation into units of equal amount; and**
- ii) multiplying that amount by the number of the units held by the financial instrument holder.”**

(IAS 32.16A(a))

The rationale which underpins this condition is that an entitlement to a pro rata share of the entity's residual assets on liquidation is consistent with having a residual interest in the assets of an entity.

If the holder of an instrument is not entitled to a pro rata share of the residual assets (ie those assets that remain after all claims have been deducted) on liquidation then the condition is not met and it will not be possible to classify the instrument as equity.

Example: Instrument entitled to limited payment on liquidation

Entity Z has two classes of puttable shares – Class A shares and Class B shares. On liquidation, Class B shareholders are entitled to a pro rata share of the entity's residual assets up to a maximum of CU 100,000. There is no limit to the rights of the Class A shareholders to share in the residual assets on liquidation.

The cap of CU 100,000 means that the B shares do not have entitlement to a pro rata share of the residual assets of the entity on liquidation. They cannot therefore be classified as equity.

The holder's entitlement to a pro rata share of the residual assets must also be based on the assets of the entity as a whole and not on that of a sub-part of the entity for the condition to be met.

Example: Shares in an investment fund

Investment fund Y is comprised of two sub-funds, a South American fund and a Far Eastern fund, and has two classes of puttable share – A shares and B shares.

On liquidation, the A shares are entitled to a pro rata share of the residual assets in the South American fund while the B shares are entitled to a pro rata share of the residual assets in the Far Eastern fund. The two sub-funds are not considered to be entities in their own right.

Neither the A shares nor the B shares meet the condition in IAS 32.16A(a) as they are entitled to a pro rata share in the residual assets of different sub-funds rather than the entity as a whole.

2.2.2 The Instrument is part of a class of instruments that is subordinate to all other classes of instruments
The second condition that must be met for a puttable instrument to be classified as equity in accordance with the Amendments is:

“(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments.

To be in such a class the instrument:

- i) has no priority over other claims to the assets of the entity on liquidation, and**
- ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.”**

(IAS 32.16A(b))

Example: Priority over other claims on liquidation

An investment fund has two classes of shares in issue:

- A shares that are puttable instruments
- B shares which meet the normal criteria for equity classification.

On liquidation, the A shareholders have a preferential right to the first CU 100,000 of residual assets and the B shareholders have a right to the remaining residual assets.

The A shares cannot be classified as equity under the Amendments as they have priority over other claims to the assets of the entity on liquidation.

No materiality threshold applies to the test of subordination, meaning that the most subordinated class of share may on occasion be a very small one.

Founders' shares in an investment fund

Many investment funds have a nominal amount of founders' shares. Such shares are generally issued to the investment manager and are neither redeemable (meaning they do not meet the definition of puttable instruments) nor entitled to dividends. Typically they have no voting rights and rank last for repayment in the event of liquidation of the fund.

Where the founders' shares are entitled to payments in the event of liquidation and rank last in terms of repayment, they will constitute the most subordinate class of shares. This is the case irrespective of their materiality (eg there may be only two founders' shares). The effect of the founders' shares is that any classes of puttable shares will have to be classified as liabilities.

It should be noted that the test of subordination refers to the order of repayment on liquidation only and not at other times.

Example: Two classes of equity, one class puttable

An entity has issued two types of financial instrument. Instrument A is an instrument without a put right while instrument B is a puttable instrument.

Instrument A meets the normal criteria for equity classification in IAS 32. Does Instrument B's put feature mean that it has priority over other claims to the assets of the entity and cannot be classified as equity under the puttable instruments exception contained in the Amendments?

No. Paragraph 16A(b) specifies that the level of an instrument's subordination is determined by its priority in liquidation. Accordingly, the existence of the put feature does not of itself imply that Instrument B is less subordinate than Instrument A.

2.2.3 All financial instruments in this most subordinate class have identical features

The third condition to be met for a puttable instrument to be classified as equity in accordance with the Amendments is as follows:

“All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.”

(IAS 32.16A(c))

To apply this condition, an entity must first of all determine what is the most subordinate class of instruments. For this purpose the most subordinate class of instruments may consist of what are considered to be two or more separate types of instrument for company secretarial purposes.

Example: Most subordinate class of shares

Entity E has, in legal terms, two distinct types of puttable shares – A shares and B shares. Both A shares and B shares are subordinate to all other claims on the entity and rank equally on liquidation.

The A shares and B shares together form the most subordinate class of shares for the purpose of applying the Amendments.

Having identified, the most subordinate class of instruments, the entity then needs to determine whether all of the items within this class have identical features in order to meet the condition in IAS 32.16A(c).

The meaning of the term ‘identical features’ is not elaborated on in the Amendments. Questions arise in practice where there are multiple instruments in the most subordinate class that have relatively minor or non-substantive differences. It is not clear whether ‘identical features’ should be taken literally so as to require every contractual term to be identical, or whether non-substantive differences should be ignored. Under this latter view, further questions arise as to which differences are non-substantive. In the absence of guidance, judgement will need to be applied.

In our view it is clear that the features to be evaluated are not limited to financial features such as the redemption price. Non-financial features such as voting rights must also be considered. It is also safe to say that any significant differences in the features of puttable instruments in the most subordinate class will result in all those instruments being classified as financial liabilities.

Example: Differences in repayment terms (varying administration fees)

Entity E has issued puttable shares which investors may put back to the entity.

When an investor puts shares back to the entity an administration fee is charged by the entity. For shares issued to wholesale investors, the fee is specified as 1%. For shares issued to retail investors the fee is 5%. Can the shares be reclassified as equity under the Amendments?

No. The wording in the standard requires identical terms and different holders are being charged different fees that would result in differing distributions. This fails the identical features condition.

It should be noted that where there are instruments in the most subordinate class of instruments with features that are deemed to be non-identical for the purpose of applying the Amendments, it is not possible for the entity to say that one of the types of instrument is more subordinate than the other in order to treat that class of share as equity under the Amendments. A class of instrument is more subordinate than another class only where this accurately reflects the rights of the respective instruments on liquidation.

Example: Different voting rights

Entity W has two classes of puttable share – A shares and B shares. The A shares and B shares are considered to be equally subordinate to all other classes of instrument on liquidation. The terms of the put options for the A and B shares are the same, and the A and B shares are equally entitled to dividends. The A shares give holders the right to vote in general meetings of the entity, however, while the B shares do not.

Neither of the two classes of puttable share can be classified as equity, as they do not have identical features due to the difference in voting rights. It is not possible for Entity W to achieve equity classification of the A shares by designating them as being more subordinate than the B shares, as this does not reflect the fact that the two classes of share are equally entitled to share in Entity W's residual assets on liquidation.

2.2.4 No other contractual obligations to deliver cash or another financial asset

The fourth condition to be met for a puttable instrument to be classified as equity in accordance with the Amendments is as follows:

“Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially 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.”

(IAS 32.16A(d))

The requirement that a puttable instrument contains no other contractual obligation to deliver cash or another financial asset means that it will not be possible for an instrument containing another liability element in addition to the put feature to be classified as equity under the Amendments.

Example: Right to require distributions under a partnership agreement

Partnership G is an incorporated partnership of civil engineers. Under the terms of the partnership agreement, the capital that a partner paid for a share in the partnership is repayable when he or she retires or leaves the partnership.

In addition to this right, a partnership share gives the partner a right at any time to:

- require the partnership to distribute an amount equal to the partner's pro rata share of the entity's profits
- require a distribution to cover the partner's personal income tax liability arising from his share of the entity's profits.

The existence of these additional contractual obligations means that it will not be possible to use the Amendments to classify the partnership shares as equity.

Example: Puttable instrument with obligation to pay dividends

Entity G has issued a class of share which gives the shareholder the right to put the share back to the entity. The shares entitle the holder to a minimum dividend of 5% per annum (based on the nominal value of the shares).

The shares cannot qualify for equity classification under the Amendments in their entirety as in addition to the put option there is also a contractual obligation to deliver cash to the holder due to the requirement to pay a minimum dividend.

2.2.5 Total expected cashflows attributable to the instrument over its life

The fifth condition to be met for a puttable instrument to achieve equity classification under the Amendments is:

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

(IAS 32.16A(e))

The cashflows attributable to an instrument include:

- the proceeds from the issue of the instrument
- returns on the instrument during its life (for example dividend payments)
- the amount payable by the entity upon the instrument holder putting the instrument back to the entity.

The condition requires that the cashflows are substantially based on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity. The Amendments do not expand on what is meant by ‘substantially’ and judgement may be required to apply this condition.

Example: Cash flows based on a formula

Entity M issues an instrument which pays discretionary dividends based on the attributable profits of Entity M as a whole, and which is puttable at a proportionate share of 75% of the fair value of the unrecognised and recognised net assets of Entity M. Does the instrument meet the condition in IAS 32.16A(e)?

In this example, the formula that determines the redemption price is based entirely on the change in the fair value of the recognised and unrecognised net assets of the entity. In our view this meets the applicable condition. It is not essential that the instrument receives 100% of the share of fair value of the recognised and unrecognised net assets of the entity in order to meet the condition.

If, however, the return on redemption of the instrument had consisted of a fixed amount of CU 100,000 plus 75% of the proportionate share of the fair value of the recognised and unrecognised net assets of the entity, then the IAS 32.16A(e) condition would be failed (assuming the CU 100,000 is ‘substantial’ in the context). This is because the fixed payment of CU 100,000 means that the cashflows are no longer substantially derived from the change in the fair value of the recognised and unrecognised net assets of the entity.

It should be noted that the evaluation of the cash flow condition must take account of the expected cash flows from dividends as well as the amount payable on exercise of the put feature.

In relation to the underlying basis for the calculation of the cashflows, further explanation is added in the Application Guidance to the Amendments, where it is noted that “Profit or loss and the change in the recognised net assets shall be measured in accordance with relevant IFRSs.” (IAS 32.AG14E).

Cashflows based under local GAAP net assets

It is possible that the terms and conditions of an instrument might be based on local GAAP net assets or profits. This might arise, for example, where an instrument was issued before the entity began to prepare its financial statements under IFRS or where consolidated financial statements are prepared under IFRS but the parent entity continues to prepare financial statements for the individual entity under local GAAP and the terms attached to instruments issued by the parent reflect this.

Where this is the case, judgement will need to be exercised in deciding whether differences between local GAAP and IFRS are sufficiently insignificant that measurement under local GAAP can be considered equivalent to measurement under IFRS.

Readers should be aware however that even where the differences between local GAAP and IFRS are viewed as being insignificant, there is the potential for complications to arise in the future. Such complications may arise from the entity entering into new transactions where GAAP differences arise, or if local GAAP and IFRS diverge in future. Judgement is essential then both at the time of the initial classification decision and on an ongoing basis.

Readers should also be aware of the IASB's decision in the IFRS for Small and Medium-sized Entities published in July 2009, that "if the instrument is entitled to an amount measured on some other basis (such as local GAAP), the amount is classified as a liability". While the IFRS for Small and Medium-sized Entities is designed to be a simplified version of full IFRS, this decision may be indicative of the IASB thinking on this issue more generally.

Another effect of the total expected cash flows condition is that a return based only on a specific part of an entity's business will fail equity classification.

Example: Puttable shares in a mining company

A diversified mining company acquires a copper mine. As a result of the acquisition, it issues a class of puttable shares to the former owners of the copper mine. Dividends on this class of shares are discretionary. The amount payable by the entity when the holder chooses to exercise his put option will be determined by reference to the fair value of the mine at that time.

This instrument does not meet the condition in IAS 32.16A(e) as the return on redemption by the holder is based on the fair value of part of the entity's business rather than the entity as a whole. The instruments will therefore be classified as financial liabilities.

What is the entity?

While it is clear that it is not possible for the total expected cashflows on an instrument to be based on a specific part of an entity's business, questions still arise in relation to identification of the 'entity' in this context.

One common question relates to instruments issued by the parent within a group. Where dividends on an instrument issued by the parent are payable on the basis of the parent company's distributable profits, it could be argued that, from the group's perspective, the requirement for cashflows to be based substantially on the entity's profit or loss is failed. The argument is that in the consolidated financial statements, the entity is the group as a whole.

In practice, however, the cashflows on a puttable instrument issued by a parent are often calculated by reference to the parent company's separate financial statements. In our view, if the instrument meets the criteria for classification as equity in those separate financial statements, the same classification should apply in the consolidated financial statements.

Similarly, if the cashflows on an instrument are calculated by reference to the consolidated financial statements and the instruments are deemed to meet the criteria for classification as equity in the consolidated financial statements, then it is reasonable for the instrument to also be classified as equity in the separate financial statements.

2.2.6 No other financial instrument that is based on profit or loss or change in net assets of the entity and has the effect of fixing the residual return to the puttable instrument holders

The final condition to be met for a financial instrument to be classified as an equity instrument under the Amendments is that:

“in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.”

(IAS 32.16B)

For the purposes of applying this condition, only the cash flows and the contractual terms and conditions of the instrument that relate to the instrument holder as an owner of the entity are considered. Non-financial contracts with the holder of the instrument that may arise where the holder of the instrument is, say, also an employee of the entity should be ignored (provided the cash flows and contractual terms of the transaction are similar to those of an equivalent contract that might occur between a non-instrument holder and the issuing entity).

Example: Profit or loss sharing agreement based on services rendered

The partners in a professional services partnership hold puttable ‘partnership units’. The partners have entered into a profit sharing agreement that allocates profit or loss to the units based on business generated during the current year.

The profit sharing arrangement should not be considered when assessing whether the puttable instruments meet the conditions for equity classification under the Amendments. The profit sharing arrangement is a transaction with the instrument holders in their role as non-owners.

If the entity cannot determine that this ‘no other financial instrument’ condition is met, it shall not classify the puttable instrument as an equity instrument.

Examples

The following are example of ‘other financial instruments’ which, when entered into on normal commercial terms with unrelated parties, are unlikely to result in puttable instruments that otherwise meet the criteria for equity classification under the Amendments being classified as financial liabilities:

- instruments with total cash flows substantially based on specific assets of the entity
- instruments with total cash flows based on a percentage of revenue
- contracts designed to reward individual employees for services rendered to the entity
- contracts requiring the payment of an insignificant percentage of profit for services rendered or goods provided.

(IAS 32.AG14J)

3 The obligations arising on liquidation exception

The second exception to the general principles of liability/equity classification in the Amendments relates to certain types of obligation arising on liquidation.

The previous version of IAS 32 did not normally require an instrument to be classified as a liability solely on the grounds that it would be repayable on the liquidation of the entity that issued it (IAS 32.25(b)). It did however require liability classification where liquidation was certain to occur and was outside the control of the entity (eg a limited life entity) or was uncertain but was at the option of the holder of the instrument.

The Amendments require that instruments with these liquidation obligations are classified as equity if a number of conditions are met. These can be summarised as:

- 1) the instrument entitles the holder to a pro rata share of the entity's net assets on liquidation
- 2) the instrument is part of a class of instruments that is subordinate to all other classes of instruments
- 3) all financial instruments in this most subordinate class have identical features
- 4) the issuer must have no other financial instrument or contract that has (a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and (b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

There are many similarities between the above conditions and those that need to be met to achieve equity classification of a puttable instrument. A brief comparison of the conditions above with those set out in Section D2.2 shows that conditions 1, 2, 3 and 6 relating to puttable instruments are essentially the same as the four conditions which need to be met for equity classification of an obligation arising on liquidation.

Many of the issues discussed in Section D2.2 are then equally applicable to instruments containing an obligation arising on liquidation. There are however some important differences. These are summarised as follows:

- a) there is no requirement that there is 'no other contractual obligation' (in addition to the obligation arising on liquidation)
- b) there is no requirement to consider the expected total cash flows throughout the life of the instrument
- c) the only feature that must be identical among the instruments in the class is the obligation for the issuing entity to deliver to the holder a pro rata share of its net assets on liquidation.

Sections D.3.1 to D.3.3 discuss these differences in more depth.

3.1 Other contractual obligations

The obligations arising on liquidation exception deals solely with those instruments that would under IAS 32's normal principles be classified as financial liabilities because they contain an obligation to deliver a pro rata share of net assets on liquidation, and liquidation is either certain to occur or is uncertain but is at the option of the holder.

Consequently, the criteria relating to the obligations arising on liquidation exception does not include a condition that the instrument contains no other contractual obligations other than the obligation for the entity to deliver a pro rata share of its net assets on liquidation. This contrasts with the criteria for classification as equity under the puttable instruments exception (see Section D.2.2.4 above), which does contain such a condition.

As a result, the components of an instrument containing other contractual obligations may need to be accounted for separately in accordance with the normal requirements of IAS 32.

Example: Instrument with a contractual obligation in addition to an obligation arising on liquidation

Entity A is a limited life investment fund. It issues a class of instrument which entitles the holder to a pro rata share of the entity's net assets on liquidation of the entity, which will be in ten years.

In addition to the obligation arising on liquidation, the instruments pay a fixed dividend amounting to CU 500,000 in each of the first three years of their ten year life.

The instrument therefore comprises different components which may need to be accounted for separately.

Application of the obligations arising on liquidation exception is only relevant to those obligations that exist at liquidation. The obligation to pay dividends in the first three years of the instrument's life does not arise on liquidation and is therefore accounted for in accordance with the normal requirements of IAS 32. A financial liability is therefore recognised for the present value of the obligation to pay dividends of CU 500,000 per annum in the first three years.

Application of the obligations arising on liquidation exception is relevant to the feature of the instrument requiring payment of a pro rata share of the entity's net assets on liquidation. If all of the criteria in the exception are met, this component of the instrument is classified as equity. If the criteria are not met, this component will be classified as a liability in accordance with the normal requirements of IAS 32.

3.2 No requirement to consider the expected total cash flows throughout the life of the instrument

Unlike the puttables exception, there is no requirement under the obligations arising on liquidation obligation rules for the total expected cash flows attributable to the instrument over its life to be based substantially on the profit or loss, the change in the recognised net assets or the change in fair value of the recognised and unrecognised net assets of the entity over the life of the instrument.

The reason for this difference is the timing of settlement of the obligation. The life of the financial instrument is the same as the life of the issuing entity, and extinguishment of the obligation can only occur at liquidation. The criteria for equity classification therefore focus only on the obligations that exist at liquidation.

3.3 The 'identical features' condition

For obligations arising on liquidation, the condition that all financial instruments in the most subordinate class have identical features is slightly different from the requirement relating to puttable instruments. It states that:

"All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation."

(IAS 32.16C(c))

It is possible then for an instrument within the most subordinate class of instruments to have different features from another instrument in that class as long as the entitlements on liquidation are the same.

Example: Differing voting rights prior to liquidation

An investment fund has two classes of share – A shares and B shares.

Both the A and the B shares give the holder the right to require the entity to enter into liquidation, upon which a pro rata share of net assets is repayable to the shareholders. Prior to liquidation, the only difference between the A and B shares is that the A shares entitle the shareholder to vote in general meeting. Upon liquidation, there are no differences between the rights of the A and B shares.

Does the difference between the voting rights of the A and B shares mean that neither can qualify for equity classification under the obligations arising on liquidation exception?

No. It is possible for the A and B shares to qualify for equity classification. The requirement under the obligations arising on liquidation exception is for all instruments in the most subordinated class to have an identical contractual obligation to deliver a pro rata share of net assets on liquidation. The differing voting rights of the A and B shares prior to liquidation are not relevant to this assessment.

4 Changes in classification as a result of the Amendments

Because of the extensive conditions attached to equity classification of these types of instruments, the equity criteria could be met in some periods but failed in others.

Care is needed as an entity that has (correctly) classified a puttable instrument or an instrument with an obligation arising on liquidation as equity might, for example, subsequently issue another, more subordinated class of instruments. This would require the instrument to be reclassified as a liability.

Example: New class of redeemable shares issued

An investment fund has only one class of puttable shares ('Class A') which meet the criteria for equity classification under the Amendments.

The fund decides to issue another class of redeemable shares ('Class B'). Class B shares are more subordinate than the Class A shares. What is the effect of this new issue on the classification of the existing class of redeemable shares?

IAS 32.16A(b) requires a puttable instrument to be in the most subordinate class of shares in order to be equity. The effect of issuing a new, more subordinated class of instruments is therefore that the Class A puttable instruments must be reclassified as financial liabilities. The Class B shares may be classified as equity instruments if all the applicable conditions are met.

In summary, the Amendments' requirements on reclassification of puttable instruments and obligations arising on liquidation are that:

- an instrument is classified or reclassified into equity from the date it meets all of the applicable conditions
- the instrument is reclassified into liabilities if it ceases to meet all those conditions
- if an instrument is reclassified from liability to equity the amount transferred to equity is the carrying value of the financial liability at the date of reclassification
- if an instrument is reclassified from equity to liability, the initial carrying value of the liability is its fair value at the date of reclassification. Any difference between this fair value and the carrying value of the equity instrument is recorded in equity.

4.1 Non-controlling interests

As discussed above, the Amendments result in some instruments that would otherwise be classified as liabilities being classified as equity, provided certain conditions are met. IAS 32.AG29A clarifies that these exceptions do not extend to the classification of non-controlling interests in consolidated financial statements.

Where for example a subsidiary classifies puttable instruments or instruments that impose an obligation only on liquidation as equity in its individual financial statements, any of those instruments held by non-controlling parties will not be presented as equity in the group's consolidated financial statements.

The logic behind this rule is that if the group were to be liquidated, the claims of those non-controlling interests to the assets of the subsidiary would have to be met first ahead of those of the parent entity's shareholders. This illustrates the potential for situations to exist where instruments are classified as equity in the single entity financial statements of a subsidiary but as liabilities at consolidated level.

4.2 Derivatives over puttable instruments and obligations arising on liquidation

Entities often issue or acquire derivatives over their own equity instruments such as warrants and share options. As discussed in Section C, derivatives over an entity's own equity which meet the fixed for fixed test are treated as equity instruments.

Where the instruments to be received or delivered by the entity on settlement of a derivative contract are puttable financial instruments (or instruments with obligations arising on liquidation) the derivative is always a financial asset or liability. This is the case even if the underlying instruments would fall to be classified as equity in accordance with the Amendments (IAS 32.22A).

E. Compound financial instruments

Summary of requirements

- compound instruments are those non-derivative instruments that possess both equity and liability characteristics
- in order to recognise the substance of such instruments, IAS 32 requires the equity and liability components to be separated on initial recognition, a process sometimes referred to as ‘split accounting’
- split accounting involves first calculating the fair value of the liability component. The equity component is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole
- the split and the amount of the liability and equity components is determined on initial recognition and is not altered subsequently.

1 Section overview

The terms of a financial instrument may contain elements which are representative of both equity and liability classification. Where this is the case, the instrument is known as a compound financial instrument. Section E looks at the accounting for compound instruments, discussing:

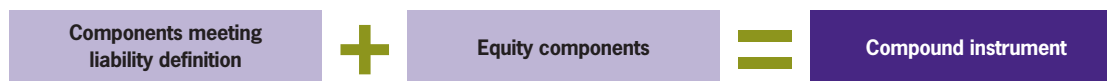
- the principle of classification in accordance with substance rather than legal form
- ‘split accounting’ for the equity and liability components of a compound instrument
- applying split accounting where an embedded derivative does not meet the definition of equity (in this case the instrument is not referred to as a compound instrument but as a ‘hybrid’ instrument).

It then goes on to discuss some of the issues relating to conversion of a compound instrument, including:

- early repayment of a convertible bond
- the effects of amending the terms of a compound instrument to induce early conversion.

2 Examples of compound financial instruments

As discussed in Section B of the Guide, the first step in accounting for any instrument is to analyse the contractual obligations attaching to it. A compound instrument contains elements which are representative of both equity and liability classification.



A common example is a convertible bond, which typically (but not always, see Section E.2.2) consists of a liability component in relation to a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert the bond into a fixed number of ordinary shares of the entity).

Other examples of possible compound financial instruments include instruments with rights to a fixed minimum dividend and additional discretionary dividends, and instruments with fixed dividend rights but with the right to share in the residual net assets of the issuing entity on the entity’s liquidation.

2.1 Financial instruments with payments based on profits of the issuer

As discussed in Section B.2.1.3, an obligation to pay interest or dividends linked to profits of the issuer is a contractual obligation to deliver cash, which therefore meets the definition of a financial liability.

Some instruments that include such an obligation also include an equity component. For example, the contractual arrangements might make clear that the obligatory payments are a minimum and that additional, discretionary dividends might be paid. Such a feature meets the definition of an equity component since:

- there is no obligation to deliver cash
- it represents an interest in the residual assets of the issuer, after deducting all of the liabilities (IAS 32.11).

An equity component should be identified only if the discretionary feature has substance. It should not be presumed to exist (since, in theory, the issuer of any instrument could decide to make additional, discretionary payments). As with all financial instruments within the scope of IAS 39, the liability should initially be recorded at its fair value. Subsequently, the instrument is measured in accordance with IAS 39 at amortised cost, using the effective interest method.

2.2 Convertible bonds

Many convertible bonds are compound instruments. However, a common misconception is that a convertible bond is always a compound financial instrument. In fact, a convertible bond will only be a compound instrument where the component relating to conversion satisfies the requirements of the ‘fixed for fixed’ test.

Example: Foreign currency denominated convertible debt

A UK company whose functional currency is pounds sterling issues a convertible bond which is denominated in US dollars.

The fact that the bond is denominated in a foreign currency means that the conversion component fails the fixed for fixed test, as a fixed amount of foreign currency is not considered to represent a fixed amount of cash (see Section C.4.1).

The key is to carefully examine the terms of each financial instrument to determine whether separate components exist and, where they do, whether they are equity components or liability components.

The following table illustrates the importance of the ‘fixed for fixed’ test in relation to conversion rights:

Do conversion rights pass fixed for fixed test?	Accounting required
Yes	<ul style="list-style-type: none">• instrument is treated as a compound instrument• liability and equity instruments split on inception• equity element is not remeasured
No	<ul style="list-style-type: none">• instrument is a hybrid instrument containing a host debt instrument with a conversion right (an embedded derivative) – see Section E.5• the instrument is split on inception (unless the conversion option is closely related to the host instrument). Where split, both elements are carried as liabilities• where separately recognised, the embedded derivative must be separately recognised at fair value through profit and loss

3 Split accounting for a compound financial instrument

IAS 32 requires the principle of substance over legal form to be applied in accounting for compound financial instruments. This involves separating the compound financial instrument into its separate components on initial recognition, a process which is often referred to as ‘split accounting’.

Taking the example of a convertible bond, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and principal, ignoring the possibility of exercise of the conversion option. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by the conversion option is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole. This approach, which is illustrated diagrammatically in Appendix C, is consistent with the definition of an equity instrument because equity is the residual interest after deducting liabilities.

Example: Compound instrument – convertible bond

Entity A issues 1,000 convertible bonds on 1 July 2008 at par value of CU 1,000 each, giving CU 1m proceeds. The bonds have a three-year term and interest at 6% is paid annually in arrears. The bonds are convertible at the option of the holder, at any time until maturity, at a rate of 250 ordinary shares per bond. The prevailing market rate of similar bonds, without the conversion feature, is 9% per annum.

The values of the liability and equity components are calculated as follows:

	CU
Present value of principal payable at the end of 3 years (CU 1m discounted at 9% for 3 years)	772,183
Present value of interest payable in arrears for 3 years (CU 60,000 discounted at 9% for each of 3 years)	151,878
Total liability component	924,061
Proceeds of issue	1,000,000
Residual – equity component	75,939

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument. Assuming a June year-end the accounting effect may be summarised as follows, assuming in this case that the bond is redeemed for cash rather than converted at the end of its term:

	Cash movement from issue/interest/ redemption (CU)	Interest charge at 9% (CU)	Liability (CU)	Equity (CU)
1 July 2008	1,000,000	–	924,061	75,939
30 June 2009	(60,000)	83,165	947,226	75,939
30 June 2010	(60,000)	85,250	972,476	75,939
30 June 2011 (pre redemption)	(60,000)	87,524	1,000,000	75,939
30 June 2011 (redemption)	(1,000,000)	–	–	75,939

If the holder had exercised the option to convert at 30 June 2011, the carrying value at that time would have been transferred to equity rather than being repaid in cash (see IAS 32.AG32).

The split of the instrument between debt and equity and the amount of the respective components is determined on initial recognition and is not altered subsequently to reflect the likelihood of conversion of the instrument.

Another example of a compound instrument could be a non-redeemable preference share with an obligation to pay a contractual dividend but where in addition, there is also a contractual right to participate in further discretionary dividends. Such an instrument would be split accounted for as follows:

Example: Non-redeemable preference shares with obligation to pay dividends at less than market rate

Entity A issues 1,000 non-redeemable preference shares at par of CU 1 each, but the shares pay dividends of only 1% per annum (which is below the market rate of 8%). This amounts to an obligation to pay CU 10 per annum. In addition, the preference shares rank equally alongside ordinary shares in a winding up and the preference shares have voting rights. The preference shares also carry the possibility of discretionary dividends (ie in addition to the 1% obligation).

The CU 10 per annum dividend obligation meets the definition of a liability, but an equity component also exists as a result of the possibility of receiving discretionary dividends and participating in the net assets of Entity A should the entity be liquidated. The shares are therefore compound financial instruments.

The liability component would be based on the net present value at time of inception of the CU 10 obligation for the annual dividend. This figure would be calculated using the market rate of interest of 8% for a debt instrument without an equity component, giving CU 125 (CU 10/0.08). The remainder of the proceeds received for issuing the shares would then be allocated to equity. The initial accounting would therefore be:

	Debit CU	Credit CU
Cash	1,000	
Financial liability		125
Equity share capital		875

The annual “dividend” of CU 10 would be charged in the profit and loss account within finance costs, but any additional dividend payment would be recognised in equity.

4 Compound instruments containing embedded non-equity derivatives

In the above example, the issuer does not have an option (at its discretion) to force early repayment. Such an option would be an embedded derivative (see glossary).

Where a compound instrument contains another embedded derivative in addition to the holder’s conversion option, the value of the additional embedded derivative must be allocated to the financial liability component (IAS 32.31). This is done using the same principles as for a normal compound financial instrument – the liability component is established by measuring the value of a liability with similar terms (including the existence of a similar embedded derivative) but without the holder’s conversion option.

The equity component is then arrived at by deducting the liability component calculated above from the fair value of the instrument as a whole.

Having performed this calculation, a further assessment must be made of whether the embedded derivative is closely related to the host debt contract. This is in accordance with the normal requirements in IAS 39 for embedded derivatives to be accounted for separately if they are not considered to be closely related to the host contract. This assessment is made before separating the equity component.

5 Hybrid instruments

A financial instrument containing an embedded derivative which does not meet the definition of equity is referred to as a hybrid instrument.

Example: Foreign currency denominated convertible debt

The convertible debt instrument denominated in a foreign currency discussed in Section E.2.2 is an example of a hybrid instrument.

The conversion component does not meet the definition of equity as a fixed amount of foreign currency is not considered to represent a fixed amount of cash (see Section C.4.1). The term 'hybrid instrument' indicates that the instrument contains a host debt contract and an embedded derivative liability (the written call option over the entity's own shares).

As in Section E.4 above, an assessment of whether the embedded derivative is closely related to the host contract is required. Unless the embedded derivative is closely related to the host contract, it should be separated out from the host contract and measured at fair value. As an alternative, however, the entity may choose to fair value the entire instrument and so avoid the practical problems in having to separate out the embedded derivative component from the host contract.

6 Conversion of a convertible bond

On conversion of a convertible bond at maturity, the liability element relating to the convertible bond should be derecognised and recognised as equity. The original amount recognised in respect of the equity component remains in equity (although it may be transferred from one line item to another within equity). There is no gain or loss on conversion at maturity.

6.1 Early settlement of a convertible bond

When a convertible bond or other form of compound instrument is extinguished before its maturity date, the issuer should allocate the consideration and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of settlement.

In allocating the consideration paid (and the transaction costs) to the separate components, the issuer applies the same method as for the original allocation of the issue proceeds to the liability and equity components. In other words, the issuer starts by allocating the settlement price to the remaining liability, and allocates the residual settlement amount to the equity component. It determines the fair value of the remaining liability using a discount rate that is based on circumstances at the settlement date. This may differ from the rate used for the original allocation.

Once this allocation has been performed, any resulting gain or loss should be treated in accordance with the accounting principles that apply to the related component.

This means that a loss is recorded in profit or loss to the extent that the amount of the consideration allocated to the liability component exceeds the carrying amount of the liability component at the date of early settlement (and vice versa). In contrast, the amount of consideration allocated to equity is recorded in equity. No gain or loss is recorded in respect of the equity component. Any remaining balance in relation to the equity component may be reclassified to another component of equity.

Example: Issuer settles convertible bond by early repayment

The details are the same as in the first example in Section E.3. However on 30 June 2010, Entity A tenders an offer of CU 1.1m (after the payment of the interest due on 30 June 2010) to the convertible bondholder to extinguish the liability and conversion rights, and the holder accepts.

IAS 32 requires that the amount paid (of CU 1.1m) is split by the same method as is used in the initial recording. However at 30 June 2010, the interest rate has changed. At that time, Entity A could have issued a one-year (ie maturity 30 June 2011) non-convertible bond at 5%. As set out in the first example in Section E.3, the carrying value of the liability at 30 June 2010 is CU 972,476.

The split of the CU 1.1m paid is as follows:

	CU
Present value of principal payable at 30/06/11 in one year's time (CU 1m discounted at 5% for 1 year)	952,381
Present value of interest payable(CU 60,000 at 5% in one year's time)	57,142
Total liability component	1,009,523
Proceeds – total fair value	1,100,000
Residual – equity component	90,477

The amount paid allocated to the liability element is CU 1,009,523. This compares to a book value of the liability at that date of CU 972,476, so a loss of CU 37,047 is reflected in the profit and loss account. The CU 90,477 of the “redemption” related to equity is debited to equity.

6.2 Amendment of the terms of a compound instrument to induce early conversion

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date.

Where this is the case, the difference between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

F. Future developments

Back in February 2008, the IASB took what was intended to be its first due process step towards a new Standard to replace IAS 32 by issuing a Discussion Paper entitled ‘Financial Instruments with Characteristics of Equity’. The Discussion Paper was a response to criticisms that IAS 32 was both difficult to apply and can result in inappropriate classification of some financial instruments. The IASB decided not to develop the Discussion Paper into an Exposure Draft, however, and the project was abandoned in favour of addressing what were felt to be greater priorities at the time.

In the IASB’s December 2012 Feedback Statement on its 2011 ‘Agenda Consultation’, the IASB indicated that it intends to reopen the debate on this area of classification by conducting a research project on it. The research project will focus on identifying financial instruments that are difficult to classify under the current requirements, or for which preparers or users question the classification. The Feedback Statement notes that any consideration of the distinction between liabilities and equity needs to be undertaken in conjunction with the Conceptual Framework work on elements of financial statements, and that the instruments identified in the course of the research will provide test cases for the staff developing the elements chapter of the Conceptual Framework. At the time of writing the IASB had not started the research project.

In the course of writing this Guide, we have indicated a number of questions and interpretive issues that arise in applying the current version of IAS 32. Despite these problems, we do not wish to see the requirements on determining the classification of financial instruments degenerate into a list of complicated rules. We therefore encourage the IASB to ensure that the development of any revised Standard is firmly based on strong principles.

Appendix A: Definition of a financial liability

A **financial liability** is defined under IAS 32.11 as:

“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, rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity’s own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.”

The references in the definition to “rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency...” and to “paragraphs 16A to 16D” of the Standard are to exceptions from the basic definition.

The reference to “rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency...” was introduced by ‘Classification of Rights Issues (Amendment to IAS 32)’ in October 2009 (see Section C.4.1.1).

Paragraph 16A and 16B deal with exceptions in respect of puttable instruments while 16C to 16D deal with the exceptions in respect of instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. These exceptions were introduced by the ‘Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements Puttable Financial Instruments and Obligations Arising on Liquidation’ published in February 2008 (see Section D for further details).

Appendix B: Definition of equity

Equity is defined under IAS 32.11 as

“any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.”

IAS 32.16 expands on this definition, saying:

“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 rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer’s own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer’s own equity instruments.

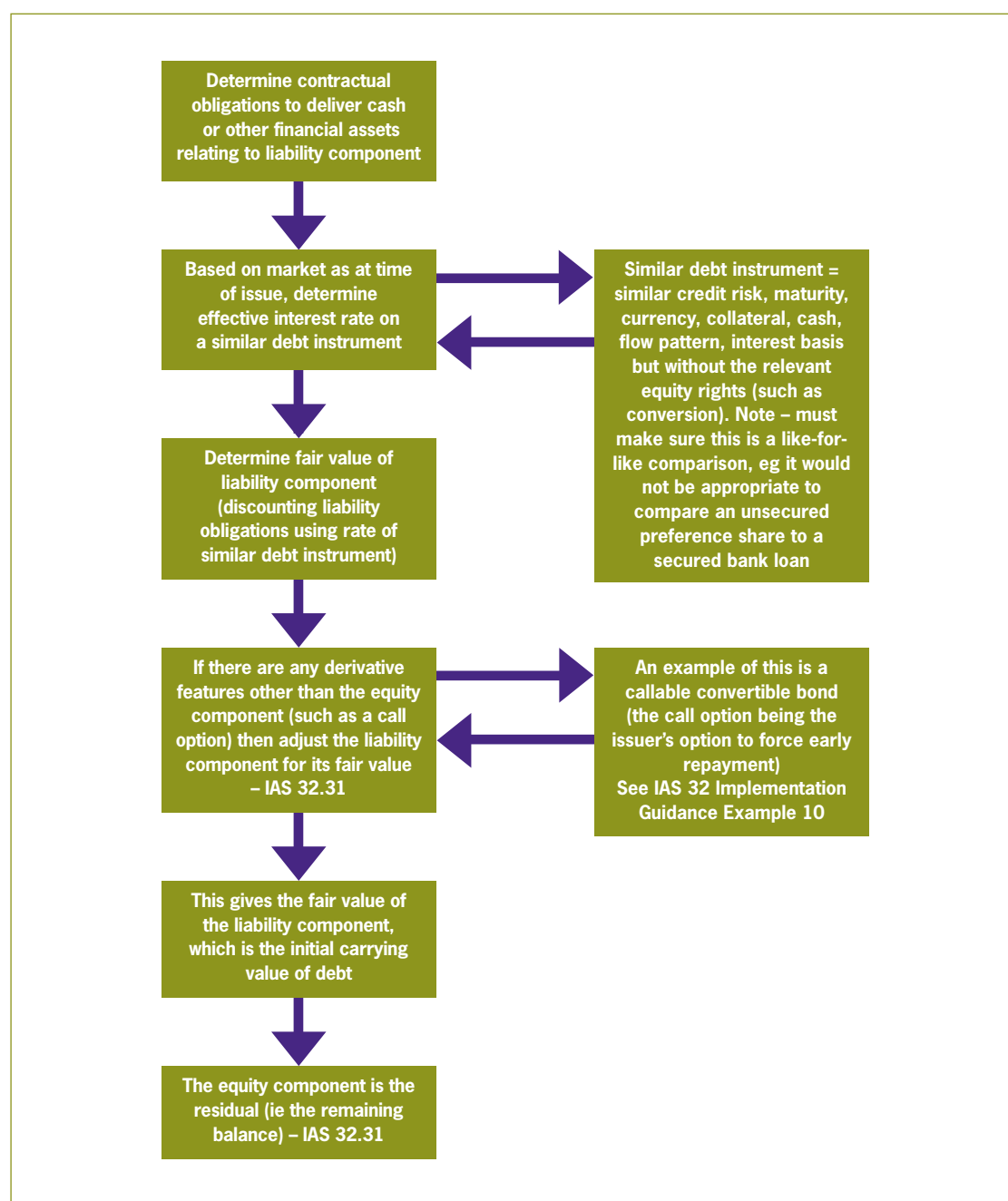
A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer’s own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.”

This definition is essentially the converse of the definition of a financial liability set out in Appendix A.

The reference to “rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency...” was introduced by ‘Classification of Rights Issues (Amendment to IAS 32)’ in October 2009 (see Section C.4.1.1).

The references in the definition to paragraphs 16A to 16D of the Standard are as a result of the ‘Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements Puttable Financial Instruments and Obligations Arising on Liquidation’ that were published in February 2008 (see Section D for further details).

Appendix C: Steps to follow in applying 'split accounting' to a compound instrument



Appendix D: Application of the fixed for fixed test

The following table illustrates the application of the fixed for fixed test discussed in Section D to various scenarios in which the conversion price or number of shares to be issued is subject to possible adjustment. The commentary refers to changes in the conversion price or ratio in a convertible bond, but the underlying technical analysis applies equally to stand-alone options and warrants that the issuer will settle in its own shares.

Nature of conversion feature	Is the conversion feature an equity component?
<p>Conversion ratio changes from one exercise date to another on a predetermined basis – the conversion ratio is adjusted on different dates by an amount that is predetermined at inception.</p>	<p>Yes. This is a point of interpretation. In our view it is reasonable to regard a conversion feature as meeting the ‘fixed for fixed’ test if the conversion ratio changes only with time, but is fixed and predetermined (ie known in advance) at any point in time.</p>
<p>Conversion ratio changes upon a share split or bonus issue – the conversion ratio is expressed as a fixed number of shares but is increased proportionately if the issuer sub-divides its shares or issues new shares without consideration (bonus shares).</p>	<p>Yes. The effect of a proportionate adjustment in these circumstances is to preserve the rights of the bondholders relative to other equity shareholders.</p>
<p>Conversion ratio changes upon a rights issue – a convertible bond provides for a change to the conversion ratio upon a rights issue.</p>	<p>Possibly. A rights issue can be analysed into:</p> <ul style="list-style-type: none"> • a bonus issue of “free” ordinary shares • an issue of new shares at market price. <p>An adjustment for the bonus issue component of a rights issue does not in our view breach the fixed for fixed test. An adjustment that alters the conversion terms based on changes in the market price (ie the second element) does not comply with the fixed for fixed test.</p>
<p>Conversion ratio changes upon a dividend payment – convertible bond contains a clause that adjusts the conversion ratio or price if the issuer pays dividends to existing shareholders.</p>	<p>Probably. If no dividends were expected to be payable on the underlying shares at the time of setting the conversion price, then clauses which adjust the conversion ratio to take account of subsequent dividend payments can generally be considered anti-dilutive and therefore consistent with the fixed for fixed test. This is on the basis that the subsequent adjustments to the conversion ratio were maintaining the relative rights of the convertible bondholder and the existing shareholders.</p> <p>A similar logic would apply if a specified level of dividends were anticipated at the time of setting the conversion price – a special dividend in excess of that specified level of dividends, which is in effect a return of excess capital, would not breach the fixed for fixed test as it would be maintaining relative rights.</p> <p>Adjustments that take place for dividends that were anticipated at the time of setting the conversion price are likely to fail the fixed for fixed test, however, as they would benefit the convertible bondholder to the detriment of the existing ordinary shareholders. Such situations are likely to be relatively rare however.</p>

Nature of conversion feature	Is the conversion feature an equity component?
<p>Conversion ratio changes upon a change of control – entity issues a convertible bond that is convertible at an improved ratio if the issuer is acquired by another entity (ie undergoes a change of control) before the maturity date of the bonds.</p>	<p>Possibly. The holder of a convertible bond issued by a quoted company will be disadvantaged if that company is acquired and ceases to be listed (because their option is then to acquire 'illiquid' shares in a private company). It is therefore common to allow or require bondholders to convert their bonds immediately on acquisition. Bondholders who convert can then sell shares to the acquirer. However, as a result of early conversion the holders have sacrificed the time value component of the conversion option's total value. An adjustment whose effect is purely to compensate for this loss of time value does not in our view fail the fixed for fixed test.</p>
<p>Conversion ratio changes if the entity issues shares at a lower share price – entity issues a convertible bond for which the conversion ratio is improved if the entity subsequently issues new shares at a lower valuation than the share price when the bonds were issued.</p>	<p>Probably not. The effect of such an adjustment is to increase the conversion ratio if the entity's share price declines and new shares are issued at the lower price. This does not preserve the rights of bondholders relative to other shareholders. Rather, it underwrites (wholly or in part) the value of the conversion option. This favours the bondholders at the expense of other shareholders. Such a provision might however be argued to be anti-dilutive if it enhances the conversion ratio only if new shares are issued at below market value (including in a bonus or rights issue – see above).</p>
<p>Convertible bond with variable conversion rate subject to a cap or floor – an entity issues an instrument that is settled in a variable number of shares but is subject to a cap to prevent excessive dilution of the existing shareholders through the issue of new shares.</p>	<p>No. This instrument includes a provision to issue a variable number of shares. It therefore fails the fixed for fixed test unless the factors that vary the conversion terms are anti-dilutive.</p>
<p>Conversion option entitling holder to acquire a fixed percentage of share capital at a fixed price per share – an entity issues a bond with a conversion option or warrant entitling the holder to acquire (say) 10% of the company's issued share capital (or fully diluted share capital) at a fixed price per share.</p>	<p>Probably. Although the number of shares does potentially vary in such circumstances (in that the number of shares that will be issued is not known until the date of conversion), this feature is typically designed to preserve the relative economic rights of the various equity shareholders. If however the feature is designed so as to benefit the holder relative to other equity shareholders, the fixed for fixed test would be breached.</p>

Glossary

Name	Description
Call option	An option contract that gives the holder the right (but not the obligation) to purchase a specified amount of the underlying asset at the given strike price, on or before the expiration date of the contract.
Compound instrument	A non-derivative financial instrument which contains both a liability and an equity component.
Derivative	A derivative is a financial instrument or other contract with all three of the following characteristics: <ol style="list-style-type: none"> its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'); it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and it is settled at a future date.
Dividend blocker	A financial instrument containing a clause that prohibits the issuer from making any distributions unless a dividend is declared in relation to another instrument.
Embedded derivative	An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
Gross-settled contracts	A contract that will be settled by only delivery of a fixed amount of an asset in exchange for the payment of a fixed price on its expiration.
Hybrid instrument	A financial instrument which does not contain an equity component but which contains a host contract and an embedded derivative.
IFRIC	The IFRS Interpretations Committee.
Issuer	The issuer is the entity which issues the instrument (not the holder). In the context of borrowings, the issuer will be the borrower.
IFRIC 2	IFRIC Interpretation 2 'Members' Shares in Co-operative Entities and Similar Instruments'.
Net cash settlement	Where one party's net gain or loss is settled in cash rather than the asset subject to the contract being exchanged at its expiration.
Put option	An option contract that gives the holder the right to sell (or put) a specified amount of the underlying asset at the given strike price, on or before the expiration date of the contract.
Puttable instrument	A puttable instrument is a financial instrument which includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put.
Subordinated instrument	A financial instrument which ranks lower in priority than other financial instruments when there is a claim upon the company which issued it
Step-up clause	A dividend clause on a financial instrument that would increase the dividend payable on the instrument at a pre-determined date in the future unless the instrument is called beforehand by the issuer
Written option	A 'written option' is where the entity is the option seller, ie it has the obligation to sell the asset (if a call) or to buy the asset (if a put) on which the option is written if the option buyer exercises the option.

Notes



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