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Approval by the Board of IAS 32 issued in December 2003

International Accounting Standard 32 *Financial Instruments: Disclosure and Presentation* (as revised in 2003) was approved for issue by thirteen of the fourteen members of the International Accounting Standards Board. Mr Leisenring dissented. His dissenting opinion is set out after the Basis for Conclusions.

Sir David Tweedie Chairman

Thomas E Jones Vice-Chairman

Mary E Barth

Hans-Georg Bruns

Anthony T Cope

Robert P Garnett

Gilbert Gélard

James J Leisenring

Warren J McGregor

Patricia L O'Malley

Harry K Schmid

John T Smith

Geoffrey Whittington

Tatsumi Yamada

Approval by the Board of *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to IAS 32 and IAS 1) issued in February 2008

Puttable Financial Instruments and Obligations Arising on Liquidation (Amendments to IAS 32 and IAS 1 *Presentation of Financial Statements*) was approved for issue by eleven of the thirteen members of the International Accounting Standards Board. Professor Barth and Mr Garnett dissented. Their dissenting opinions are set out after the Basis for Conclusions.

Sir David Tweedie

Chairman

Thomas E Jones

Vice-Chairman

Mary E Barth

Stephen Cooper

Philippe Danjou

Jan Engström

Robert P Garnett

Gilbert Gélard

James J Leisenring

Warren J McGregor

John T Smith

Tatsumi Yamada

Wei-Guo Zhang

IAS 32

Approval by the Board of *Classification of Rights Issues* (Amendment to IAS 32) issued in October 2009

Classification of Rights Issues (Amendment to IAS 32) was approved for issue by thirteen of the fifteen members of the International Accounting Standards Board. Messrs Leisenring and Smith dissented from the issue of the amendment. Their dissenting opinions are set out after the Basis for Conclusions.

Sir David Tweedie Chairman

Stephen Cooper

Philippe Danjou

Jan Engström

Patrick Finnegan

Robert P Garnett

Gilbert Gélard

Amaro Luiz de Oliveira Gomes

Prabhakar Kalavacherla

Patricia McConnell

Warren J McGregor

Tatsumi Yamada

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Basis for Conclusions on IAS 32 *Financial Instruments: Presentation*

This Basis for Conclusions accompanies, but is not part of, IAS 32.

References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 32 *Financial Instruments: Disclosure and Presentation** in 2003. Individual Board members gave greater weight to some factors than to others.
- BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*. The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies, and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of proposed amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, with a comment deadline of 14 October 2002. The Board received over 170 comment letters on the Exposure Draft.
- BC3 Because the Board did not reconsider the fundamental approach to the accounting for financial instruments established by IAS 32 and IAS 39, this Basis for Conclusions does not discuss requirements in IAS 32 that the Board has not reconsidered.
- BC3A In July 2006 the Board published an exposure draft of proposed amendments to IAS 32 relating to the classification of puttable instruments and instruments with obligations arising on liquidation. The Board subsequently confirmed the proposals and in 2008 issued an amendment that now forms part of IAS 32. A summary of the Board's considerations and reasons for its conclusions is in paragraphs BC50–BC74.

* In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7. The paragraphs relating to disclosures that were originally published in this Basis for Conclusions were relocated, if still relevant, to the Basis for Conclusions on IFRS 7.

Definitions (paragraphs 11–14 and AG3–AG24)

Financial asset, financial liability and equity instrument (paragraphs 11 and AG3–AG14)

- BC4 The revised IAS 32 addresses the classification as financial assets, financial liabilities or equity instruments of financial instruments that are indexed to, or settled in, an entity's own equity instruments. As discussed further in paragraphs BC6–BC15, the Board decided to preclude equity classification for such contracts when they (a) involve an obligation to deliver cash or another financial asset or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the entity, (b) in the case of a non-derivative, are not for the receipt or delivery of a fixed number of shares or (c) in the case of a derivative, are not for the exchange of a fixed number of shares for a fixed amount of cash or another financial asset. The Board also decided to preclude equity classification for contracts that are derivatives on derivatives on an entity's own equity. Consistently with this decision, the Board also decided to amend the definitions of financial asset, financial liability and equity instrument in IAS 32 to make them consistent with the guidance about contracts on an entity's own equity instruments. The Board did not reconsider other aspects of the definitions as part of this project to revise IAS 32, for example the other changes to the definitions proposed by the Joint Working Group in its Draft Standard *Financial Instruments and Similar Items* published by the Board's predecessor body, IASC, in 2000.

Foreign currency denominated pro rata rights issues

- BC4A In 2005 the International Financial Reporting Interpretations Committee (IFRIC) was asked whether the equity conversion option embedded in a convertible bond denominated in a foreign currency met IAS 32's requirements to be classified as an equity instrument. IAS 32 states that a derivative instrument relating to the purchase or issue of an entity's own equity instruments is classified as equity only if it results in the exchange of a fixed number of equity instruments for a fixed amount of cash or other assets. At that time, the IFRIC concluded that if the conversion option was denominated in a currency other than the issuing entity's functional currency, the amount of cash to be received in the functional currency would be variable. Consequently, the instrument was a derivative liability that should be measured at its fair value with changes in fair value included in profit or loss.
- BC4B However, the IFRIC also concluded that this outcome was not consistent with the Board's approach when it introduced the 'fixed for fixed' notion in IAS 32. Therefore, the IFRIC decided to recommend that the Board amend IAS 32 to permit a conversion or stand-alone option to be classified as equity if the exercise

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price was fixed in any currency. In September 2005 the Board decided not to proceed with the proposed amendment.

- BC4C In 2009 the Board was asked by the IFRIC to consider a similar issue. This issue was whether a right entitling the holder to receive a fixed number of the issuing entity's own equity instruments for a fixed amount of a currency other than the issuing entity's functional currency (foreign currency) should be accounted for as a derivative liability.
- BC4D These rights are commonly described as 'rights issues' and include rights, options and warrants. Laws or regulations in many jurisdictions throughout the world require the use of rights issues when raising capital. The entity issues one or more rights to acquire a fixed number of additional shares pro rata to all existing shareholders of a class of non-derivative equity instruments. The exercise price is normally below the current market price of the shares. Consequently, a shareholder must exercise its rights if it does not wish its proportionate interest in the entity to be diluted. Issues with those characteristics are discussed in IFRS 2 *Share-based Payment* and IAS 33 *Earnings per Share*.
- BC4E The Board was advised that rights with the characteristics discussed above were being issued frequently in the current economic environment. The Board was also advised that many issuing entities fixed the exercise price of the rights in currencies other than their functional currency because the entities were listed in more than one jurisdiction and might be required to do so by law or regulation. Therefore, the accounting conclusions affected a significant number of entities in many jurisdictions. In addition, because these are usually relatively large transactions, they can have a substantial effect on entities' financial statement amounts.
- BC4F The Board agreed with the IFRIC's 2005 conclusion that a contract with an exercise price denominated in a foreign currency would not result in the entity receiving a fixed amount of cash. However, the Board also agreed with the IFRIC that classifying rights as derivative liabilities was not consistent with the substance of the transaction. Rights issues are issued only to existing shareholders on the basis of the number of shares they already own. In this respect they partially resemble dividends paid in shares.
- BC4G The Board decided that a financial instrument that gives the holder the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency is an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.
- BC4H In excluding grants of rights with these features from the scope of IFRS 2, the Board explicitly recognised that the holder of the right receives it as a holder of equity instruments, ie as an owner. The Board noted that IAS 1 *Presentation of Financial Statements* requires transactions with owners in their capacity as owners to be recognised in the statement of changes in equity rather than in the statement of comprehensive income.

- BC4I Consistently with its conclusion in IFRS 2, the Board decided that a pro rata issue of rights to all existing shareholders to acquire additional shares is a transaction with an entity's owners in their capacity as owners. Consequently, those transactions should be recognised in equity, not comprehensive income. Because the Board concluded that the rights were equity instruments, it decided to amend the definition of a financial liability to exclude them.
- BC4J Some respondents to the exposure draft expressed concerns that the wording of the amendment was too open-ended and could lead to structuring risks. The Board rejected this argument because of the extremely narrow amendment that requires the entity to treat all of its existing owners of the same class of its own non-derivative equity instruments equally. The Board also noted that a change in the capital structure of an entity to create a new class of non-derivative equity instruments would be transparent because of the presentation and disclosure requirements in IFRSs.
- BC4K The Board decided not to extend this conclusion to other instruments that grant the holder the right to purchase the entity's own equity instruments such as the conversion feature in convertible bonds. The Board also noted that long-dated foreign currency rights issues are not primarily transactions with owners in their capacity as owners. The equal treatment of all owners of the same class of equity instruments was also the basis on which, in IFRIC 17 *Distributions of Non-cash Assets to Owners*, the IFRIC distinguished non-reciprocal distributions to owners from exchange transactions. The fact that the rights are distributed pro rata to existing shareholders is critical to the Board's conclusion to provide an exception to the 'fixed for fixed' concept in IAS 32 as this is a narrow targeted transaction with owners in their capacity as owners.

Presentation (paragraphs 15–50 and AG25–AG39)

Liabilities and equity (paragraphs 15–27 and AG25–AG29)

- BC5 The revised IAS 32 addresses whether derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments are financial assets, financial liabilities or equity instruments. The original IAS 32 dealt with aspects of this issue piecemeal and it was not clear how various transactions (eg net share settled contracts and contracts with settlement options) should be treated under the Standard. The Board concluded that it needed to clarify the accounting treatment for such transactions.
- BC6 The approach agreed by the Board can be summarised as follows:
A contract on an entity's own equity is an equity instrument if, and only if:
- (a) it contains no contractual obligation to transfer cash or another financial asset, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; and

- (b) if the instrument will or may be settled in the entity's own equity instruments, it is either (i) a non-derivative that includes no contractual obligation for the entity to deliver a variable number of its own equity instruments, or (ii) a derivative that will be settled by the entity exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

No contractual obligation to deliver cash or another financial asset (paragraphs 17–20, AG25 and AG26)

Puttable instruments (paragraph 18(b))

- BC7 The Board decided that a financial instrument that gives the holder the right to put the instrument back to the entity for cash or another financial asset is a financial liability of the entity. Such financial instruments are commonly issued by mutual funds, unit trusts, co-operative and similar entities, often with the redemption amount being equal to a proportionate share in the net assets of the entity. Although the legal form of such financial instruments often includes a right to the residual interest in the assets of an entity available to holders of such instruments, the inclusion of an option for the holder to put the instrument back to the entity for cash or another financial asset means that the instrument meets the definition of a financial liability. The classification as a financial liability is independent of considerations such as when the right is exercisable, how the amount payable or receivable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity.
- BC7A The Board reconsidered its conclusions with regards to some puttable instruments and amended IAS 32 in February 2008 (see paragraphs BC50–BC74).
- BC8 The Board noted that the classification of a puttable instrument as a financial liability does not preclude the use of descriptors such as 'net assets attributable to unitholders' and 'change in net assets attributable to unitholders' on the face of the financial statements of an entity that has no equity (such as some mutual funds and unit trusts) or whose share capital is a financial liability under IAS 32 (such as some co-operatives). The Board also agreed that it should provide examples of how such entities might present their income statement* and balance sheet† (see Illustrative Examples 7 and 8).

* IAS 1 *Presentation of Financial Statements* (as revised in 2007) requires an entity to present all income and expense items in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income).

† IAS 1 (revised 2007) replaced the term 'balance sheet' with 'statement of financial position'.

Implicit obligations (paragraph 20)

- BC9 The Board did not debate whether an obligation can be established implicitly rather than explicitly because this is not within the scope of an improvements project. This question will be considered by the Board in its project on revenue, liabilities and equity. Consequently, the Board retained the existing notion that an instrument may establish an obligation indirectly through its terms and conditions (see paragraph 20). However, it decided that the example of a preference share with a contractually accelerating dividend which, within the foreseeable future, is scheduled to yield a dividend so high that the entity will be economically compelled to redeem the instrument, was insufficiently clear. The example was therefore removed and replaced with others that are clearer and deal with situations that have proved problematic in practice.

Settlement in the entity's own equity instruments (paragraphs 21–24 and AG27)

- BC10 The approach taken in the revised IAS 32 includes two main conclusions:
- (a) When an entity has an obligation to purchase its own shares for cash (such as under a forward contract to purchase its own shares), there is a financial liability for the amount of cash that the entity has an obligation to pay.
 - (b) When an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability. In other words, when a contract is settled in a variable number of the entity's own equity instruments, or by the entity exchanging a fixed number of its own equity instruments for a variable amount of cash or another financial asset, the contract is not an equity instrument but is a financial asset or a financial liability.

When an entity has an obligation to purchase its own shares for cash, there is a financial liability for the amount of cash that the entity has an obligation to pay.

- BC11 An entity's obligation to purchase its own shares establishes a maturity date for the shares that are subject to the contract. Therefore, to the extent of the obligation, those shares cease to be equity instruments when the entity assumes the obligation. This treatment under IAS 32 is consistent with the treatment of shares that provide for mandatory redemption by the entity. Without a requirement to recognise a financial liability for the present value of the share redemption amount, entities with identical obligations to deliver cash in exchange for their own equity instruments could report different information in their financial statements depending on whether the redemption clause is embedded in the equity instrument or is a free-standing derivative contract.

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- BC12 Some respondents to the Exposure Draft suggested that when an entity writes an option that, if exercised, will result in the entity paying cash in return for receiving its own shares, it is incorrect to treat the full amount of the exercise price as a financial liability because the obligation is conditional upon the option being exercised. The Board rejected this argument because the entity has an obligation to pay the full redemption amount and cannot avoid settlement in cash or another financial asset for the full redemption amount unless the counterparty decides not to exercise its redemption right or specified future events or circumstances beyond the control of the entity occur or do not occur. The Board also noted that a change would require a reconsideration of other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity's control. These include, for example, (a) the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation, (b) the treatment of preference shares that are redeemable at the option of the holder as financial liabilities for the full amount of the conditional obligation, and (c) the treatment of financial instruments (puttable instruments) that give the holder the right to put the instrument back to the issuer for cash or another financial asset, the amount of which is determined by reference to an index, and which therefore has the potential to increase and decrease, as financial liabilities for the full amount of the conditional obligation.

When an entity uses its own equity instruments as currency in a contract to receive or deliver a variable number of shares, the contract is not an equity instrument, but is a financial asset or a financial liability.

- BC13 The Board agreed that it would be inappropriate to account for a contract as an equity instrument when an entity's own equity instruments are used as currency in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a net share-settled derivative contract on gold or an obligation to deliver as many shares as are equal in value to CU10,000). Such a contract represents a right or obligation of a specified amount rather than a specified equity interest. A contract to pay or receive a specified amount (rather than a specified equity interest) is not an equity instrument. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and the entity may not even know whether it will receive or deliver its own shares.
- BC14 In addition, the Board noted that precluding equity treatment for such a contract limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. For example, the Board believes that an entity should not be able to obtain equity treatment for a transaction simply by including a share settlement clause when the contract is for a specified value, rather than a specified equity interest.

- BC15 The Board rejected the argument that a contract that is settled in the entity's own shares must be an equity instrument because no change in assets or liabilities, and thus no gain or loss, arises on settlement of the contract. The Board noted that any gain or loss arises before settlement of the transaction, not when it is settled.

Contingent settlement provisions (paragraphs 25 and AG28)

- BC16 The revised Standard incorporates the conclusion previously in SIC-5 *Classification of Financial Instruments—Contingent Settlement Provisions* that a financial instrument for which the manner of settlement depends on the occurrence or non-occurrence of uncertain future events, or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder (ie a 'contingent settlement provision'), is a financial liability.
- BC17 The amendments do not include the exception previously provided in paragraph 6 of SIC-5 for circumstances in which the possibility of the entity being required to settle in cash or another financial asset is remote at the time the financial instrument is issued. 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. There is a contractual obligation to transfer economic benefits as a result of past events because the entity is unable to avoid a settlement in cash or another financial asset unless an event occurs or does not occur in the future.
- BC18 However, the Board also concluded that contingent settlement provisions that would apply only in the event of liquidation of an entity should not influence the classification of the instrument because to do so would be inconsistent with a going concern assumption. A contingent settlement provision that provides for payment in cash or another financial asset only on the liquidation of the entity is similar to an equity instrument that has priority in liquidation and therefore should be ignored in classifying the instrument.
- BC19 Additionally, the Board decided that if the part of a contingent settlement provision that could require settlement in cash or a variable number of own shares is not genuine, it should be ignored for the purposes of classifying the instrument. The Board also agreed to provide guidance on the meaning of 'genuine' in this context (see paragraph AG28).

Settlement options (paragraphs 26 and 27)

- BC20 The revised Standard requires that if one of the parties to a contract has one or more options as to how it is settled (eg net in cash or by exchanging shares for cash), the contract is a financial asset or a financial liability unless all of the settlement alternatives would result in equity classification. The Board concluded that entities should not be able to circumvent the accounting requirements for financial assets and financial liabilities simply by including an option to settle a

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contract through the exchange of a fixed number of shares for a fixed amount. The Board had proposed in the Exposure Draft that past practice and management intentions should be considered in determining the classification of such instruments. However, respondents to the Exposure Draft noted that such requirements can be difficult to apply because some entities do not have any history of similar transactions and the assessment of whether an established practice exists and of what is management's intention can be subjective. The Board agreed with these comments and accordingly concluded that past practice and management intentions should not be determining factors.

Alternative approaches considered

BC21 In finalising the revisions to IAS 32 the Board considered, but rejected, a number of alternative approaches:

- (a) To classify as an equity instrument any contract that will be settled in the entity's own shares. The Board rejected this approach because it does not deal adequately with transactions in which an entity is using its own shares as currency, eg when an entity has an obligation to pay a fixed or determinable amount that is settled in a variable number of its own shares.
- (b) To classify a contract as an equity instrument only if (i) the contract will be settled in the entity's own shares, and (ii) the changes in the fair value of the contract move in the same direction as the changes in the fair value of the shares from the perspective of the counterparty. Under this approach, contracts that will be settled in the entity's own shares would be financial assets or financial liabilities if, from the perspective of the counterparty, their value moves inversely with the price of the entity's own shares. An example is an entity's obligation to buy back its own shares. The Board rejected this approach because its adoption would represent a fundamental shift in the concept of equity. The Board also noted that it would result in a change to the classification of some transactions, compared with the existing *Framework* and IAS 32, that had not been exposed for comment.
- (c) To classify as an equity instrument a contract that will be settled in the entity's own shares unless its value changes in response to something other than the price of the entity's own shares. The Board rejected this approach to avoid an exception to the principle that non-derivative contracts that are settled in a variable number of an entity's own shares should be treated as financial assets or financial liabilities.
- (d) To limit classification as equity instruments to outstanding ordinary shares, and classify as financial assets or financial liabilities all contracts that involve future receipt or delivery of the entity's own shares. The Board rejected this approach because its adoption would represent a fundamental shift in the concept of equity. The Board also noted that it would result in a change to the classification of some transactions

compared with the existing IAS 32 that had not been exposed for comment.

Compound financial instruments (paragraphs 28–32 and AG30–AG35)

- BC22 The Standard requires the separate presentation in an entity's balance sheet* of liability and equity components of a single financial instrument. It is more a matter of form than a matter of substance that both liabilities and equity interests are created by a single financial instrument rather than two or more separate instruments. The Board believes that an entity's financial position is more faithfully represented by separate presentation of liability and equity components contained in a single instrument.

Allocation of the initial carrying amount to the liability and equity components (paragraphs 31, 32 and AG36–AG38 and Illustrative Examples 9–12)

- BC23 The previous version of IAS 32 did not prescribe a particular method for assigning the initial carrying amount of a compound financial instrument to its separated liability and equity components. Rather, it suggested approaches that might be considered, such as:
- (a) assigning to the less easily measurable component (often the equity component) the residual amount after deducting from the instrument as a whole the amount separately determined for the component that is more easily determinable (a 'with-and-without' method); and
 - (b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts pro rata so that the sum of the components equals the amount of the instrument as a whole (a 'relative fair value' method).
- BC24 This choice was originally justified on the grounds that IAS 32 did not deal with the measurement of financial assets, financial liabilities and equity instruments.
- BC25 However, since the issue of IAS 39, IFRSs contain requirements for the measurement of financial assets and financial liabilities. Therefore, the view that IAS 32 should not prescribe a particular method for separating compound financial instruments because of the absence of measurement requirements for financial instruments is no longer valid. IAS 39, paragraph 43, requires a financial liability to be measured on initial recognition at its fair value. Therefore, a relative fair value method could result in an initial measurement of the liability component that is not in compliance with IAS 39.

* IAS 1 (as revised in 2007) replaced the term 'balance sheet' with 'statement of financial position'.

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- BC26 After initial recognition, a financial liability that is classified as at fair value through profit or loss is measured at fair value under IAS 39, and other financial liabilities are measured at amortised cost. If the liability component of a compound financial instrument is classified as at fair value through profit or loss, an entity could recognise an immediate gain or loss after initial recognition if it applies a relative fair value method. This is contrary to IAS 32, paragraph 31, which states that no gain or loss arises from recognising the components of the instrument separately.
- BC27 Under the *Framework*, and IASs 32 and 39, 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. Paragraph 67 of the *Framework* further states that the amount at which equity is recognised in the balance sheet is dependent on the measurement of assets and liabilities.
- BC28 The Board concluded that the alternatives in IAS 32 to measure on initial recognition the liability component of a compound financial instrument as a residual amount after separating the equity component or on the basis of a relative fair value method should be eliminated. Instead the liability component should be measured first (including the value of any embedded non-equity derivative features, such as an embedded call feature), and the residual amount assigned to the equity component.
- BC29 The objective of this amendment is to make the requirements about the entity's separation of the liability and equity components of a single compound financial instrument consistent with the requirements about the initial measurement of a financial liability in IAS 39 and the definitions in IAS 32 and the *Framework* of an equity instrument as a residual interest.
- BC30 This approach removes the need to estimate inputs to, and apply, complex option pricing models to measure the equity component of some compound financial instruments. The Board also noted that the absence of a prescribed approach led to a lack of comparability among entities applying IAS 32 and that it therefore was desirable to specify a single approach.
- BC31 The Board noted that a requirement to use the with-and-without method, under which the liability component is determined first, is consistent with the proposals of the Joint Working Group of Standard Setters in its Draft Standard and Basis for Conclusions in *Financial Instruments and Similar Items*, published by IASC in December 2000 (see Draft Standard, paragraphs 74 and 75 and Application Supplement, paragraph 318).

Treasury shares (paragraphs 33, 34 and AG36)

- BC32 The revised Standard incorporates the guidance in SIC-16 *Share Capital—Reacquired Own Equity Instruments (Treasury Shares)*. The acquisition and subsequent resale by an entity of its own equity instruments represents a transfer between those holders of equity instruments who have given up their equity interest and those who continue to hold an equity instrument, rather than a gain or loss to the entity.

Interest, dividends, losses and gains (paragraphs 35–41 and AG37)

Costs of an equity transaction (paragraphs 35 and 37–39)

BC33 The revised Standard incorporates the guidance in SIC-17 *Equity—Costs of an Equity Transaction*. Transaction costs incurred as a necessary part of completing an equity transaction are accounted for as part of the transaction to which they relate. Linking the equity transaction and costs of the transaction reflects in equity the total cost of the transaction.

BC34–BC48 [Deleted]

Summary of changes from the Exposure Draft

BC49 The main changes from the Exposure Draft's proposals are as follows:

- (a) The Exposure Draft proposed to define a financial liability as a contractual obligation to deliver cash or another financial asset to another entity or to exchange financial instruments with another entity under conditions that are potentially unfavourable. The definition in the Standard has been expanded to include some contracts that will or may be settled in the entity's own equity instruments. The Standard's definition of a financial asset has been similarly expanded.
- (b) The Exposure Draft proposed that a financial instrument that gives the holder the right to put it back to the entity for cash or another financial asset is a financial liability. The Standard retains this conclusion, but provides additional guidance and illustrative examples to assist entities that, as a result of this requirement, either have no equity as defined in IAS 32 or whose share capital is not equity as defined in IAS 32.
- (c) The Standard retains and clarifies the proposal in the Exposure Draft that terms and conditions of a financial instrument may indirectly create an obligation.
- (d) The Exposure Draft proposed to incorporate in IAS 32 the conclusion previously in SIC-5. This is that a financial instrument for which the manner of settlement depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder is a financial liability. The Standard clarifies this conclusion by requiring contingent settlement provisions that apply only in the event of liquidation of an entity or are not genuine to be ignored.
- (e) The Exposure Draft proposed that a derivative contract that contains an option as to how it is settled meets the definition of an equity instrument if the entity had all of the following: (i) an unconditional right and ability to settle the contract gross; (ii) an established practice of such settlement;

and (iii) the intention to settle the contract gross. These conditions have not been carried forward into the Standard. Rather, a derivative with settlement options is classified as a financial asset or a financial liability unless all the settlement alternatives would result in equity classification.

- (f) The Standard provides explicit guidance on accounting for the repurchase of a convertible instrument.
- (g) The Standard provides explicit guidance on accounting for the amendment of the terms of a convertible instrument to induce early conversion.
- (h) The Exposure Draft proposed that a financial instrument that is an equity instrument of a subsidiary should be eliminated on consolidation when held by the parent, or presented in the consolidated balance sheet within equity when not held by the parent (as a minority interest* separate from the equity of the parent). The Standard requires all terms and conditions agreed between members of the group and the holders of the instrument to be considered when determining if the group as a whole has an obligation that would give rise to a financial liability. To the extent there is such an obligation, the instrument (or component of the instrument that is subject to the obligation) is a financial liability in consolidated financial statements.
- (i) [Deleted]
- (j) [Deleted]
- (k) In August 2005, the IASB issued IFRS 7 *Financial Instruments: Disclosures*. As a result, disclosures relating to financial instruments, if still relevant, were relocated to IFRS 7.

Amendments for some puttable instruments and some 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

Amendment for puttable instruments

BC50 As discussed in paragraphs BC7 and BC8, puttable instruments meet the definition of a financial liability and the Board concluded that all such instruments should be classified as liabilities. However, constituents raised the following concerns about classifying such instruments as financial liabilities if they represent the residual claim to the net assets of the entity:

- (a) On an ongoing basis, the liability is recognised at not less than the amount payable on demand. This can result in the entire market capitalisation of

* In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended 'minority interests' to non-controlling interests'.

the entity being recognised as a liability depending on the basis for which the redemption value of the financial instrument is calculated.

- (b) Changes in the carrying value of the liability are recognised in profit or loss. This results in counter-intuitive accounting (if the redemption value is linked to the performance of the entity) because:
 - (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss is recognised.
 - (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain is recognised.
- (c) It is possible, again depending on the basis for which the redemption value is calculated, that the entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.
- (d) The issuing entity's statement of financial position portrays the entity as wholly, or mostly, debt funded.
- (e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not performance.

Furthermore, constituents contended that additional disclosures and adapting the format of the statement of comprehensive income and statement of financial position did not resolve these concerns.

BC51 The Board agreed with constituents that many puttable instruments, despite meeting the definition of a financial liability, represent a residual interest in the net assets of the entity. The Board also agreed with constituents that additional disclosures and adapting the format of the entity's financial statements did not resolve the problem of the lack of relevance and understandability of that current accounting treatment. Therefore, the Board decided to amend IAS 32 to improve the financial reporting of these instruments.

BC52 The Board considered the following ways to improve the financial reporting of instruments that represent a residual interest in the net assets of the entity:

- (a) to continue to classify these instruments as financial liabilities, but amend their measurement so that changes in their fair value would not be recognised;
- (b) to amend IAS 32 to require separation of all puttable instruments into a put option and a host instrument; or
- (c) to amend IAS 32 to provide a limited scope exception so that financial instruments puttable at fair value would be classified as equity, if specified conditions were met.

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

- BC53 The Board decided against this approach because:
- (a) it is inconsistent with the principle in IAS 32 and IAS 39 that only equity instruments are not remeasured after their initial recognition;
 - (b) it retains the disadvantage that entities whose instruments are all puttable would have no equity instruments; and
 - (c) it introduces a new category of financial liabilities to IAS 39, and thus increases complexity.

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

- BC54 The Board concluded that conducting further research into an approach that splits a puttable share into an equity component and a written put option component (financial liability) would duplicate efforts of the Board's longer-term project on liabilities and equity. Consequently, the Board decided not to proceed with a project at this stage to determine whether a puttable share should be split into an equity component and a written put option component.

Classify as equity instruments puttable instruments that represent a residual interest in the entity

- BC55 The Board decided to proceed with proposals to amend IAS 32 to require puttable financial instruments that represent a residual interest in the net assets of the entity to be classified as equity provided that specified conditions are met. The proposals represented a limited scope exception to the definition of a financial liability and a short-term solution, pending the outcome of the longer-term project on liabilities and equity. In June 2006 the Board published an exposure draft proposing that financial instruments puttable at fair value that meet specific criteria should be classified as equity.
- BC56 In response to comments received from respondents to that exposure draft, the Board amended the criteria for identifying puttable instruments that represent a residual interest in the entity, to those included in paragraphs 16A and 16B. The Board decided on those conditions for the following reasons:
- (a) to ensure that the puttable instruments, as a class, represent the residual interest in the net assets of the entity;
 - (b) to ensure that the proposed amendments are consistent with a limited scope exception to the definition of a financial liability; and
 - (c) to reduce structuring opportunities that might arise as a result of the amendments.

- BC57 The Board decided that the instrument must entitle the holder to a pro rata share of the net assets on liquidation because the net assets on liquidation represent the ultimate residual interest of the entity.
- BC58 The Board decided that the instrument must be in the class of instruments that is subordinate to all other classes of instruments on liquidation in order to represent the residual interest in the entity.
- BC59 The Board decided that all instruments in the class that is subordinate to all other classes of instruments must have identical contractual terms and conditions. In order to ensure that the class of instruments as a whole is the residual class, the Board decided that no instrument holder in that class can have preferential terms or conditions in its position as an owner of the entity.
- BC60 The Board decided that the puttable instruments should contain no contractual obligation to deliver a financial asset to another entity other than the put. That is because the amendments represent a limited scope exception to the definition of a financial liability and extending that exception to instruments that also contain other contractual obligations is not appropriate. Moreover, the Board concluded that if the puttable instrument contains another contractual obligation, that instrument may not represent the residual interest because the holder of the puttable instrument may have a claim to some of the net assets of the entity in preference to other instruments.
- BC61 As well as requiring a direct link between the puttable instrument and the performance of the entity, the Board also decided that there should be no financial instrument or contract with a return that is more residual. The Board decided to require that there must be no other financial instrument or contract that has total cash flows based substantially on the performance of the entity and has the effect of significantly restricting or fixing the return to the puttable instrument holders. This criterion was included to ensure that the holders of the puttable instruments represent the residual interest in the net assets of the entity.
- BC62 An instrument holder may enter into transactions with the issuing entity in a role other than that of an owner. The Board concluded that it is inappropriate to consider cash flows and contractual features related to the instrument holder in a non-owner role when evaluating whether a financial instrument has the features set out in paragraph 16A or paragraph 16C. That is because those cash flows and contractual features are separate and distinct from the cash flows and contractual features of the puttable financial instrument.
- BC63 The Board also decided that contracts (such as warrants and other derivatives) to be settled by the issue of puttable financial instruments should be precluded from equity classification. That is because the Board noted that the amendments represent a limited scope exception to the definition of a financial liability and extending that exception to such contracts is not appropriate.

Amendment for obligations to deliver to another party a pro rata share of the net assets of the entity only on liquidation

- BC64 Issues similar to those raised by constituents relating to classification of puttable financial instruments apply to some financial instruments that create an obligation only on liquidation of the entity.
- BC65 In the exposure draft published in June 2006, the Board proposed to exclude from the definition of a financial liability a contractual obligation that entitles the holder to a pro rata share of the net assets of the entity only on liquidation of the entity. The liquidation of the entity may be:
- (a) certain to occur and outside the control of the entity (limited life entities); or
 - (b) uncertain to occur but at the option of the holder (for example, some partnership interests).
- BC66 Respondents to that exposure draft were generally supportive of the proposed amendment.
- BC67 The Board decided that an exception to the definition of a financial liability should be made for instruments that entitle the holder to a pro rata share of the net assets of an entity only on liquidation if particular requirements are met. Many of those requirements, and the reasons for them, are similar to those for puttable financial instruments. The differences between the requirements are as follows:
- (a) there is no requirement that there be no other contractual obligations;
 - (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.

The reason for the differences is the timing of settlement of the obligation. The life of the financial instrument is the same as the life of the issuing entity; the extinguishment of the obligation can occur only at liquidation. Therefore, the Board concluded that it was appropriate to focus only on the obligations that exist at liquidation. The instrument must be subordinate to all other classes of instruments and represent the residual interests only at that point in time. However, if the instrument contains other contractual obligations, those obligations may need to be accounted for separately in accordance with the requirements of IAS 32.

Non-controlling interests

- BC68 The Board decided that puttable financial instruments or 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 should be classified as equity in the separate financial statements of the issuer if they represent the residual class of instruments (and all the relevant requirements are met). The Board decided that such instruments were not the residual interest in the consolidated financial statements and therefore that non-controlling interests that contain an obligation to transfer a financial asset to another entity should be classified as a financial liability in the consolidated financial statements.

Analysis of costs and benefits

- BC69 The Board acknowledged that the amendments made in February 2008 are not consistent with the definition of a liability in the *Framework*, or with the underlying principle of IAS 32, which is based on that definition. Consequently, those amendments added complexity to IAS 32 and introduced the need for detailed rules. However, the Board also noted that IAS 32 contains other exceptions to its principle (and the definition of a liability in the *Framework*) that require instruments to be classified as liabilities that otherwise would be treated as equity. Those exceptions highlight the need for a comprehensive reconsideration of the distinctions between liabilities and equity, which the Board is undertaking in its long-term project.
- BC70 In the interim, the Board concluded that classifying as equity the instruments that have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D would improve the comparability of information provided to the users of financial statements. That is because financial instruments that are largely equivalent to ordinary shares would be consistently classified across different entity structures (eg some partnerships, limited life entities and co-operatives). The specified instruments differ from ordinary shares in one respect; that difference is the obligation to deliver cash (or another financial asset). However, the Board concluded that the other characteristics of the specified instruments are sufficiently similar to ordinary shares for the instruments to be classified as equity. Consequently, the Board concluded that the amendments will result in financial reporting that is more understandable and relevant to the users of financial statements.
- BC71 Furthermore, in developing the amendments, the Board considered the costs to entities of obtaining information necessary to determine the required classification. The Board believes that the costs of obtaining any new information would be slight because all of the necessary information should be readily available.
- BC72 The Board also acknowledged that one of the costs and risks of introducing exceptions to the definition of a financial liability is the structuring opportunities that may result. The Board concluded that financial structuring opportunities are minimised by the detailed criteria required for equity classification and the related disclosures.
- BC73 Consequently, the Board believed that the benefits of the amendments outweigh the costs.

IAS 32 BC

- BC74 The Board took the view that, in most cases, entities should be able to apply the amendments retrospectively. The Board noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides relief when it is impracticable to apply a change in accounting policy retrospectively as a result of a new requirement. Furthermore, the Board took the view that the costs outweighed the benefits of separating a compound financial instrument with an obligation to deliver a pro rata share of the net assets of the entity only on liquidation when the liability component is no longer outstanding on the date of initial application. Hence, there is no requirement on transition to separate such compound instruments.

Dissenting Opinions

Dissent of James J Leisenring from the issue of IAS 32 in December 2003

- DO1 Mr Leisenring dissents from IAS 32 because, in his view, the conclusions about the accounting for forward purchase contracts and written put options on an issuer's equity instruments that require physical settlement in exchange for cash are inappropriate. IAS 32 requires a forward purchase contract to be recognised as though the future transaction had already occurred. Similarly it requires a written put option to be accounted for as though the option had already been exercised. Both of these contracts result in combining the separate forward contract and the written put option with outstanding shares to create a synthetic liability.
- DO2 Recording a liability for the present value of the fixed forward price as a result of a forward contract is inconsistent with the accounting for other forward contracts. Recording a liability for the present value of the strike price of an option results in recording a liability that is inconsistent with the *Framework* as there is no present obligation for the strike price. In both instances the shares considered to be subject to the contracts are outstanding, have the same rights as any other shares and should be accounted for as outstanding. The forward and option contracts meet the definition of a derivative and should be accounted for as derivatives rather than create an exception to the accounting required by IAS 39. Similarly, if the redemption feature is embedded in the equity instrument (for example, a redeemable preference share) rather than being a free-standing derivative contract, the redemption feature should be accounted for as a derivative.
- DO3 Mr Leisenring also objects to the conclusion that a purchased put or call option on a fixed number of an issuer's equity instruments is not an asset. The rights created by these contracts meet the definition of an asset and should be accounted for as assets and not as a reduction in equity. These contracts also meet the definition of derivatives that should be accounted for as such consistently with IAS 39.

**Dissent of Mary E Barth and Robert P Garnett
from the issue of *Puttable Financial Instruments
and Obligations Arising on Liquidation*
(Amendments to IAS 32 and IAS 1) in February
2008**

- DO1 Professor Barth and Mr Garnett voted against the publication of the Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements—*Puttable Financial Instruments and Obligations Arising on Liquidation*. The reasons for their dissent are set out below.
- DO2 These Board members believe that the decision to permit entities to classify as equity some puttable financial instruments and some financial instruments that entitle the holder to a pro rata share of the net assets of the entity only on liquidation is inconsistent with the *Framework*. The contractual provisions attached to those instruments give the holders the right to put the instruments to the entity and demand cash. The *Framework*'s definition of a liability is that it is a present obligation of the entity arising from a past event, the settlement of which is expected to result in an outflow of resources of the entity. Thus, financial instruments within the scope of the amendments clearly meet the definition of a liability in the *Framework*.
- DO3 These Board members do not agree with the Board that an exception to the *Framework* is justified in this situation. First, the Board has an active project on the *Framework*, which will revisit the definition of a liability. Although these Board members agree that standards projects can precede decisions in the *Framework* project, the discussions to date in the *Framework* project do not make it clear that the Board will modify the existing elements definitions in such a way that these instruments would be equity. Second, the amendments would require disclosure of the expected cash outflow on redemption or repurchase of puttable instruments classified as equity. These disclosures are similar to those for financial liabilities; existing standards do not require similar disclosure for equity instruments. The Board's decision to require these disclosures reveals its implicit view these instruments are, in fact, liabilities. Yet, the *Framework* is clear that disclosure is not a substitute for recognition. Third, these Board members see no cost-benefit or practical reasons for making this exception. The amendments require the same or similar information to be obtained and disclosed as would be the case if these obligations were classified as liabilities. Existing standards offer presentation alternatives for entities that have no equity under the *Framework*'s definitions.
- DO4 These Board members also do not agree with the Board that there are benefits to issuing these amendments. First, paragraph BC70 in the Basis for Conclusions states that the amendments will result in more relevant and understandable financial reporting. However, as noted above, these Board members do not believe that presenting as equity items that meet the *Framework*'s definition of a

liability results in relevant information. Also as noted above, existing standards offer presentation alternatives that result in understandable financial reporting.

- DO5 Second, paragraph BC70 states that the amendments would increase comparability by requiring more consistent classification of financial instruments that are largely equivalent to ordinary shares. These Board members believe that the amendments decrease comparability. These instruments are not comparable to ordinary shares because these instruments oblige the entity to transfer its economic resources; ordinary shares do not. Also, puttable instruments and instruments that entitle the holder to a pro rata share of the net assets of the entity only on liquidation will be classified as equity by some entities and as liabilities by other entities, depending on whether the other criteria specified in the amendments are met. Thus, these amendments account similarly for economically different instruments, which decreases comparability.
- DO6 Finally, these Board members do not believe that the amendments are based on a clear principle. Rather, they comprise several paragraphs of detailed rules crafted to achieve a desired accounting result. Although the Board attempted to craft these rules to minimise structuring opportunities, the lack of a clear principle leaves open the possibility that economically similar situations will be accounted for differently and economically different situations will be accounted for similarly. Both of these outcomes also result in lack of comparability.

Dissent of James J Leisenring and John T Smith from the issue of *Classification of Rights Issues* (Amendment to IAS 32) in October 2008

- DO1 Messrs Leisenring and Smith dissent from the amendment *Classification of Rights Issues* for the reasons set out below.
- DO2 Mr Smith agrees with the concept of accounting for a rights issue as equity in specified circumstances and supports both the IFRIC recommendation and staff recommendation in July 2009 that the Board make ‘an extremely narrow amendment’ to IAS 32 to deal with this issue. However, he dissents because he believes the change is not extremely narrow and will provide a means for an entity to use its equity instruments as a way to engage in speculative foreign currency transactions and structure them as equity transactions, a concern identified by the Board in the Basis for Conclusions on IAS 32.
- DO3 In their comment letters on the exposure draft, some respondents expressed concerns that the wording of the amendment was too open-ended and could lead to structuring risks. Mr Smith believes that these concerns are well-founded because there is no limitation on what qualifies as a class of equity. Without some limitation, an entity could, for example, establish a foreign currency trading subsidiary, issue shares to a non-controlling interest and deem the shares to be a class of equity in the consolidated group.
- DO4 The staff acknowledged the concerns expressed in comment letters that a new class of equity could be created for the purpose of obtaining a desired accounting treatment. However, the Board decided not to attempt to limit such structuring opportunities. The Board was concerned that a requirement that a pro rata offer of rights must be made to all existing owners (rather than only all existing owners of a particular class) of equity instruments would mean that the amendment would not be applicable to most of the transactions to which the Board intended the amendment to apply.
- DO5 Instead of trying to narrow the amendment, the Board simply acknowledged that under the amendment, ‘You could set up a new class of shares today and one minute later issue shares to that class and ... speculate in foreign currency without it going through the income statement.’ Mr Smith believes the Board should have explored other alternatives. Mr Smith believes that the Board should have sought solutions that could in fact provide a means of narrowing the amendment to limit structuring while accommodating appropriate transactions.
- DO6 Mr Smith believes that structuring opportunities could be curtailed significantly if some limitations were placed on the type of class of equity instruments that qualify for the exemption. There are a number of factors or indicators that could have been incorporated into the amendment that would limit the exception. For example, the amendment could have specified that non-controlling interests do not constitute a class. The amendment could have further required that qualification for the exemption is limited to those classes of equity instruments in which (a) ownership in the class is diverse or (b) the class is registered on an

exchange and shares are exchanged in the marketplace or (c) shares in that class when issued were offered to the public at large and sold in more than one jurisdiction and there was no agreement to subsequently offer rights to shares of the entity; and the amount of capital provided by the class is substantial relative to the other classes of equity. Clearly, some combination of these and other alternatives could have been used to limit structuring opportunities. Mr Smith believes that a better solution could have been found and without introducing some limits around the type of class of equity instruments that qualify, the Board did not produce an extremely narrow amendment.

- DO7 Mr Leisenring agrees that when an entity issues rights to acquire its own equity instruments those rights should be classified as equity. However, he does not accept that the issue must be pro rata to all existing shareholders of a class of non-derivative equity instruments. He does not accept that whether or not the offer is pro rata is relevant to determining if the transaction meets the definition of a liability.
- DO8 Paragraph BC4J suggests that the Board limited its conclusion to those transactions issued on a pro rata basis because of concerns about structuring risks. If that is of concern the suggestions contained in Mr Smith's dissent would be much more effective and desirable than introducing a precedent that transactions such as this rights offering must simply be pro rata to be considered a transaction with owners as owners.
- DO9 Mr Leisenring would have preferred to conclude that a right granted for a fixed amount of a currency was a 'fixed for fixed' exchange rather than create additional conditions to the determination of a liability.

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IAS 32 *Financial Instruments: Presentation* Illustrative Examples

These examples accompany, but are not part of, IAS 32.

Accounting for contracts on equity instruments of an entity

IE1 The following examples* illustrate the application of paragraphs 15–27 and IAS 39 to the accounting for contracts on an entity's own equity instruments (other than the financial instruments specified in paragraphs 16A and 16B or paragraphs 16C and 16D).

Example 1: Forward to buy shares

IE2 This example illustrates the journal entries for forward purchase contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (ie the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

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

IAS 32 IE

Assumptions:

Contract date	1 February 20X2
Maturity date	31 January 20X3
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on 1 February 20X2	CU0
Fair value of forward on 31 December 20X2	CU6,300
Fair value of forward on 31 January 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

IE3 In this subsection, the forward purchase contract on the entity's own shares will be settled net in cash, ie there is no receipt or delivery of the entity's own shares upon settlement of the forward contract.

On 1 February 20X2, Entity A enters into a contract with Entity B to receive the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 in exchange for a payment of CU104,000 in cash (ie CU104 per share) on 31 January 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

1 February 20X2

The price per share when the contract is agreed on 1 February 20X2 is CU100. The initial fair value of the forward contract on 1 February 20X2 is zero.

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

31 December 20X2

On 31 December 20X2, the market price per share has increased to CU110 and, as a result, the fair value of the forward contract has increased to CU6,300.

Dr Forward asset	CU6,300	
		Cr Gain
		CU6,300

To record the increase in the fair value of the forward contract.

31 January 20X3

On 31 January 20X3, the market price per share has decreased to CU106. The fair value of the forward contract is CU2,000 ($[\text{CU}106 \times 1,000] - \text{CU}104,000$).

On the same day, the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 to Entity B and Entity B has an obligation to deliver CU106,000 ($\text{CU}106 \times 1,000$) to Entity A, so Entity B pays the net amount of CU2,000 to Entity A.

Dr Loss	CU4,300	
		Cr Forward asset
		CU4,300

To record the decrease in the fair value of the forward contract (ie $\text{CU}4,300 = \text{CU}6,300 - \text{CU}2,000$).

Dr Cash	CU2,000	
		Cr Forward asset
		CU2,000

To record the settlement of the forward contract.

(b) Shares for shares ('net share settlement')

- IE4 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) above, except for recording the settlement of the forward contract, as follows:

31 January 20X3

The contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU}104 \times 1,000$) worth of its shares to Entity B and Entity B has an obligation to deliver CU106,000 ($\text{CU}106 \times 1,000$) worth of shares to Entity A. Thus, Entity B delivers a net amount of CU2,000 ($\text{CU}106,000 - \text{CU}104,000$) worth of shares to Entity A, ie 18.9 shares ($\text{CU}2,000/\text{CU}106$).

Dr Equity	CU2,000	
		Cr Forward asset
		CU2,000

To record the settlement of the forward contract.

(c) Cash for shares ('gross physical settlement')

IE5 Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B (CU104 × 1,000) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

1 February 20X2

Dr Equity	CU100,000	
		Cr Liability
		CU100,000

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IAS 39, paragraph AG64).

31 December 20X2

Dr Interest expense	CU3,600	
		Cr Liability
		CU3,600

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

31 January 20X3

Dr Interest expense	CU340	
		Cr Liability
		CU340

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

Dr Liability	CU104,000	
		Cr Cash
		CU104,000

To record the settlement of the obligation to redeem Entity A's own shares for cash.

(d) Settlement options

- IE6 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward repurchase contract is a financial asset or a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the forward contract as a derivative.

Example 2: Forward to sell shares

IE7 This example illustrates the journal entries for forward sale contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by receiving cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (ie the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	1 February 20X2
Maturity date	31 January 20X3
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on 1 February 20X2	CU0
Fair value of forward on 31 December 20X2	(CU6,300)
Fair value of forward on 31 January 20X3	(CU2,000)

(a) Cash for cash ('net cash settlement')

IE8 On 1 February 20X2, Entity A enters into a contract with Entity B to pay the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 in exchange for CU104,000 in cash (ie CU104 per share) on 31 January 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

1 February 20X2

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

31 December 2X02

Dr Loss	CU6,300	
		Cr Forward liability
		CU6,300

To record the decrease in the fair value of the forward contract.

31 January 20X3

Dr Forward liability	CU4,300	
		Cr Gain
		CU4,300

To record the increase in the fair value of the forward contract (ie CU4,300 = CU6,300 – CU2,000).

The contract is settled net in cash. Entity B has an obligation to deliver CU104,000 to Entity A, and Entity A has an obligation to deliver CU106,000 (CU106 × 1,000) to Entity B. Thus, Entity A pays the net amount of CU2,000 to Entity B.

Dr Forward liability	CU2,000	
		Cr Cash
		CU2,000

To record the settlement of the forward contract.

(b) Shares for shares ('net share settlement')

- IE9 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a), except:

31 January 20X3

The contract is settled net in shares. Entity A has a right to receive CU104,000 (CU104 × 1,000) worth of its shares and an obligation to deliver CU106,000 (CU106 × 1,000) worth of its shares to Entity B. Thus, Entity A delivers a net amount of CU2,000 (CU106,000 – CU104,000) worth of its shares to Entity B, ie 18.9 shares (CU2,000/CU106).

Dr Forward liability	CU2,000	
		Cr Equity
		CU2,000

To record the settlement of the forward contract. The issue of the entity's own shares is treated as an equity transaction.

(c) Shares for cash ('gross physical settlement')

- IE10 Assume the same facts as in (a), except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of the entity's own shares. Similarly to (a) and (b) above, the price per share that Entity A will receive in one year is fixed at CU104. Accordingly, Entity A has a right to receive CU104,000 in cash (CU104 × 1,000) and an obligation to deliver 1,000 of its own shares in one year. Entity A records the following journal entries.

1 February 20X2

No entry is made on 1 February. No cash is paid or received because the forward has an initial fair value of zero. A forward contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash or another financial asset meets the definition of an equity instrument because it cannot be settled otherwise than through the delivery of shares in exchange for cash.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

31 January 20X3

On 31 January 20X3, Entity A receives CU104,000 in cash and delivers 1,000 shares.

Dr Cash	CU104,000	
		Cr Equity
		CU104,000

To record the settlement of the forward contract.

(d) Settlement options

- IE11 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward contract is a financial asset or a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognises a derivative asset or liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 3: Purchased call option on shares

IE12 This example illustrates the journal entries for a purchased call option right on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for the entity's own shares. It also discusses the effect of settlement options (see (d) below):

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)
Exercise right holder	Reporting entity (Entity A)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU104
Market price per share on 31 January 20X3	CU104
Fixed exercise price to be paid on 31 January 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU3,000
Fair value of option on 31 January 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

IE13 On 1 February 20X2, Entity A enters into a contract with Entity B that gives Entity B the obligation to deliver, and Entity A the right to receive the fair value of 1,000 of Entity A's own ordinary shares as of 31 January 20X3 in exchange for CU102,000 in cash (ie CU102 per share) on 31 January 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

The price per share when the contract is agreed on 1 February 2002 is CU100. The initial fair value of the option contract on 1 February 2002 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU102 exceeds the market price per share of CU100 and it would therefore not be economic for Entity A to exercise the option. In other words, the call option is out of the money.

Dr Call option asset	CU5,000	
	Cr Cash	CU5,000

To recognise the purchased call option.

31 December 20X2

On 31 December 20X2, the market price per share has increased to CU104. The fair value of the call option has decreased to CU3,000, of which CU2,000 is intrinsic value ($[(CU104 - CU102) \times 1,000]$), and CU1,000 is the remaining time value.

Dr Loss	CU2,000	
	Cr Call option asset	CU2,000

To record the decrease in the fair value of the call option.

31 January 20X3

On 31 January 20X3, the market price per share is still CU104. The fair value of the call option has decreased to CU2,000, which is all intrinsic value ($[(CU104 - CU102) \times 1,000]$) because no time value remains.

Dr Loss	CU1,000	
	Cr Call option asset	CU1,000

To record the decrease in the fair value of the call option.

On the same day, Entity A exercises the call option and the contract is settled net in cash. Entity B has an obligation to deliver CU104,000 ($CU104 \times 1,000$) to Entity A in exchange for CU102,000 ($CU102 \times 1,000$) from Entity A, so Entity A receives a net amount of CU2,000.

Dr Cash	CU2,000	
	Cr Call option asset	CU2,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

- IE14 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) except for recording the settlement of the option contract as follows:

31 January 20X3

Entity A exercises the call option and the contract is settled net in shares. Entity B has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of Entity A's shares to Entity A in exchange for CU102,000 ($\text{CU102} \times 1,000$) worth of Entity A's shares. Thus, Entity B delivers the net amount of CU2,000 worth of shares to Entity A, ie 19.2 shares ($\text{CU2,000}/\text{CU104}$).

Dr Equity	CU2,000	
Cr Call option asset		CU2,000

To record the settlement of the option contract. The settlement is accounted for as a treasury share transaction (ie no gain or loss).

(c) Cash for shares ('gross physical settlement')

- IE15 Assume the same facts as in (a) except that settlement will be made by receiving a fixed number of shares and paying a fixed amount of cash, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity A has a right to receive 1,000 of Entity A's own outstanding shares in exchange for CU102,000 ($\text{CU102} \times 1,000$) in cash, if Entity A exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr Equity	CU5,000	
Cr Cash		CU5,000

To record the cash paid in exchange for the right to receive Entity A's own shares in one year for a fixed price. The premium paid is recognised in equity.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract that gives a right to receive a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

31 January 20X3

Entity A exercises the call option and the contract is settled gross. Entity B has an obligation to deliver 1,000 of Entity A's shares in exchange for CU102,000 in cash.

Dr Equity	CU102,000	
		Cr Cash
		CU102,000

To record the settlement of the option contract.

(d) Settlement options

- IE16 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the call option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognises a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 4: Written call option on shares

IE17 This example illustrates the journal entries for a written call option obligation on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU104
Market price per share on 31 January 20X3	CU104
Fixed exercise price to be paid on 31 January 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU3,000
Fair value of option on 31 January 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

IE18 Assume the same facts as in Example 3(a) above except that Entity A has written a call option on its own shares instead of having purchased a call option on them. Accordingly, on 1 February 20X2 Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A's own ordinary shares as of 31 January 20X3 in exchange for CU102,000 in cash (ie CU102 per share) on 31 January 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

Dr Cash	CU5,000	
Cr Call option obligation		CU5,000

To recognise the written call option.

31 December 20X2

Dr Call option obligation	CU2,000	
Cr Gain		CU2,000

To record the decrease in the fair value of the call option.

31 January 20X3

Dr Call option obligation	CU1,000	
Cr Gain		CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity B exercises the call option and the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 ($CU104 \times 1,000$) to Entity B in exchange for CU102,000 ($CU102 \times 1,000$) from Entity B, so Entity A pays a net amount of CU2,000.

Dr Call option obligation	CU2,000	
Cr Cash		CU2,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

- IE19 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a), except for recording the settlement of the option contract, as follows:

31 December 20X3

Entity B exercises the call option and the contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of Entity A's shares to Entity B in exchange for CU102,000 ($\text{CU102} \times 1,000$) worth of Entity A's shares. Thus, Entity A delivers the net amount of CU2,000 worth of shares to Entity B, ie 19.2 shares ($\text{CU2,000}/\text{CU104}$).

Dr	Call option obligation	CU2,000	
	Cr	Equity	CU2,000

To record the settlement of the option contract. The settlement is accounted for as an equity transaction.

(c) Cash for shares ('gross physical settlement')

- IE20 Assume the same facts as in (a) except that settlement will be made by delivering a fixed number of shares and receiving a fixed amount of cash, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity B has a right to receive 1,000 of Entity A's own outstanding shares in exchange for CU102,000 ($\text{CU102} \times 1,000$) in cash, if Entity B exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr	Cash	CU5,000	
	Cr	Equity	CU5,000

To record the cash received in exchange for the obligation to deliver a fixed number of Entity A's own shares in one year for a fixed price. The premium received is recognised in equity. Upon exercise, the call would result in the issue of a fixed number of shares in exchange for a fixed amount of cash.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

31 January 20X3

Entity B exercises the call option and the contract is settled gross. Entity A has an obligation to deliver 1,000 shares in exchange for CU102,000 in cash.

Dr Cash	CU102,000
Cr Equity	CU102,000

To record the settlement of the option contract.

(d) Settlement options

- IE21 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the call option is a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognises a derivative liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 5: Purchased put option on shares

IE22 This example illustrates the journal entries for a purchased put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)
Exercise right holder	Reporting entity (Entity A)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU95
Market price per share on 31 January 20X3	CU95
Fixed exercise price to be paid on 31 January 20X3	CU98
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU4,000
Fair value of option on 31 January 20X3	CU3,000

(a) Cash for cash ('net cash settlement')

IE23 On 1 February 20X2, Entity A enters into a contract with Entity B that gives Entity A the right to sell, and Entity B the obligation to buy the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 at a strike price of CU98,000 (ie CU98 per share) on 31 January 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

The price per share when the contract is agreed on 1 February 20X2 is CU100. The initial fair value of the option contract on 1 February 20X2 is CU5,000, which

Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU98 is less than the market price per share of CU100. Therefore it would not be economic for Entity A to exercise the option. In other words, the put option is out of the money.

Dr Put option asset	CU5,000	
Cr Cash		CU5,000

To recognise the purchased put option.

31 December 20X2

On 31 December 20X2 the market price per share has decreased to CU95. The fair value of the put option has decreased to CU4,000, of which CU3,000 is intrinsic value ($[(CU98 - CU95) \times 1,000]$) and CU1,000 is the remaining time value.

Dr Loss	CU1,000	
Cr Put option asset		CU1,000

To record the decrease in the fair value of the put option.

31 January 20X3

On 31 January 20X3 the market price per share is still CU95. The fair value of the put option has decreased to CU3,000, which is all intrinsic value ($[(CU98 - CU95) \times 1,000]$) because no time value remains.

Dr Loss	CU1,000	
Cr Put option asset		CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity A exercises the put option and the contract is settled net in cash. Entity B has an obligation to deliver CU98,000 to Entity A and Entity A has an obligation to deliver CU95,000 ($CU95 \times 1,000$) to Entity B, so Entity B pays the net amount of CU3,000 to Entity A.

Dr Cash	CU3,000	
Cr Put option asset		CU3,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

IE24 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as shown in (a), except:

31 January 20X3

Entity A exercises the put option and the contract is settled net in shares. In effect, Entity B has an obligation to deliver CU98,000 worth of Entity A's shares to Entity A, and Entity A has an obligation to deliver CU95,000 worth of Entity A's shares ($CU95 \times 1,000$) to Entity B, so Entity B delivers the net amount of CU3,000 worth of shares to Entity A, ie 31.6 shares ($CU3,000/CU95$).

Dr Equity	CU3,000	
	Cr Put option asset	CU3,000

To record the settlement of the option contract.

(c) Cash for shares ('gross physical settlement')

IE25 Assume the same facts as in (a) except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of Entity A's shares, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity B has an obligation to pay CU98,000 in cash to Entity A ($CU98 \times 1,000$) in exchange for 1,000 of Entity A's outstanding shares, if Entity A exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr Equity	CU5,000	
	Cr Cash	CU5,000

To record the cash received in exchange for the right to deliver Entity A's own shares in one year for a fixed price. The premium paid is recognised directly in equity. Upon exercise, it results in the issue of a fixed number of shares in exchange for a fixed price.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of Entity A.

31 January 20X3

Entity A exercises the put option and the contract is settled gross. Entity B has an obligation to deliver CU98,000 in cash to Entity A in exchange for 1,000 shares.

Dr Cash	CU98,000
Cr Equity	CU98,000

To record the settlement of the option contract.

(d) Settlement options

- IE26 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the put option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognises a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 6: Written put option on shares

IE27 This example illustrates the journal entries for a written put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU95
Market price per share on 31 January 20X3	CU95
Fixed exercise price to be paid on 31 January 20X3	CU98
Present value of exercise price on 1 February 20X2	CU95
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU4,000
Fair value of option on 31 January 20X3	CU3,000

(a) Cash for cash ('net cash settlement')

IE28 Assume the same facts as in Example 5(a) above, except that Entity A has written a put option on its own shares instead of having purchased a put option on its own shares. Accordingly, on 1 February 20X2, Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A's outstanding ordinary shares as of 31 January 20X3 in exchange for CU98,000 in cash (ie CU98 per share) on 31 January 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

Dr Cash	CU5,000	
Cr Put option liability		CU5,000

To recognise the written put option.

31 December 20X2

Dr Put option liability	CU1,000	
Cr Gain		CU1,000

To record the decrease in the fair value of the put option.

31 January 20X3

Dr Put option liability	CU1,000	
Cr Gain		CU1,000

To record the decrease in the fair value of the put option.

On the same day, Entity B exercises the put option and the contract is settled net in cash. Entity A has an obligation to deliver CU98,000 to Entity B, and Entity B has an obligation to deliver CU95,000 (CU95 × 1,000) to Entity A. Thus, Entity A pays the net amount of CU3,000 to Entity B.

Dr Put option liability	CU3,000	
Cr Cash		CU3,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

IE29 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those in (a), except for the following:

31 January 20X3

Entity B exercises the put option and the contract is settled net in shares. In effect, Entity A has an obligation to deliver CU98,000 worth of shares to Entity B, and Entity B has an obligation to deliver CU95,000 worth of Entity A's shares (CU95 × 1,000) to Entity A. Thus, Entity A delivers the net amount of CU3,000 worth of Entity A's shares to Entity B, ie 31.6 shares (3,000/95).

IAS 32 IE

Dr Put option liability	CU3,000	
Cr Equity		CU3,000

To record the settlement of the option contract. The issue of Entity A's own shares is accounted for as an equity transaction.

(c) Cash for shares ('gross physical settlement')

IE30 Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of shares, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity A has an obligation to pay CU98,000 in cash to Entity B (CU98 × 1,000) in exchange for 1,000 of Entity A's outstanding shares, if Entity B exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr Cash	CU5,000	
Cr Equity		CU5,000

To recognise the option premium received of CU5,000 in equity.

Dr Equity	CU95,000	
Cr Liability		CU95,000

To recognise the present value of the obligation to deliver CU98,000 in one year, ie CU95,000, as a liability.

31 December 20X2

Dr Interest expense	CU2,750	
Cr Liability		CU2,750

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

31 January 20X3

Dr Interest expense	CU250	
Cr Liability		CU250

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

On the same day, Entity B exercises the put option and the contract is settled gross. Entity A has an obligation to deliver CU98,000 in cash to Entity B in exchange for CU95,000 worth of shares ($CU95 \times 1,000$).

Dr Liability	CU98,000	
		Cr Cash
		CU98,000

To record the settlement of the option contract.

(d) Settlement options

- IE31 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the written put option is a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the put option as a derivative liability.

Entities such as mutual funds and co-operatives whose share capital is not equity as defined in IAS 32

Example 7: Entities with no equity

IE32 The following example illustrates a format of a statement of comprehensive income and statement of financial position that may be used by entities such as mutual funds that do not have equity as defined in IAS 32. Other formats are possible.

Statement of comprehensive income for the year ended 31 December 20X1

	20X1	20X0
	CU	CU
Revenue	2,956	1,718
Expenses (classified by nature or function)	(644)	(614)
Profit from operating activities	<u>2,312</u>	<u>1,104</u>
Finance costs		
– other finance costs	(47)	(47)
– distributions to unitholders	(50)	(50)
Change in net assets attributable to unitholders	<u><u>2,215</u></u>	<u><u>1,007</u></u>

Statement of financial position at 31 December 20X1

	20X1		20X0	
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IAS 1)	<u>91,374</u>		<u>78,484</u>	
Total non-current assets		91,374		78,484
Current assets (classified in accordance with IAS 1)	<u>1,422</u>		<u>1,769</u>	
Total current assets		1,422		1,769
Total assets		<u>92,796</u>		<u>80,253</u>
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	<u>647</u>		<u>66</u>	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unitholders (classified in accordance with IAS 1)	<u>280</u>		<u>136</u>	
		(280)		(136)
Net assets attributable to unitholders		<u>91,869</u>		<u>80,051</u>

Example 8: Entities with some equity

IE33 The following example illustrates a format of a statement of comprehensive income and statement of financial position that may be used by entities whose share capital is not equity as defined in IAS 32 because the entity has an obligation to repay the share capital on demand but does not have all the features or meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. Other formats are possible.

Statement of comprehensive income for the year ended 31 December 20X1

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

Statement of financial position at 31 December 20X1

	20X1		20X0	
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IAS 1)	908		830	
Total non-current assets		908		830
Current assets (classified in accordance with IAS 1)	383		350	
Total current assets		383		350
Total assets		<u>1,291</u>		<u>1,180</u>
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		<u>717</u>		<u>681</u>
Non-current liabilities (classified in accordance with IAS 1)	187		196	
		(187)		(196)
OTHER COMPONENTS OF EQUITY ^(a)				
Reserves eg revaluation surplus, retained earnings etc	530		485	
		530		485
		<u>717</u>		<u>681</u>
MEMORANDUM NOTE – Total members' interests				
Share capital repayable on demand		202		161
Reserves		530		485
		<u>732</u>		<u>646</u>

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

Accounting for compound financial instruments

Example 9: Separation of a compound financial instrument on initial recognition

- IE34 Paragraph 28 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.
- IE35 An entity issues 2,000 convertible bonds at the start of year 1. The bonds have a three-year term, and are issued at par with a face value of CU1,000 per bond, giving total proceeds of CU2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent.
- IE36 The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar bonds having no conversion rights, as shown below.

	CU
Present value of the principal – CU2,000,000 payable at the end of three years	1,544,367
Present value of the interest – CU120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (by deduction)	151,878
Proceeds of the bond issue	<u>2,000,000</u>

Example 10: Separation of a compound financial instrument with multiple embedded derivative features

- IE37 The following example illustrates the application of paragraph 31 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.
- IE38 Assume that the proceeds received on the issue of a callable convertible bond are CU60. The value of a similar bond without a call or equity conversion option is CU57. Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar bond without an equity conversion option is CU2. In this case, the value allocated to the liability component under

paragraph 31 is CU55 (CU57 – CU2) and the value allocated to the equity component is CU5 (CU60 – CU55).

Example 11: Repurchase of a convertible instrument

- IE39 The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of its liability and equity components in the financial statements, ie no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.
- IE40 On 1 January 20X0, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 maturing on 31 December 20X9. The debenture is convertible into ordinary shares of Entity A at a conversion price of CU25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.
- IE41 In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

	CU
Liability component	
Present value of 20 half-yearly interest payments of CU50, discounted at 11%	597
Present value of CU1,000 due in 10 years, discounted at 11%, compounded half-yearly	343
	940
Equity component	
(difference between CU1,000 total proceeds and CU940 allocated above)	60
Total proceeds	1,000

- IE42 On 1 January 20X5, the convertible debenture has a fair value of CU1,700.
- IE43 Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for CU1,700, which the holder accepts. At the date of repurchase, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

IAS 32 IE

IE44 The repurchase price is allocated as follows:

	Carrying value	Fair value	Difference
	CU	CU	CU
Liability component:			
Present value of 10 remaining half-yearly interest payments of CU50, discounted at 11% and 8%, respectively	377	405	
Present value of CU1,000 due in 5 years, discounted at 11% and 8%, compounded half-yearly, respectively	585	676	
	962	1,081	(119)
Equity component	60	619 ^(a)	(559)
Total	1,022	1,700	(678)

(a) This amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of CU1,700.

IE45 Entity A recognises the repurchase of the debenture as follows:

Dr Liability component	CU962	
Dr Debt settlement expense (profit or loss)	CU119	
Cr Cash		CU1,081

To recognise the repurchase of the liability component.

Dr Equity	CU619	
Cr Cash		CU619

To recognise the cash paid for the equity component.

IE46 The equity component remains as equity, but may be transferred from one line item within equity to another.

Example 12: Amendment of the terms of a convertible instrument to induce early conversion

IE47 The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

IE48 On 1 January 20X0, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 with the same terms as described in Example 11. On 1 January 20X1, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to CU20 if the debenture is converted before 1 March 20X1 (ie within 60 days).

IE49 Assume the market price of Entity A's ordinary shares on the date the terms are amended is CU40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

Number of ordinary shares to be issued to debenture holders under amended conversion terms:

Face amount	CU1,000	
New conversion price	<u>/CU20</u>	per share
Number of ordinary shares to be issued on conversion	<u>50</u>	shares

Number of ordinary shares to be issued to debenture holders under original conversion terms:

Face amount	CU1,000	
Original conversion price	<u>/CU25</u>	per share
Number of ordinary shares to be issued on conversion	<u>40</u>	shares

Number of incremental ordinary shares issued upon conversion

<u>10</u>	shares
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Value of **incremental** ordinary shares issued upon conversion

CU40 per share x 10 incremental shares	<u>CU400</u>
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IE50 The incremental consideration of CU400 is recognised as a loss in profit or loss.