STAFF PAPER

April 2013

IASB Meeting

Project	Conceptual Framework		
Paper topic	Draft Discussion paper Elements of financial statements: definition of equity and distinction between liabilities and equity instruments		
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Appendix A – Distinction between liabilities and equity

A1. Section 5 of this [draft] discussion paper discusses two approaches to distinguishing liabilities from equity instruments: a narrow equity approach and a pure cash approach. This appendix illustrates how those approaches, as well as the existing approach in IAS 32 *Financial Instruments: Presentation*, would apply to four examples.

Example A: Forward sale of own shares – Shares used as currency

Fact pattern

A2. Entity A borrows CU1,000 on 1 January 20X1. In exchange, it must issue shares on 31 December 20X2 with an aggregate fair value on that date of CU1,210, representing principal of CU1,000 plus interest at a market rate of 10%.

A3. A note on the fact pattern: a more common example of such a transaction would involve receiving services from employees, or perhaps other parties, on 1 January 20X1, rather than cash. This example does not use such a fact pattern for the following reasons:

a. For services received from parties other than employees, the treatment required by IFRS 2 *Share-based payment* is largely

comparable with the approach discussed in this paper. Accordingly, such an example would not reveal any differences.

b. For services received from employees, the need to illustrate vesting conditions would make the example more complex and obscure the comparison being made.

A4. Under IFRS 2, when an entity issues equity instruments in exchange for services received from employees or others, the entity would recognise an expense to reflect the consumption of those services.[1] The approach discussed in this paper would not change that conclusion.

IAS 32 approach

A5. Applying IAS 32, Entity A would present the following in its statement of financial position, statement of comprehensive income and statement of changes in equity:

IAS 32 Approach

Statement of financial position

	1 Jan 20X1	31 Dec 20X1	31 Dec 20X2
Liability	-1,000	-1,100	0
Net assets	-1,000	-1,100	0
Share capital	0	0	1,210
Retained earnings	-1,000	-1,100	-1,210
	-1,000	-1,100	0

Statement of comprehensive income

	31 Dec 20X1	31 Dec 20X2
Legal expenses	-1,000	0
Interest expense	-100	-110
Loss	-1,100	-110

[1] Basis for Conclusions on IFRS 2, paragraphs BC45-BC53

Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders
Opening 1 Jan 20X1	0	0	0
Loss for X1	0	-1100	-1100
31 December 20X1	0	-1,100	-1,100
Loss for X2	0	-110	-110
New shares issued	1,210	0	1,210
31 December 20X2	1,210	-1,210	0

Narrow equity approach

A6. In this example the narrow equity approach would lead to the same results as IAS 32

Pure cash approach

A7. Applying the pure cash approach, Entity A would present the following:

Statement of financial position

	1 Jan 20X1	31 Dec 20X1	31 Dec 20X2
Liability	0	0	0
Net assets	0	0	0
Share capital	0	0	1,210
Retained earnings	-1,000	-1,100	-1,210
Future shareholders	1,000	1,100	0
	0	0	0

Statement of comprehensive income

	31 Dec 20X1	31 Dec 20X2
Legal expenses	-1000	0
Interest expense	0	0
Loss	-1,000	0

Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders	Future shareholders	Total
Opening 1 Jan 20X1	0	0	**0**	0	**0**
Loss for X1	0	-1,000	**-1,000**	0	**-1000**
Wealth transfer	0	-100	**-100**	100	**0**
Change in net assets	0	-1,100	**-1,100**	100	**-1000**
Obligation to issue new shares	0	0	**0**	1,000	**1000**
31 December 20X1	0	-1,100	**-1,100**	1,100	**0**
Loss for X2	0	0	**0**	0	**0**
Wealth transfer	0	-110	**-110**	110	**0**
Change in net assets	0	-110	**-110**	110	**0**
New shares issued	1,210	0	**1,210**	-1,210	**0**
31 December 20X2	1,210	-1,210	**0**	0	**0**

Examples B-D: Written put option

A8. Examples B-D illustrate how the approaches described in this [draft] discussion paper would apply for different types of written put option:

a. Example B: Written put option, settlement net in cash

b. Example C: Written put option, settlement net in shares

c. Example D: Written put option, settlement gross (cash for shares).

Example B: Written put option, settlement net in cash

A9. Example B illustrates how the approaches described in this [draft] discussion paper would treat a written put option that must be settled net in cash (in other words, if the strike price exceeds the share price at expiry, the issuer must pay cash equal to that excess).

Fact pattern

A10. An entity issues a written put option on 1,000 of its own shares on 1 February 20X2. The issuer receives a premium of CU5,000 for the option. The option is exercisable only on 31 January 20X3, in exchange for paying a strike price of CU98 per share (CU98,000 in total). The option will be settled net in cash. In other words, if the holder exercises the option, it will receive the fair value of 1,000 shares on exercise date (31 January 20X3), less the total strike price of CU98,000.

A11. Further data:

	1 February X2	31 December X2	31 January X3
Fair value per share	CU100	CU95	CU95
Fair value of option	CU5,000	CU4,000	CU3,000

A12. On 31 January 20X3, the holder exercises the option, receiving cash of CU3,000 (ie CU98,000 – CU95,000).

IAS 32 approach, narrow equity approach and pure cash approach

A13. The same treatment would apply under IAS 32, the narrow equity approach and the pure cash approach. The issuer treats the contract as a derivative financial liability because the issuer has an obligation to deliver an economic resource (cash). The issuer would present the following information:

Statement of financial position

	1 Feb 20X2	**31 Dec 20X2**	**31 Jan 20X3**
Cash	5,000	5,000	2,000
Derivative liability	-5,000	-4,000	0
Net assets	0	1,000	2,000
Share capital	0	0	0
Retained earnings	0	1,000	2,000
Total equity	0	1,000	2,000

Statement of comprehensive income

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

Statement of changes in equity

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	0	0	0
Profit for X2	0	1,000	1,000
31 December 20X2	0	1,000	1,000
Profit for January X3	0	1,000	1,000
31 January 20X3	0	2,000	2,000

Example C: Written put option, settlement net in shares

Fact pattern

A14. The facts are as in example B, except that the option will be settled net in shares. In other words, if the holder exercises the option, the issuer will issue shares whose total fair value equals the amount of cash that would be paid in example B. Neither party pays cash when the option is exercised or expires.

A15. On 31 January 20X3, the holder exercises the option. The issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.[2]

IAS 32 approach

A16. Under IAS 32, the issuer treats the obligation to deliver a variable number of shares as a liability (because the issuer is, in effect, using its own shares as currency). The issuer accounts for the transactions as shown below. The accounting at 31 January 20X1 and 31 December 20X2 is the same as in

[2] The example assumes fractional shares are possible.

example B. The accounting differs at 31 January 20X3 because the issuer must settle by issuing shares, not by paying cash.

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Derivative liability	-5,000	-4,000	0
Net assets	0	1,000	5,000
Share capital	0	0	3,000
Retained earnings	0	1,000	2,000
Total equity	0	1,000	5,000

Statement of comprehensive income

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

Statement of changes in equity

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	0	0	0
Profit for X2	0	1,000	1,000
31 December 20X2	0	1,000	1,000
Profit for January X3	0	1,000	1,000
Shares issued	3,000	0	3,000
31 January 20X3	3,000	2,000	5,000

Narrow equity approach

A17. In this example the narrow equity approach would lead to the same results as IAS 32.

Pure cash approach

A18. The obligation to issue shares is not an obligation to transfer economic resources. Therefore, applying the pure cash approach, that obligation is an equity claim, not a liability.

A19. At inception (1 February 20X2), the issuer recognises:

a. cash of CU5,000 and,

b. within equity, an equity claim of CU5,000. That equity claim represents the issuer's obligation to stand ready to issue its own shares if the holder exercises its option.

A20. At 31 December 20X2, the issuer remeasures the equity claim to its new fair value of CU4,000, recognising in the statement of changes in equity a wealth transfer of CU1,000 from the column labelled 'obligation to issue shares' (which represents the interest of option holders) to the section for existing shareholders. For illustration, the example shows that wealth transfer as a transfer to retained earnings, but other classifications would be possible, provided that the statement identifies clearly which class of equity holder benefits from the transfer.[3]

A21. At 31 January 20X3:

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

b. the issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.[4] At this point, the issuer transfers CU3,000 from the column labelled 'obligation to issue shares' to the section for existing shareholders. Example C assumes that the entire amount of CU3,000 is transferred to share capital, rather

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

[4] The example assumes fractional shares are possible.

than to some other category attributable to existing shareholders.

c. if the option expires unissued, the issuer transfers any remaining balance from the column labelled 'obligation to issue shares' to the section for existing shareholders.

A22. The issuer would present the amounts shown below:

Statement of financial position

	1 Jan 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Net assets	5,000	5,000	5,000
Share capital	0	0	3,000
Retained earnings	0	1,000	2,000
Obligation to issue shares	5,000	4,000	0
Total equity	5,000	5,000	5,000

Statement of comprehensive income

	31 Dec 20X2	31 Jan 20X3
Income	0	0
Expense	0	0
Profit or loss	0	0

Statement of changes in equity	Share capital	Retained earnings	**Total existing shareholders**	**Obligation to issue shares**	**Total**
Opening 1 Feb 20X2	0	0	**0**	0	**0**
Profit or loss for X2	0	0	**0**	0	**0**
Change in fair value of option	0	1,000	**1,000**	-1,000	**0**
Change in net assets	**0**	**1,000**	**1,000**	-1,000	**0**
Written option issued	0	0	0	5,000	**5,000**
31 December 20X2	0	**1,000**	**1,000**	4,000	**5,000**
Profit or loss for Jan X3	0	0	**0**	0	**0**
Change in fair value of option	0	**1,000**	**1,000**	-1,000	**0**
Change in net assets	**0**	**1,000**	**1,000**	**-1,000**	**0**
New shares issued	3,000	0	3,000	-3,000	**0**
31 January X3	3,000	2,000	**5,000**	0	**5,000**

A23. The following comments can be made about examples B and C:

a. The treatment under IAS 32 and the narrow equity approach at 1 February 20X2 and 31 December 20X2 does not depict in a faithful and understandable manner the fact that these two examples will cause different effects on the resources of the issuer. In example B, the issuer suffers a cash outflow of CU3,000. In example C, no cash outflow can occur. In contrast, the pure cash approach does depict that difference.

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

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

   ii. The pure cash approach depicts this similarity in the statement of changes in equity in the line labelled ‘Change in net assets’, in the column labelled ‘Total existing shareholders’.

Example D: Written put option, settlement gross (cash for shares)

Fact pattern

A24. The facts are as in examples B and C, except that the option will be settled gross in shares, by delivering a fixed number of shares for a fixed amount of cash. In other words, if the holder exercises the option, the issuer must pay the strike price (CU98,000) to the holder, and the holder must then deliver 1,000 shares. Additional data:

	1 February X2	31 December X2	31 January X3
Present value of total strike price	CU95,000	CU97,750	CU98,000

IAS 32 approach

A25. IAS 32 would treat this instrument as follows:

a. On issuing the option, the issuer:

i. recognises a cash receipt of CU5,000.

ii. recognises a liability of CU95,000, equal to the present value of the strike price of CU98,000 that the issuer will need to pay if the holder exercises its option.

iii. recognises a reduction of CU90,000 in equity. This is the difference between the initial carrying amount of the liability (CU95,000) and the premium received in cash (CU5,000). IAS 32 does not specify which category of equity should be used to record this transaction. For illustration, this example records this transaction in retained earnings, but other approaches might be possible.

b. The issuer recognises interest expense on the liability to pay the strike price: CU2,750 for the 11 months to 31 December 20X2 and a further CU250 for the 1 month to 31 January 20X3. As a result, the carrying amount of the liability is CU97,750 on 31 December 20X2,

and CU98,000 on 31 January 20X3, immediately before exercise or expiry.

c. At 31 January 20X3, the holder exercises its option. As a result, the issuer must pay in cash the strike price of CU98,000.

d. At 31 January 20X3, when the holder exercises its option it delivers 1,000 shares to the issuer, reducing by 1,000 the number of shares in circulation.[5] IFRSs do not prescribe which classes of equity an issuer should use to present such a transaction, because determining which categories are most relevant to users may depend on local legislation and on the reporting issuer's governing constitution. IAS 1 requires an issuer to disclose a description of the nature and purpose of each reserve within equity. For illustration, the example assumes that the issuer records this receipt by transferring CU95,000 from share capital to retained earnings.[6]

e. If the share price at 31 January 20X2 were above the strike price of CU98 per share, the holder would not exercise its option, which would thus expire. On expiry, the issuer would derecognise its obligation under the written put, with a corresponding increase in equity. The issuer would not recognise any income or expense when the option expires.

A26. Applying IAS 32, the issuer would present the following:

[5] That reduction occurs, regardless of whether the shares are cancelled or are held 'in treasury' for possible re-issue.

[6] For simplicity, the example ignores any other shares the issuer has in circulation, and ignores the issuer's other assets and liabilities.

Statement of financial position

	1 Jan 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	-93,000
Obligation under written put	-95,000	-97,750	0
Net assets	-90,000	-92,750	-93,000
Share capital	0	0	-95,000
Retained earnings	-90,000	-92,750	2,000
Total equity	-90,000	-92,750	-93,000

Statement of comprehensive income

	31 Dec 20X2	31 Jan 20X3
Income	0	0
Interest expense	-2,750	-250
Profit or loss	-2,750	-250

Statement of changes in equity

	Share capital	Retained earnings	**Total existing shareholders**
Opening 1 Jan 20X2	0	0	**0**
Written option issued	0	-90,000	**-90,000**
Profit or loss for X2	0	-2,750	**-2,750**
31 December 20X2	0	**-92,750**	**-92,750**
Profit or loss for Jan X3	0	-250	**-250**
Repurchase of own shares	-95,000	95,000	**0**
31 January X3	-95,000	2,000	**-93,000**

A27. As explained in appendix B, IAS 32 does not specify where the entity would recognise the debit of CU90,000 on issuing the written option, nor what transfers, if any, it would make between categories of equity when the option is exercised or expires. This paper is not intended to imply a preference for any particular treatment in that regard.

Narrow equity approach

A28. The narrow equity approach might need to be defined more precisely to determine how it would apply in this example.

a. One possibility would be to treat it in the same way as IAS 32 does.

b. Another possibility would be to treat the written put option as a derivative, and measure it at fair value through profit or loss. This would result in the same accounting as in example B, except that on settlement, the entity would pay cash of CU98,000, and would at that date recognise CU95,000 as a reduction in equity.

Pure cash approach

A29. To illustrate the pure cash approach, the example needs to take a position on two questions for which the discussion paper does not propose answers, because these appear to be questions to be resolved at the standards level, rather than in the conceptual framework:

a. How to measure the rights and obligations that arise under a written put option (see paragraphs B1-B3 of appendix B); and

b. Whether changes in liabilities arising under a written put option result in income or expense, or in a wealth transfer between holders of different classes of equity (see paragraphs B4-B5 of appendix B).

A30. One response to those questions would be to measure those rights and obligations in the same way as under IAS 32, and to treat the changes in those measures as income and expense, rather than as a wealth transfer. That would produce the same accounting as under IAS 32.

A31. A second response to those questions would be to measure those rights and obligations in the same way as under IAS 32, but to treat the changes in those measures as a wealth transfer, rather than as income and expense. Using that response, the CU2,750 of interest to 31 December 20X3 and further interest of CU250 to 31 January 20X3 would be reported in the statement of changes in equity, rather than as an expense in profit or loss.

A32. A third response to those questions would be to use the expected value approach discussed in paragraph B2.c of appendix B, and to treat the changes in the

measure of the rights and obligations as a wealth transfer, rather than as income and expense. The rest of this example illustrates that third response.

Additional facts

A33. The following additional facts are supplied to apply the expected value approach.

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Implied probability of exercise	60%	80%	100%
Implied present value of strike price	57,000	78,200	98,000
Implied value of shares on exercise	-52,000	-74,200	-95,000
Fair value of option	5,000	4,000	3,000

A34. The implied present value of the strike price is calculated as follows at 1 February 20X2. The total exercise price is CU98,000. The present value of that expected amount is CU95,000. The expected (ie probability-weighted) value of that amount is CU57,000 (ie CU95,000, multiplied by the implied probability of exercise). The implied probability of exercise (60% at 1 February 20X2) is given in the fact pattern. In real life, it would be determined in calculating the fair value of the option, or would be derived in a manner to be consistent with an observed fair value of the option and other observed market data.

A35. The implied expected value of the shares on exercise is the expected value of the shares that would be received on exercise, multiplied by the implied probability of exercise. In this example, it is the amount implied by the need to be consistent with the fair value of the option.

Applying the expected value approach

A36. Using the expected value approach described in the previous paragraph, example D applies the pure cash approach as follows. On issuing the option, the issuer:

a. recognises a cash receipt of CU5,000. This amount is also the fair value of the option.

b. recognises a liability of CU57,000, as calculated above. This is the expected present value of the strike price of CU98,000 that the issuer will need to pay if the holder exercises its put option, and reflects the implied probability of exercise (60%).

c. recognises in equity an equity claim of CU52,000, as calculated above. The illustration records this claim in a separate class of equity labelled 'right to receive own shares'. A more complete description is: 'right to receive own shares if holders of written put options exercise their options'. That claim is an equity claim, not an asset, because it does not entitle the issuer to receive any economic benefits and so is not an economic resource.

d. At 31 December 20X2, the issuer remeasures both its obligation to stand ready to pay the strike price, and its equity claim. The fair value of the option is now CU4,000, a decrease of CU1,000 since inception. The example assumes the implied probability of exercise is now 80%. As a result, the issuer:

   i. remeasures its liability by CU21,200 to CU78,200 (= CU57,000 +CU21,200).

   ii. remeasures the right to receive its own shares by CU22,200 to CU74,200 (= CU54,200 +CU22,000)

   iii. recognises a wealth transfer of CU1,000 from the holders of the option to the existing shareholders. That amount equals the reduction in the fair value of the option from CU5,000 to CU4,000 (an economic gain for existing shareholders and an economic loss for option holders). The fair value of CU4,000 equals the difference between carrying amounts of the liability (CU78,200) and of the right to receive own shares (CU74,200).

e. For the 11 months to 31 December 20X2, the issuer recognises no interest. It would be possible to calculate interest on the carrying amount of the liability. However, as that carrying amount changes over the life of the option, the amount of interest would also change. Furthermore, because it would be calculated on a different base each period, the cumulative interest recognised over the life of the option would not have a clearly describable meaning. Therefore, this illustration does not attempt to identify an interest component of the

change in carrying amount of the liability to stand ready to pay the strike price.

f. At 31 January 20X3, the implied probability of exercise is now 100% because the strike price is above the share price and exercise is now imminent. Accordingly, the issuer:

   i. remeasures its liability by CU19,800 to CU98,000 (= CU78,200 +CU19,800).

   ii. remeasures the right to receive its own shares by CU20,800 to CU95,000 (= CU74,200 +CU20,800). This is the current market price of the shares that issuer will receive on exercise.

   iii. recognises a further wealth transfer of CU1,000 from the holders of the option to the existing shareholders. That amount equals the reduction in the fair value of the option from CU4,000 to CU3,000. The fair value equals the difference between carrying amounts of the liability (CU98,000) and of the right to receive own shares (CU95,000).

g. At 31 January 20X3, the holder exercises its option. As a result, the issuer must pay in cash the strike price of CU98,000. In exchange, it receives 1,000 shares. At that time, the issuer transfers CU95,000 from the column labelled 'right to receive own shares' to one of the columns labelled as attributable to the remaining shareholders. For illustration, the example uses the column 'share capital' for this purpose. The issuer does not recognise any income or expense on exercise of the option.

h. If the share price at 31 January 20X2 were above the strike price of CU98 per share, the holder would not exercise its option, which would expire. At that time, the issuer would remeasure to zero both the right to receive its shares and its obligation under the put option. The net effect of that remeasurement is the change in fair value of the

option (down to zero) and represents a final wealth transfer from option holders to existing shareholders.

A37. Applying the pure cash approach, the issuer would present the following:

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	-93,000
Obligation under written put	-57,000	-78,200	0
Net assets	-52,000	-73,200	-93,000
Share capital	0	0	-95,000
Retained earnings	0	1,000	2,000
Equity: existing shareholders	0	1,000	
Right to receive own shares	-52,000	-74,200	0
Total equity	-52,000	-73,200	-93,000

Statement of comprehensive income

	31 Dec 20X2	31 Jan 20X3
Income	0	0
Interest expense	0	0
Profit or loss	0	0

Statement of changes in equity

	Share capital	Retained earnings	**Total existing shareholders**	**Right to receive shares**	**Total**
Opening 1 February 20X2	0	0	**0**	0	**0**
Profit or loss for X2	0	0	**0**	0	**0**
Change in fair value of option	0	1,000	**1,000**	-22,200	**-21,200**
Change in net assets	**0**	**1,000**	**1,000**	-22,200	**-21,200**
Written option issued	0	0	**0**	-52,000	-52,000
31 December 20X2	0	**1,000**	**1,000**	-74,200	**-73,200**
Profit or loss for Jan X3	0	0	**0**	0	**0**
Change in fair value of option	0	**1,000**	**1,000**	-20,800	**-19,800**
Change in net assets	**0**	**1,000**	**1,000**	**-20,800**	**-19,800**
Repurchase of own shares	-95,000	0	95,000	95,000	**0**
31 January X3	-95,000	2,000	**-93,000**	0	**-93,000**

Journal entries used to apply the pure cash approach:

1 February 20X2		
Dr Right to receive own shares	52,000	
Dr Cash	5,000	
Cr Obligation under written put		57,000
To record issue of written put issued		
31 December 20X2		
Dr Right to receive own shares	22,200	
Dr Retained earnings		1,000
Cr Obligation under written put		21,200
To remeasure the right to receive own shares and the obligation under the written put, and to record the wealth transfer of CU1,000 from option holders to existing shareholders		
31 January 20X3		
Dr Right to receive own shares	20,800	
Dr Retained earnings		1,000
Cr Obligation under written put		19,800
To remeasure the right to receive own shares and the obligation under the written put, and to record the wealth transfer of CU1,000 from option holders to existing shareholders		

31 January 20X3		
Dr Obligation under written put	98,000	
Cr Cash		98,000
To record cash paid to settle obligation under written put		
Dr Share capital	95,000	
Cr Right to receive own shares		95,000
To record receipt of 1,000 own shares from holders of written put options		

Appendix B

Measuring written puts on own shares

B1. This appendix provides background information to explain some alternatives illustrated in example D in appendix A. That example deals with a written put options on an entity's own shares. Such instruments give rise to a liability under all three approaches illustrated in appendix A. This appendix discusses some things that would need to be considered in deciding how to measure such liabilities and how to report changes in their carrying amount.

B2. How should an entity measure written put options on its own shares? Possible approaches are:

a. The present value of the redemption amount, the existing requirement in IAS 32.[7] This measure is simple, and conveys information about the possible outflow of economic resources, but it has the following disadvantages:

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

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

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

[7] IAS 32 paragraph 23

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

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

   ii. this measure would require estimates of the probabilities, which would require subjective estimates or models. One approach would be to use the probabilities that are implied in a fair value measurement of the entire option, as illustrated in example D in appendix A. If those fair values are determined using models, those probabilities (or information needed to derive them) should already be available. However, if those fair values are observed directly from market prices or if those fair values are immaterial, a model would be needed solely to determine the implied probabilities.

d. This approach has some similarities with the REO approach described in paragraph 40 of [agenda paper 10E(a)]. As noted above, the IASB and FASB rejected REO, partly because they viewed it as too complex.

e. An all or nothing approach that measures the option at the present value of the strike if some threshold is passed, and at zero if the threshold is not passed. This approach would be simpler than the expected value approach illustrated in example D, but it would ignore the time value of the option (ie the possibility that the threshold might be passed in the future). The threshold might be, for example:

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

   ii. when the entity concludes that exercise is likely.

B3. This [draft] discussion paper does not conclude on how an entity should measure the obligation that arises under a written put option on its own shares.

Changes in carrying amount of written put options on own shares

B4. There are two views on how to treat changes in the carrying amount of obligations arising under written put options on an entity's own shares:

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

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

B5. Example D illustrates view B. Arguably, deciding which view to adopt in particular cases is a matter for standards level decisions, not for the conceptual framework. Therefore, this [draft] discussion paper does not investigate this issue further. (One topical case where this issue is relevant is for NCI puts, as discussed below.)

Implications for NCI puts

B6. IAS 32 requires that the issuer of a written put on its own shares should measure its liability at the present value of the redemption amount. One instrument subject to that requirement is a written put option that obliges a parent to purchase shares of its subsidiary that are held by a non-controlling-interest shareholder on request by that shareholder (an NCI put). In May 2012 the IFRIS Interpretations Committee addressed NCI puts in a draft IFRIC interpretation *Put Options Written on Non-controlling Interests*.

B7. Under the draft interpretation, changes in the measurement of NCI puts would, in the parent's consolidated financial statements, be recognised in profit or loss. The Interpretations Committee reached that conclusion because it reasoned that changes in the measurement of NCI puts do not change the relative interests of the parent and the non-controlling-interest shareholder and therefore are not equity transactions (ie they are not transactions with owners in their capacity as owners). It follows that the NCI put is a financial liability, and thus within the scope of IFRS 9 *Financial Instruments*, so that the gains and losses would be recognised in profit or loss. In addition, that conclusion ensures consistency with the treatment of written put options embedded in an equity instrument (ie redeemable equity instruments), for which changes in carrying amount are also recognised in profit or loss.

B8. In March 2013, the IASB discussed feedback received in the comment letters on the draft interpretation, and the Interpretations Committee's reactions to that feedback. The IASB tentatively decided to re-consider the requirements in IAS 32, including whether all or particular put options and forward contracts written on an entity's own equity should be measured on a net basis at fair value, consistently with derivatives that are within the scope of IAS 39 and IFRS 9. The IASB will continue to discuss this issue.

B9. To a number of commentators, the approach in IAS 32 seems particularly problematic for written put options on the issuer's own shares (and NCI puts) with a strike price equal to fair value (fair value puts). For these instruments, the requirement in IAS 32 means that:

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

b. changes in the fair value of the liability would be recognised in profit or loss. Part of those changes arises from changes in the value of unrecognised assets, such as goodwill. A number of commentators believe this does not result in relevant or understandable information for users.

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

B10. This [draft] discussion paper does not conclude on whether changes in the measure of NCI puts should be recognised in profit or loss or in equity.

Appendix C –Effect of pure cash approach on different classes of instrument

This table compares the current treatment of various instruments under IAS 32 with the way they would be treated under the pure cash approach discussed in this paper.

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

Instrument	*Current treatment*	*Effect of pure cash approach*
Obligation to deliver a variable number of shares, whose total fair value equals a fixed amount	Liability, measured at amortised cost, with interest expense reported in profit or loss	Equity claim, measured at as if it were a financial liability: most likely at amortised cost, with interest expense reported in the statement of changes in equity (SCE) as a wealth transfer to the future shareholders from existing shareholders.
Obligation to deliver a variable number of shares, whose total fair value equals a specified amount indexed to the gold price	Liability, measured at fair value (under the fair value option), or at amortised cost with separate measurement of an embedded derivative at fair value through profit or loss	Equity claim, measured as if it were a financial liability that requires the issuer to pay the specified amount. Changes in carrying amount reported in the SCE.

Instrument	*Current treatment*	*Effect of pure cash approach*
Forward contract to repurchase own shares, settled gross	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss
Written put option on own shares, settled gross	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss	Liability at [to be determined, see appendix B] Subsequent measurement at [to be determined]
Written put option on non-controlling interest (NCI put), settled gross for a cash payment equal to the fair value of the underlying NCI.	Liability at present value of the gross redemption amount (ie fair value of the underlying NCI). Subsequent changes in that amount in profit or loss.[8]	Liability at [to be determined, see appendix B] Subsequent measurement at [to be determined]
Purchased call option to repurchase own shares, settled gross	No asset or liability. Recognise in equity, initial measurement net at proceeds received. No remeasurement [if not fixed for fixed, then derivative]	No asset or liability. Equity claim to receive shares, initial measurement net at proceeds received. Subsequent remeasurement (net) to fair value through SCE.

[8] See draft IFRIC interpretation *Put Options Written on Non-controlling Interests*

Instrument	*Current treatment*	*Effect of pure cash approach*
Forward sale of own shares, settled gross	Do not recognise until exercise [if not fixed for fixed, then derivative]	Asset at present value of gross issue proceeds. Subsequent measurement at amortised cost. To be determined: whether interest expense (and impairment loss, if applicable) in profit or loss or in SCE. No liability
Purchased put on own shares, settled gross	No asset or liability. Recognised in equity, initial measurement net at proceeds paid. No remeasurement [if not fixed for fixed, then derivative]	Asset, initial measurement net at proceeds paid. Subsequent remeasurement (net) to fair value through SCE to show wealth transfers between different equity claimants.
Written call on own shares, settled gross	Equity claim, initial measurement net at proceeds received No remeasurement [if not fixed for fixed, then derivative]	Equity claim, initial measurement net at proceeds received Subsequent remeasurement (net) to fair value through SCE
All net cash-settled derivatives on own shares	Derivative asset or liability measured net: fair value through profit or loss	Derivative asset or liability measured net: fair value through profit or loss

Instrument	*Current treatment*	*Effect of pure cash approach*
All derivatives on own shares if they must be settled by net delivery or net receipt of shares with no cash payment (net share settlement)	Derivative asset or liability: fair value through profit or loss	Equity claim measured net: fair value, remeasured through SCE
Derivative obligation that permits the holder to elect whether the issuer will settle in cash or in shares	Financial liability Measure in accordance with IFRS 9	Financial liability Measure in accordance with IFRS 9
Derivative obligation that permits the issuer to elect whether to settle in cash or in shares	Financial liability Measure in accordance with IFRS 9	Equity claim (because the issuer is not obliged to deliver economic resources) Measured as if it were a financial liability, with changes in carrying amount reported in the SCE.
Cash-settled share based payment	Recognise as an expense and a liability Remeasure the liability through profit or loss	Recognise as an expense and a liability Remeasure the liability through profit or loss
Equity-settled share based payment	Recognise as an expense and as an equity claim Do not remeasure	Recognise as an expense and as an equity claim Remeasure the equity claim through SCE

Appendix D –rights and obligations arising under options and forwards on an entity's own shares

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