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Introduction

1. The objective of this paper is to provide:

    (a) a brief overview of the requirements in IAS 32 *Financial Instruments: Presentation* relevant to distinguishing between liabilities and equity (paragraphs 4–9); and

    (b) a brief history of the amendments leading up to the fixed-for-fixed principle in IAS 32 (paragraphs 10–21).

2. This paper provides a high-level—and simplified—summary of the requirements in IAS 32. The following should not be taken as a substitute for reading IAS 32 and its Basis for Conclusions.

3. This paper includes two Appendices for further reading:

    (a) Appendix A includes a brief outline of relevant requirements in IFRS 2 *Share-based Payments* (for comparison purposes).

    (b) Appendix B compares the requirements in IFRS to US GAAP.

Relevant requirements in IAS 32

4. Whether a financial instrument is an *equity instrument* depends on the definitions of *financial asset* and *financial liability*—that is, an equity instrument is a

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financial instrument that does **not** meet the definitions of financial asset or financial liability.[1] In other words, equity instruments form a residual category.

5. For this summary we have broken down the requirements of IAS 32 as follows:

   (a) Two principles in IAS 32 for distinguishing equity instruments from non-equity instruments (paragraphs 6–7);

   (b) Two exceptions to the two principles (paragraph 8); and

   (c) Additional rules that accompany the two principles in IAS 32 (paragraph 9).

Two principles in IAS 32 for distinguishing equity instruments from non-equity instruments

6. The first (and, arguably, the primary) principle in IAS 32 for distinguishing a financial liability from an equity instrument is the existence of a contractual obligation to deliver cash or another financial asset (including, as one particular example, obligations to exchange financial assets or financial liabilities under conditions that are potentially unfavorable). If an entity has such a contractual obligation, the financial instrument is a financial liability. If it does not have such an obligation, the financial instrument is an equity instrument (subject to the second principle, which is discussed below).

7. The second principle in IAS 32 is relevant to any exchange contract that will, or may be, settled with the entity's own equity instruments.[2] This principle is often called the 'the fixed-for-fixed condition' and its origins are discussed in paragraphs (10–21). The exchange contact is a financial liability if **either** the amount of cash (or other financial asset) **or** the number of own equity instruments is variable. If **both** are fixed, it is an equity instrument. More precisely, a contract is a financial liability if it is:

[1] Separating a financial instrument into equity and non-equity components is discussed later in this paper (eg some convertible debt). Consistently with IFRSs, we use the term 'financial instrument' in this paper to include also a component of a financial instrument that is separately classified and measured.

[2] Some would argue that IAS 32 has a single principle (set out in paragraph 6) and that this is an exception to that principle.

(a) a non-derivative for which the entity is, or may be, obliged to deliver a variable number of its own equity instruments (eg a payable whereby the entity must deliver a variable number of its own shares with a value equal to CU100); **or**

(b) a derivative that will, or may be, settled by any exchange that **is not** an exchange of a fixed amount of cash (or another financial asset) for a fixed number of the entity's own equity instruments (eg a written call option whereby the entity will deliver 100 of its own shares in exchange for a cash amount that is linked to the price of gold).

Two exceptions to the principles in IAS 32

8. IAS 32 was amended in 2008 and 2009 to address specific issues raised by constituents. Each amendment created an exception to the Standard's principles for distinguishing equity instruments from non-equity instruments:

(a) Some puttable instruments (and some instruments that impose an obligation to deliver a pro rata share of net assets only upon liquidation, such as the shares issued by a limited-life entity) are classified as equity even though they contain a contractual obligation to deliver cash.[3]

(b) Rights, options, or warrants to issue a fixed number of the entity's own equity instruments in exchange for a fixed amount of **any** currency are equity instruments if the entity offers those instruments pro rata to all of its existing owners of the same class. In all other cases, derivatives that may be settled with a fixed amount of a foreign currency are not equity instruments (ie because the amount of cash is not considered 'fixed' for the purposes of applying the fixed-for-fixed condition in IAS 32).[4]

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[3] This amendment did not change the definition of a financial liability. Rather it changed only the classification of particular financial liabilities (ie particular contracts that meet the definition of a financial liability are classified as equity).

[4] In contrast to the amendment described in bullet (a), this amendment changed the definition of a financial liability.

Additional rules that accompany the two principles in IAS 32

9. There are additional requirements and rules in IAS 32 that were designed to facilitate the application of the principles, prevent abuse, and address some of the apparent counter-intuitive results that occur:

   (a) Contractual obligations: A critical feature in distinguishing a financial liability from an equity instrument is the existence of a contractual obligation to deliver cash (or another financial asset). In some situations the terms and conditions of the contract may not explicitly establish a contractual obligation but nevertheless an indirect contractual obligation may exist.

   (b) Settlement options: When a derivative gives either party a choice over how it is settled, it is a non-equity instrument. That is true even if the issuer has an unconditional right to choose to deliver a fixed number of its own equity instruments in exchange for a fixed amount of cash.

   (c) Contingent settlement provisions: Some instruments have contingent settlement provisions that are triggered by the occurrence (or non-occurrence) of uncertain future events that are beyond the control of both the issuer and the holder (eg a change in a stock market index). Such instruments are financial liabilities unless the contingent settlement provision is 'not genuine'[5] or is triggered only in the event of the issuer's liquidation.

   (d) Compound instruments: If an instrument contains both equity and non-equity components (eg some convertible debt), those components must be separately classified and measured (ie the instrument is bifurcated). IAS 32 contains rules for initially separating and measuring the components as well as for accounting for the instrument's conversion and extinguishment.

   (e) Written derivatives to purchase own equity: Some put options and forward purchase contracts written on an entity's own equity

[5] Paragraph AG28 in IAS 32 says that a contingent settlement provision is 'not genuine' if it is extremely rare, highly abnormal, and very unlikely to occur.

instruments give rise to financial liabilities that are measured at the present value of the redemption amount (ie they are not measured on a net basis like other derivatives).

A brief history of the development of the fixed-for-fixed principle in IAS 32

10. Of the two principles in IAS 32 for distinguishing equity instruments from non-equity instruments, the existence of an obligation to transfer cash or another financial asset is consistent with the Conceptual Framework definition of a liability, while the fixed-for-fixed condition is not. The Basis for Conclusions on IAS 32 does not describe in detail the reason for the inconsistency other than as follows:

> 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.
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> …
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> 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.

11. The views above were developed over a number of years by the IASB and its predecessor the IASC.

12. The definitions in IAS 32, as first published in 1995, were consistent with the Conceptual Framework, which noted that:

> An obligation of an enterprise to issue or deliver its own equity instruments, such as a share option or warrant, is itself an equity instrument, not a financial liability, since the enterprise is not obliged to deliver cash or another financial asset. An enterprise's obligation to exchange its own equity instruments for financial assets of another party is not potentially unfavourable since it results in an increase in equity and cannot result in a loss to the enterprise. The possibility that existing holders of an equity interest in the enterprise may find the fair value of their interest reduced as a result of the obligation does not make the obligation unfavourable to the enterprise itself.

13. However, shortly after IAS 32 came into effect in 1996, it was amended in 1998. In those amendments the following short clause was added after the definition of a liability:

> An enterprise may have a contractual obligation that it can settle either by payment of financial assets or by payment in the form of its own equity securities. In such a case, if the number of equity securities required to settle the obligation varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the holder of the obligation is not exposed to gain or loss from fluctuations in the price of its equity securities. Such an obligation should be accounted for as a financial liability of the enterprise.

14. The 1998 amendment did not carry a clear Basis for Conclusions on that particular amendment, because it was issued as part of the introduction of IAS 39 *Financial Instruments: Recognition and Measurement* at that time.

15. Shortly after the 1998 amendment was effective (2001), IAS 32 was amended yet again in 2003. The 2003 amendment introduced the fixed-for-fixed condition.

16. As noted in Agenda Paper 7D, the work on liabilities and equity at the time was led by the FASB. In the year 2000, the FASB issued two exposure drafts:

    (a) *Accounting for Financial instruments with Characteristics of Liabilities, Equity or Both* (the 2000 FASB ED); and

    (b) *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities* (the 2000 FASB Concepts ED).

17. Those exposure drafts were developed in response to concerns raised by preparers, auditors, regulators and others about the classification of instruments that:

    (a) have characteristics of liabilities but are presented as equity;

    (b) have characteristics of equity but are presented in the 'mezzanine' section of the statement of financial position, or

    (c) have characteristics of both liabilities and equity but are classified either entirely as liabilities or entirely as equity.

18. The definition of a liability in Concepts Statement No. 6 is similar to the definition of a liability proposed in the IASB's Conceptual Framework DP. That is, obligations to transfer assets meet the definition of liability but obligations that require or permit an entity to transfer its own equity instruments do not.

19. The 2000 FASB Concepts ED proposed to change the existing definition of a liability. The FASB noted in paragraph 167 of the Basis for Conclusions on the 2000 FASB ED that:

> For most common types of financial instruments issued by an entity, application of the definitions in Concepts Statement No. 6 appropriately reflects those relationships. However, the Board decided that for certain financial instrument components, it is necessary to look beyond the

> issue of whether the financial instrument requires the transfer of assets or an issuance of equity shares and consider the nature of the relationship established by the financial instrument component.

20. The nature of that relationship was viewed from the perspective of the risk and benefits of ownership. In the FASB's view (at the time), the risks and benefits of a holder of an obligation of a fixed amount settled through the issuance of a variable number of equity instruments are different to those of a holder of an entity's equity instruments. Therefore it proposed to expand the definition of a liability to include obligations to transfer an entity's own equity instruments if the risks and benefits associated with the value of the holder's investment are not similar to those of a holder of the equity instrument.

21. In paragraph 185 of the 2000 FASB ED, the FASB applied that definition and concluded that an obligation that requires settlement by issuance of a fixed number of the issuer's equity instruments should be classified as equity.

22. Following on from the work of the FASB, the IASB amended IAS 32 again in 2003, introducing the fixed-for-fixed condition.

Appendix A – IFRS 2 requirements (for comparison)

Relevant requirements

A1. IFRS 2 sets out the requirements for distinguishing between cash-settled share based payments and equity-settled share-based payments. In contrast to IAS 32, the distinction in IFRS 2 relies almost entirely on the existing definition of a liability in the *Conceptual Framework*. IFRS 2 makes one adjustment to that definition, to address transactions for which the obligation rests with another group entity or other related party.

A2. For share-based payment transactions in which the terms of the arrangement provide either the entity or the supplier of goods or services with a choice of whether the entity settles the transaction in cash or by issuing equity instruments, the entity is required to account for that transaction (or the components of that transaction):

(a) as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash (or other assets);

(b) as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

A3. Arguably, the main objective of IFRS 2 is to require that an entity recognise expenses associated with share-based payments. Thus, it could be said that the main focus was on the debit side of the transaction, rather than the classification of the credit.

Appendix B—A brief comparison of the requirements in IFRSs and US GAAP

B1. There are some similarities between IAS 32 and US GAAP:

(a) Perpetual instruments are equity[6].

(b) Mandatorily redeemable instruments are financial liabilities.

(c) Forward purchase contracts that oblige the entity to repurchase its own equity instruments for cash (or other assets) are financial liabilities and are measured at the present value of the redemption amount (ie they are 'grossed up').

B2. There are some notable differences between US GAAP and IFRS:

(a) Under US GAAP, contingently redeemable instruments (ie instruments with a conditional redemption feature[7]) and puttable instruments are equity. (However, the Securities and Exchange Commission (SEC) requires those instruments to be classified outside of the 'permanent equity' section of the balance sheet in a separate section entitled 'temporary equity' or 'mezzanine equity'.) In contrast, IAS 32 requires most puttable instruments and instruments with contingent settlement provisions to be classified as liabilities.

(b) Under US GAAP, put options written on an entity's own equity instruments are not measured at the present value of the redemption amount—ie written put options are never 'grossed up'. Rather those contracts are measured on a net basis. In contrast, in particular circumstances, IAS 32 requires such a gross-up.

(c) Except for some convertible debt, US GAAP generally does not have a concept of compound financial instruments (ie an instrument with equity and non-equity components). In contrast, IAS 32 requires the issuer to

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[6] This statement ignores dividends. If the dividends associated with those instruments are nondiscretionary, the accounting treatment would be different. Under IAS 32, the instrument would be a compound instrument—the non-equity component (the obligation to pay dividends over the life of the instrument) and the equity component (the perpetual share) would be separately classified and measured. In contrast, under US GAAP, the instrument would be equity in its entirety (and a liability would not be recognized until a dividend is declared).

[7] An example is a share that is redeemable only if there is a change of control.

evaluate the contractual terms of an instrument to determine whether it contains equity and non-equity components. The components must be separately classified and measured. Moreover, while both US GAAP and IAS 32 require some types of convertible debt to be separated into equity and non-equity components, the details of that guidance are very different and, thus, have different results.

(d) While both IAS 32 and US GAAP classify as equity some instruments settled with the issuer's own equity instruments, there are significant differences between the two sets of requirements. For example, under US GAAP there is a two-step process for determining whether derivatives on an entity's own equity instruments are equity or non-equity. The first step considers whether there are any contingent exercise provisions[8]—and, if so, whether the provision is based on an observable market or index other than those referenced to the issuer's own shares or operations. The fixed-for-fixed condition in IAS 32 does not consider contingent exercise provisions (ie under IFRSs, such provisions do not affect how derivatives written on an entity's own equity are classified). The second step under US GAAP uses a concept similar to IAS 32's fixed-for-fixed condition. However, the details of those concepts are significantly different.

[8] The following is an example of a contingent exercise provision—Company A writes a call option that permits Counterparty X to purchase 100 shares of Company A's common stock for CU10 per share if the S&P 500 index increases 500 points during the year.