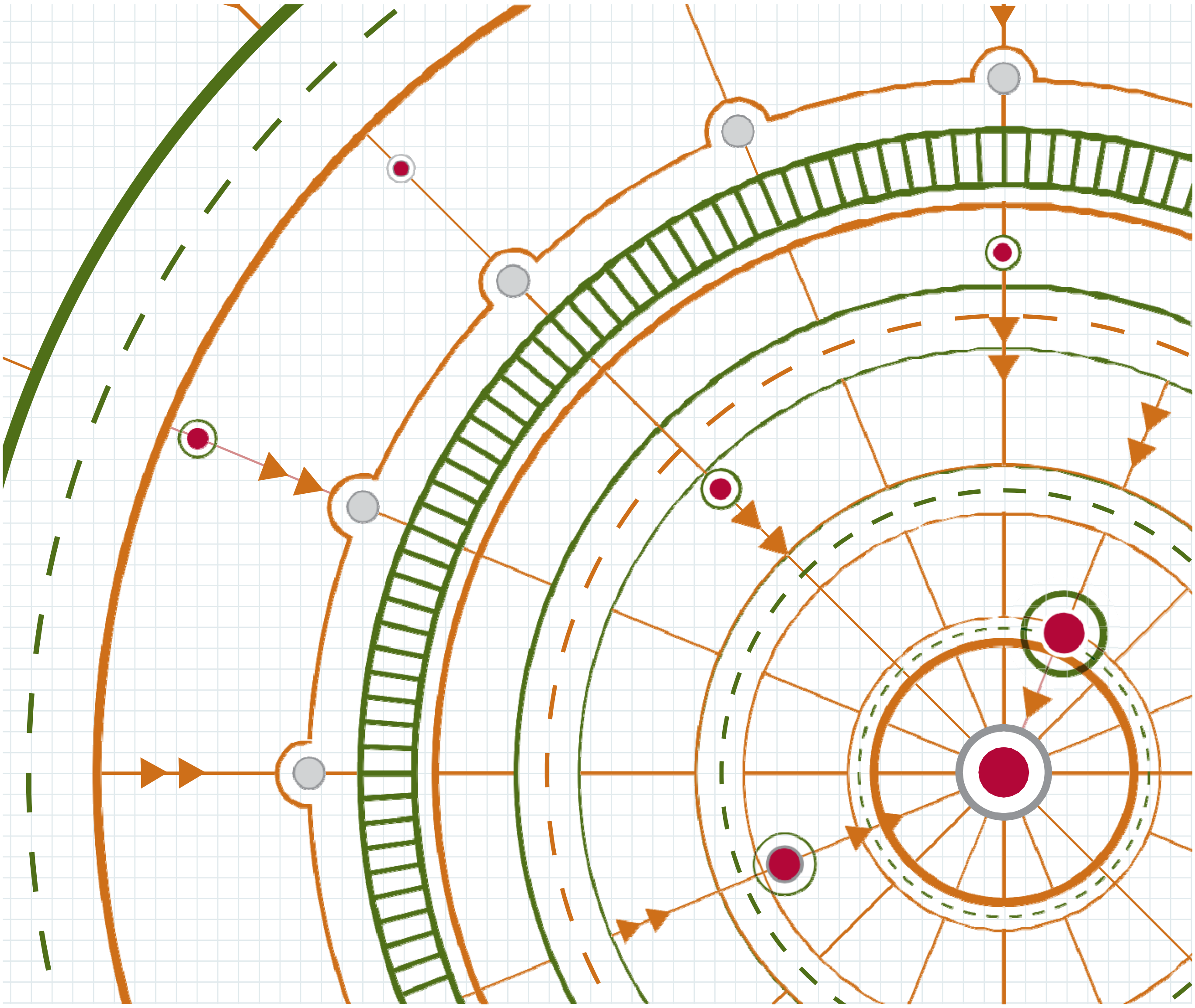
IFRS for SMEs® Standard (2015) + Q&As

IFRS® Foundation—Supporting Material for the *IFRS for SMEs* Standard

Module 22—Liabilities and Equity



IFRS® Foundation
Supporting Material
for the *IFRS for SMEs®* Standard

including the full text of
Section 22 *Liabilities and Equity*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions and case studies

IFRS® Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Telephone: +44 (0)20 7246 6410
Email: info@ifrs.org
Web: www.ifrs.org

Publications Department
Telephone: +44 (0)20 7332 2730
Email: publications@ifrs.org

This module has been prepared by IFRS Foundation (Foundation) education staff. It has not been approved by the International Accounting Standards Board (Board). The module is designed to assist users of the *IFRS for SMEs*® Standard (Standard) to implement and consistently apply the Standard.

Right of use: Although the Foundation encourages you to use this module for educational purposes, you must do so in accordance with the terms of use below. If you intend to include our material in a commercial product, please contact us as you will need a separate licence. For details on using our Standards, please visit www.ifrs.org/issued-standards.

You must ensure you have the most current material available from our website. Your right to use this module will expire when this module is withdrawn or updated, at which time you must cease to use it and/or make it available. It is your sole responsibility to ensure you are using relevant material by checking the Foundation's website for any amendments to the Standard, SME Implementation Group Q&As not yet incorporated and/or new versions of the modules.

Terms of Use

1) You can only reproduce the module in whole or in part in a printed or electronic stand-alone document provided that:
    (a) such document is supplied to participants free of charge;
    (b) you do not use or reproduce, or allow anyone else to use or reproduce, the Foundation logo that appears on or in the module;
    (c) you do not use or reproduce any trade mark that appears on or in the module if you are using all or part of the material to incorporate into your own documentation; and
    (d) you can only provide this module in whole through your website if you include a prominent link to our website (please see our terms and conditions page for details on how to link your website to ours).
2) The trade marks include those listed below.
3) When you copy any extract from this publication for inclusion in another document you must ensure:
    (a) the documentation includes a copyright acknowledgement;
    (b) the documentation includes a statement that the Foundation is the author of the module and that the original module can be accessed via the IFRS website www.ifrs.org;
    (c) the documentation includes in a prominent place an appropriate disclaimer, like that above;
    (d) the extract is shown accurately; and
    (e) the extract is not used in a misleading context.

If you intend to provide any part of this module in print or electronically for any other purpose, please contact the Foundation as you will need a written licence which may or may not be granted. For more information, please contact the licences team (www.ifrs.org/legal/education-material-licensing).

Please address publication and copyright matters to IFRS Foundation Publications Department:
Email: publications@ifrs.org Web: www.ifrs.org

Trade mark notice

Contents

INTRODUCTION 1
Which version of the *IFRS for SMEs* Standard? 1
This module 1
IFRS for SMEs Standard 2
Introduction to the requirements 3
What has changed since the 2009 *IFRS for SMEs* Standard 3

REQUIREMENTS AND EXAMPLES 4
Scope of this Section 4
Classification of a financial instrument as liability or equity 6
Original issue of shares or other equity instruments 13
Sales of options, rights and warrants 18
Capitalisation or bonus issues of shares and share splits 20
Convertible debt or similar compound financial instruments 22
Extinguishing financial liabilities with equity instruments 26
Treasury shares 29
Non-controlling interest and transactions in shares of a consolidated subsidiary 34
Disclosures 40
Appendix to Section 22 41

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS 43

COMPARISON WITH FULL IFRS STANDARDS 44

TEST YOUR KNOWLEDGE 45

APPLY YOUR KNOWLEDGE 50
Case study 1 50
Answer to case study 1 51
Case study 2 53
Answer to case study 2 54

Module 22 – Liabilities and Equity

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015.

This module has been prepared by IFRS Foundation education staff.

The contents of Section 22 *Liabilities and Equity* of the *IFRS for SMEs* Standard are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* Standard (Glossary) is also part of the requirements. Terms defined in the Glossary are reproduced in **bold type** the first time they appear in the text of Section 22. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs*® Standard?

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the IFRS for SMEs* Standard.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

This module focuses on the general requirements for presenting financial statements applying Section 22 *Liabilities and Equity* of the *IFRS for SMEs* Standard. It introduces the subject and reproduces the official text along with explanatory notes and examples designed to enhance understanding of the requirements. The module identifies the significant judgements required in classifying financial instruments as either liabilities or equity. In addition, the module includes questions designed to test your understanding of the requirements and case studies that provide a practical opportunity to apply the requirements to classify financial instruments as either liabilities or equity applying the *IFRS for SMEs* Standard.

Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

- identify whether a financial instrument is within the scope of Section 22;

- classify financial instruments issued by an entity as either liabilities or equity;
- account for equity instruments issued to parties acting in their capacity as investors in equity instruments (ie in their capacity as owners);
- account for equity issued by means of sales of options, rights, warrants, bonus issues, share splits and similar transactions;
- identify puttable instruments and instruments that impose upon the entity an obligation to deliver a pro rata share of net assets only on liquidation, which should be classified as equity (some exceptions are specified);
- identify compound financial instruments (eg convertible instruments) and allocate the proceeds between the liability component and the equity component of such instruments;
- account for the extinguishment of a financial liability partially or fully by the issue of equity instruments;
- account for treasury shares;
- measure and account for non-cash dividends to owners; and
- account for changes in a parent's controlling interest in a subsidiary that do not result in a loss of control.

IFRS for SMEs Standard

The *IFRS for SMEs* Standard is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* Standard is comprised of mandatory requirements and other non-mandatory material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;
- the Basis for Conclusions, which summarises the Board's main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the *IFRS for SMEs* Standard, Appendix A: Effective date and transition, and Appendix B: Glossary of terms, are part of the mandatory requirements.

In the *IFRS for SMEs* Standard, there are appendices to Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* These appendices provide non-mandatory guidance.

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board with supporting implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as 'questions and answers' (Q&As). These Q&As provide non-mandatory, timely guidance on specific accounting questions raised with the SMEIG by entities implementing the *IFRS for SMEs* Standard and other interested parties. At the time of issue of this module (January 2019) the SMEIG has not issued any Q&As relevant to this module.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit rating agencies.

The objective of Section 22 is to prescribe the requirements for the classification of financial instruments as either liabilities or equity.

What has changed since the 2009 *IFRS for SMEs* Standard

The following changes were made to Section 22 by the 2015 Amendments:

- the addition of clarifying guidance on classifying financial instruments as equity or a liability (see paragraph 22.3A);
- the exemption from the initial measurement requirements in paragraph 22.8 for equity instruments issued as part of a business combination, including business combinations of entities or businesses under common control (see paragraph 22.8);
- the addition of the conclusions of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* to provide guidance on debt for equity swaps when the financial liability is renegotiated and the debtor extinguishes the liability by issuing equity instruments (see paragraphs 22.8 and 22.15A–22.15C);
- the clarification that income tax relating to distributions to holders of equity instruments (owners) and to transaction costs of an equity transaction should be accounted for in accordance with Section 29—based on the amendments to IAS 32 *Financial Instruments: Presentation* from *Annual Improvements to IFRSs 2009-2011* Cycle (see paragraphs 22.17);
- the modification to require that the liability component of a compound financial instrument is accounted for in the same way as a similar standalone financial liability (see paragraph 22.15);
- the addition of undue cost or effort exemption from the requirement to measure the liability to pay a non-cash distribution at the fair value of the non-cash assets to be distributed and clarifying guidance on accounting for the settlement of the dividend payable (see paragraphs 22.18-22.18A and 22.20); and
- the exemption from the requirements in paragraph 22.18 for distributions of non-cash assets ultimately controlled by the same parties before and after the distribution (see paragraph 22.18B)

In addition, this module reproduces other editorial changes.

Module 22 – Liabilities and Equity

REQUIREMENTS AND EXAMPLES

Scope of this section

22.1 This section establishes principles for classifying **financial instruments** as either **liabilities** or **equity** and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as **owners**). Section 26 *Share-based Payment* addresses accounting for a transaction in which the entity receives goods or services (including employee services) as consideration for its equity instruments (including shares or share options) from employees and other vendors acting in their capacity as vendors of goods and services.

Notes

A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity (see the Glossary).

This section does not apply to the holder of the financial asset. Furthermore, it is important to note the difference between Section 22 and Section 26 *Share-based Payment*. Section 26 specifies the accounting and reporting for equity instruments issued to suppliers of goods or services, including employees, in return for goods or services. Section 22 addresses the accounting for equity instruments issued to parties acting in their capacity as owners. The notes below explain in more detail what is covered by Section 22.

Classifying financial instruments as either liabilities or equity

The distinction between equity and liability can often be of great importance to entities because it affects whether interest, dividends, losses and gains on those instruments are recognised in equity (ie as an appropriation of or addition to equity) or included in profit for the year (see the notes under paragraph 22.3). The distinction will also affect gearing (leverage) and solvency ratios, which may affect compliance with debt covenants.

Accounting for equity instruments issued to parties acting in their capacity as owners

Section 22 covers the accounting treatment for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as owners); for example, issues of shares or other equity instruments, capital contributions, reacquisitions of the entity's own equity instruments and dividends.

Owners are defined in the *IFRS for SMEs* Standard as holders of instruments classified as equity. Consequently, 'an owner' in an entity is any party holding an instrument in that entity which is classified as equity.

Equity includes capital contributed by and other amounts attributable to the owners of the entity (eg retained earnings). Categories of equity may differ depending upon the nature of the organisation, for example, depending upon whether the entity is a sole proprietorship, partnership or corporation. The categories might also differ depending on legal and other requirements in different jurisdictions.

The *IFRS for SMEs* Standard does not specify categories of equity. Consequently, Section 22 specifies only general accounting requirements for the equity of an entity.

This module provides many examples of accounting for equity transactions with parties acting in their capacity as owners. The examples illustrate common ways of accounting for these transactions within equity that also meet the requirements of this section. However, an entity must comply with the legal requirements of its jurisdiction as well as with Section 22. Compliance in a company's jurisdiction may involve the recognition of 'reserves' classified differently than those illustrated in the examples that follow. Jurisdictions may specify requirements for categorising equity into a number of 'reserves' and may restrict the use of some 'reserves' in specific circumstances. Jurisdictions may restrict the 'reserves' out of which dividends can be paid.

Accounting for changes in a parent's ownership interest that do not result in a loss of control

Changes in a parent's controlling interest in a subsidiary that do not result in a loss of control are treated as equity transactions with the owners and no gain or loss is recognised (see paragraph 22.19).

Definition: equity

In the *IFRS for SMEs* Standard, equity is the residual interest in the assets of the entity after deducting all its liabilities (see the Glossary).

Definition: financial liability

In the *IFRS for SMEs* Standard, a financial liability is any liability that is:

(a) a contractual obligation:

  (i) to deliver cash or another financial asset to another entity; or

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

or

(b) a contract that will be or may be settled in the entity's own equity instruments and:

  (i) under which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments, or

  (ii) will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

  (see the Glossary of terms of the *IFRS for SMEs* Standard (Glossary))

Part (b) of the definition of a financial liability relates to classification of certain complex financial instruments and is unlikely to be relevant to most entities that make simple transactions. Module 11 *Basic Financial Instruments* and Module 12 *Other Financial Instrument Issues* contain more detail on applying the definition of a financial liability.

Examples—acting in the capacity of an owner

Ex1 **On 1 January 20X1, the controlling shareholder of SME A contributes cash of CU50,000(1) and a property with a fair value of CU50,000 to SME A.**

The controlling shareholder is acting in the capacity of an owner of SME A. Both the contribution of cash and the contribution of property are within the scope of Section 22.

22.2 This section shall be applied when classifying all types of financial instruments except:

(a) those interests in **subsidiaries**, **associates** and **joint ventures** that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Interests in Joint Ventures*.

(b) employers' rights and obligations under **employee benefit** plans, to which Section 28 *Employee Benefits* applies.

(c) contracts for contingent consideration in a **business combination** (see Section 19 *Business Combinations and Goodwill*). This exemption applies only to the acquirer.

(d) financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 applies, except that paragraphs 22.3–22.6 shall be applied to **treasury shares** purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans and all other **share-based payment arrangements**.

Notes

The general classification principles established in Section 22 do not apply to the financial instruments specified in paragraph 22.2. These financial instruments are covered by other sections of the *IFRS for SMEs* Standard.

Classification of a financial instrument as liability or equity

22.3 Equity is the residual interest in the **assets** of an entity after deducting all its liabilities. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Equity includes investments by the owners of the entity, plus additions to those investments earned through profitable operations and retained for use in the entity's operations, minus reductions to owners' investments as a result of unprofitable operations and distributions to owners.

22.3A An entity shall classify a financial instrument as a **financial liability** or as equity in accordance with the substance of the contractual arrangement, not merely its legal form, and in accordance with the definitions of a financial liability and an equity instrument. Unless an entity has an unconditional right to avoid delivering **cash** or another **financial asset** to settle a contractual obligation, the obligation meets the definition of a financial liability, and is classified as such, except for those instruments classified as equity instruments in accordance with paragraph 22.4.

---

(1) In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

Notes

Section 22 requires the issuer of a financial instrument to classify the instrument or its component parts on initial recognition as a financial liability or as an equity instrument, in accordance with the substance of the contractual arrangement and with the definitions of a financial liability and equity.

After classification under Section 22, the following requirements apply:

- Sections 11 and 12 cover the accounting treatment for financial liabilities. Interest, dividends, losses and gains relating to a financial instrument, or to a component of a financial instrument that is a financial liability, are recognised in profit or loss (except in limited prescribed circumstances where it may be recognised in other comprehensive income). Dividend payments on shares that are wholly recognised as financial liabilities are therefore recognised as expenses in the same way that interest on a bond is recognised. Similarly, gains and losses associated with redemptions or refinancing of financial liabilities are recognised in profit or loss. Changes in the fair value of specified financial liabilities are recognised in profit or loss in the period of the change.
- Section 22 covers the accounting treatment for equity instruments. Distributions to the holders of an equity instrument reduce equity directly. Dividends on, and redemptions or refinancing of, equity instruments are therefore recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

When an issuer determines whether a financial instrument is a financial liability or an equity instrument, the instrument is an equity instrument only if the instrument does not meet the definition of a financial liability.

Some considerations when making the assessment

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder, or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, that obligation meets the definition of a financial liability, except for those instruments that are classified as equity instruments in accordance with the exemption in paragraph 22.4.

The appropriate classification is determined by the entity at the point of initial recognition. An entity must consider all terms and conditions agreed between itself (and its consolidated subsidiaries, if any) and the holders of the instruments. Entities should distinguish cases in which the entity contractually has no discretion over paying out cash or other financial assets from cases in which consequences result from failure to make a payment. Even if an entity expects to deliver cash or other financial assets to the holder of the instrument, if the entity has no contractual obligation to do so, the instrument is not a financial liability.

In addition, the potential inability of an issuer to settle an obligation when contractually required to do so, for example because of the need to obtain approval for payment from a regulatory authority or because of a lack of funds or profits, does not negate the contractual obligation.

Share capital can come in many forms. If distributions to shareholders are at the discretion of the issuer (even if they are cumulative) and there is no requirement to redeem the shares, the shares are equity instruments. The classification of issued shares as equity instruments or as financial liabilities is not affected by, for example:

- a history of making distributions;
- an intention to make distributions in the future; or
- the amount of the issuer's 'reserves' or profit or loss for the period.

Examples—classification of financial instruments as equity or financial liabilities

Ex2 **SME A issues ordinary shares. Shareholders are entitled to a pro rata share of any dividends or other distributions of the entity. Dividends are discretionary.**

SME A does not have a contractual obligation to make dividend distributions or to redeem the shares (ie it cannot be required to deliver cash or another financial asset to the shareholders). The ordinary shares are classified as equity.

Ex3 **The facts are the same as in Example 2 except that, because of legal requirements in its jurisdiction, SME A is required to pay an annual dividend of at least 10% of the par value of its issued shares.**

SME A has a contractual obligation to make dividend distributions (ie it is required to deliver cash or another financial asset to the shareholders and it does not, therefore, have the unconditional right to avoid such payment). The ordinary shares are financial liabilities accounted for in accordance with Section 11 or Section 12, as appropriate.

Ex4 **The facts are the same as in Example 2. However, in this example, in SME A's jurisdiction, tax is not payable on distributed profits less than CU100,000. A 50% tax rate applies to all undistributed profits and to any distributed profits in excess of CU100,000. Consequently, SME A always plans to make dividend payments of at least CU100,000 in the light of the significant tax benefits.**

Regardless of the intention of SME A and the probability of the entity making dividend payments, it has no contractual obligation to deliver cash (or other financial assets) to the shareholders. The ordinary shares are classified as equity.

Ex5 **The facts are the same as in Example 2. However, in this example, SME A must redeem the shares for par in the event of an initial public offering (IPO). SME A has discretion on whether to initiate an IPO.**

Because SME A has discretion on whether to initiate an IPO, it can avoid redeeming the shares by avoiding the IPO. The ordinary shares are classified as equity.

Ex6 **SME A has 100,000 preference shares in issue, which are all held by institutional investors. The preference shares must be redeemed for cash on the earlier of five years from the issue date of the shares or the date upon which SME A initiates an IPO. SME A has discretion on whether to initiate an IPO.**

SME A has a contractual obligation to deliver cash to its preference shareholders on the earlier of a specified date (ie five years after the issue date of the preference shares) or on the date of initiation of an IPO. Because SME A cannot avoid the redemption of the preference shares, the preference shares are classified as financial liabilities and are accounted for under Section 11 or Section 12, as appropriate.

Ex7 **SME A issues preference shares that must be redeemed at par 30 years later. Dividends are discretionary.**

A contractual obligation to deliver cash exists to repay the principal in 30 years' time. That present obligation is a liability. Because the dividend payments are at the discretion of SME A, it could avoid paying those dividends and consequently they are not liabilities. SME A has issued a compound financial instrument. At initial recognition, in accordance with paragraph 22.13, the present value of the amount to be redeemed in cash is the financial liability component with the residual amount of the proceeds being the equity component of the compound financial instrument.
The liability component is accounted for in accordance with Section 11 or Section12, as appropriate.

Ex8 **SME A issues preference shares that are redeemable at par at the option of the holder. Dividends are discretionary.**

A contractual obligation to deliver cash exists to repay the principal at the holder's request. That present obligation is a liability. SME A cannot avoid redeeming the shares. Because the dividend payments are at the discretion of SME A, it could avoid paying those dividends and consequently they are not liabilities. SME A has issued a compound financial instrument. At initial recognition, in accordance with paragraph 22.13, the present value of the amount to be redeemed in cash is the financial liability component, with the residual amount of the proceeds being the equity component of the compound financial instrument. The liability component is accounted for in accordance with Section 11 or Section 12, as appropriate.

For examples 7 and 8, refer to paragraph 22.13 to obtain more detail about the method for determining the liability and equity components of the compound financial instrument.

Ex9 **SME A issues preference shares that are redeemable at par at the option of SME A. Dividends are discretionary.**

SME A does not have a contractual obligation to make dividend distributions or redeem the shares (ie it cannot be required to deliver cash or another financial asset to another party). The preference shares are classified as equity.

An obligation will arise if SME A exercises its option and informs the shareholders of its intention to redeem.

Ex10 **A shareholder provides an interest-free loan without a specified maturity date to SME A. However, the shareholder may ask for the loan to be repaid at any time. The shareholder does not intend to require the loan to be repaid.**

A contractual obligation to deliver cash exists because of the need to repay the principal. A contractual obligation conditional on a counterparty exercising its right is a financial liability, because the entity does not have the unconditional right to avoid delivering cash or another financial asset. The loan is a financial liability and is accounted for in accordance with Section 11 or Section 12, as appropriate.

22.4 Some financial instruments that meet the definition of a liability are classified as equity because they represent the residual interest in the net assets of the entity:

(a) a puttable instrument is a financial instrument that gives the holder the right to sell that instrument back to the issuer for cash or another financial asset or is automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. A puttable instrument that has all of the following features is classified as an equity instrument:

  (i) it entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets.

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

  (iii) all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.

  (iv) apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments.

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

(b) instruments, or components of instruments, that are subordinate to all other classes of instruments are classified as equity if they 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.

Notes

Because a puttable instrument contains a contractual obligation for the issuer to deliver cash or another financial asset to the holder, such instruments are classified as financial liabilities in accordance with the requirements of Section 22. However, because they represent the residual interest in the net assets of the entity, puttable instruments that meet all the criteria in paragraph 22.4(a) are classified as equity, which is an exception to the principle in Section 22.

Pro rata share of the net assets on liquidation

A pro rata share in 22.4(a)(i) and 22.4(b) would be determined by:

(i) dividing the entity's net assets on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

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

Subordinate class

When determining whether an instrument is in the subordinate class, an entity evaluates the instrument's claim on liquidation as if it were to liquidate on the date when it classifies the instrument. An entity reassesses the classification if there is a change in relevant circumstances; for example, if the entity issues a new type of financial instrument or redeems an existing financial instrument.

If an entity has only one class of financial instruments, that class is treated as if it were the subordinate class.

22.5 The following are examples of instruments that are classified as liabilities instead of equity:

(a) an instrument is classified as a liability if the distribution of net assets on liquidation is subject to a maximum amount (a ceiling). For example, if on liquidation the holders of the instrument receive a pro rata share of the net assets, but this amount is limited to a ceiling and the excess net assets are distributed to a charity organisation or the government, the instrument is not classified as equity.

(b) a puttable instrument is classified as equity if, when the put option is exercised, the holder receives a pro rata share of the net assets of the entity measured in accordance with this Standard. However, if the holder is entitled to an amount measured on some other basis (such as local GAAP), the instrument is classified as a liability.

(c) an instrument is classified as a liability if it obliges the entity to make payments to the holder before liquidation, such as a mandatory dividend.

(d) a puttable instrument that is classified as equity in a subsidiary's **financial statements** is classified as a liability in its parent entity's consolidated financial statements.

(e) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

22.6 Members' shares in co-operative entities and similar instruments are equity if:

(a) the entity has an unconditional right to refuse redemption of the members' shares; or

(b) redemption is unconditionally prohibited by local law, regulation or the entity's governing charter.

Notes

Partnerships and some cooperative entities may provide their members with a right to redeem their interests in the issuer for cash at any time, which results in the members' interests being classified as financial liabilities. This right to redeem may be a legal requirement.

Classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to members' and 'change in net asset value attributable to members' in the financial statements of an entity with no contributed equity. It also does not preclude the use of additional disclosures to show that total members' interests comprise items such as 'reserves' that meet the definition of equity and puttable instruments that do not.

Examples—members' shares in co-operative entities

Ex11 **Cooperative A has instruments in issue that allow the holders to exercise their right to request redemption of their instrument at specified dates and amounts. All other characteristics of the instrument are equity. Cooperative A's governing charter states that the entity has a choice whether to accept the holder's request. The charter has no other conditions or limitations on the level of redemptions or on the entity's discretion to make payments to holders. Cooperative A has never refused to redeem holders' shares, although the governing board has the right to do so.**

The instrument is equity. Cooperative A has no obligation to transfer cash or other financial asset. A history of or an intention to make discretionary payments does not trigger classification as a liability.

Ex12 **The following example illustrates a format for a statement of comprehensive income and a statement of financial position that may be used by entities whose share capital is not equity because the entity has an obligation to repay the share capital on demand, but does not have all the features, or meet all the conditions in paragraph 22.4. In this example, the entity has no obligation to deliver a share of 'reserves' to its members.**

SME A's statement of comprehensive income for the year ended 31 December 20X1

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

SME A's statement of financial position at 31 December 20X1

	31 December 20X1 *CU*	*31 December 20X0* *CU*
Assets		
…		
Total assets	1,291	1180
Liabilities		
Current liabilities (classified in accordance with Section 4)	X	X
Share capital repayable on demand	202	161
Total current liabilities	574	499
Total assets less current liabilities	717	681
Non-current liabilities (classified in accordance with Section 4)	X	X
Total non-current liabilities	187	196

Other components of equity[2]		
Retained earnings	530	485
	717	681
Memorandum note—total members' interests		
Share capital repayable on demand	202	161
Reserves (retained earnings)	530	485
	732	646

Original issue of shares or other equity instruments

22.7 An entity shall recognise the issue of shares or other equity instruments as equity when it issues those instruments and another party is obliged to provide cash or other resources to the entity in exchange for the instruments:

(a) if the equity instruments are issued before the entity receives the cash or other resources, the entity shall present the amount receivable as an offset to equity in its **statement of financial position**, not as an asset;

(b) if the entity receives the cash or other resources before the equity instruments are issued, and the entity cannot be required to repay the cash or other resources received, the entity shall recognise the corresponding increase in equity to the extent of consideration received; and

(c) to the extent that the equity instruments have been subscribed for but not issued, and the entity has not yet received the cash or other resources, the entity shall not recognise an increase in equity.

Notes

If a company issues shares at a premium to their par value, the excess over the par value is sometimes credited to an account in equity called the 'share premium' (or 'capital surplus'). The share premium is a component of contributed equity. Use of a 'share premium' account is sometimes specified by legislation. For example, a jurisdiction's legislation may permit or require the share premium to be used when 'writing-off' share issue costs and/or for transferring an option reserve within equity when options lapse.

Some of the examples below illustrate ways a share premium account is required to be used in some jurisdictions. It is important to note that requirements for the use of share premium often depend on a jurisdiction's legislation.

---

(2) In this example, the entity has no obligation to deliver a share of its 'reserves' to its members, so the 'reserves' are shown as equity. If there is such an obligation, this section of the statement of financial position may need to be fully or partially transferred to liabilities, depending upon the amount of the obligation.

Examples—issue of shares

Ex13 **SME A has issued share capital of CU100,000, which was contributed at par on incorporation of SME A. The par value of the ordinary shares of the entity is CU1 per share.**

At a later date SME A issued a further 50,000 ordinary shares at CU5 per share at a premium. The shares are issued for cash.

Journal entries:

Dr Cash (financial asset)	CU250,000	
Cr Share capital (equity)		CU50,000
Cr Share premium (equity)		CU200,000

To recognise the issue of 50,000 shares at a premium for cash.

Disclosure of equity in the statement of financial position:

Extract from SME A's statement of financial position

	After issue	*Before issue*
	CU	*CU*
…		
Equity		
Share capital	150,000	100,000
Share premium	200,000	-
…		
Total equity attributable to owners of the parent	XXX,XXX	XXX,XXX

Ex14 **The facts are the same as in Example 13. However, in this example, although the entity has issued 50,000 shares, the cash for those shares has not yet been received by the entity.**

Journal entries:

Dr Receivable for shares (financial asset presented as an offset to equity)	CU250,000	
Cr Share capital (equity)		CU50,000
Cr Share premium (equity)		CU200,000

To recognise the issue of 50,000 shares at a premium prior to receipt of cash.

Disclosure of equity in the statement of financial position:

Extract from SME A's statement of financial position

	After issue	*Before issue*
	CU	*CU*
…		
Equity		
Share capital	150,000	100,000
Share premium	200,000	-
Receivable for equity shares	(250,000)	-
…		
Total equity attributable to owners of the parent	XXX,XXX	XXX,XXX

Ex15 **The facts are the same as in Example 13. However, in this example, the additional 50,000 ordinary shares have been subscribed and paid for, but are yet to be issued. SME A does not have any obligation to refund the cash received—it must correspondingly issue the shares.**

Journal entries:

Dr Cash (financial asset)	CU250,000	
Cr Advance received for shares to be issued (equity)		CU250,000

To recognise the cash received for future share issue.

Disclosure of equity in the statement of financial position:

Extract from SME A's statement of financial position

	After subscription	*Before subscription*
	CU	*CU*
…		
Equity		
Share capital	100,000	100,000
Advance received for shares to be issued	250,000	-
…		
Total equity attributable to owners of the parent	XXX,XXX	XXX,XXX

22.8 An entity shall measure equity instruments, other than those issued as part of a business combination or those accounted for in accordance with paragraphs 22.15A-22.15B, at the fair value of the cash or other resources received or receivable, net of **transaction costs**. If payment is deferred and the time value of money is **material**, the initial **measurement** shall be on a **present value** basis.

Example—fair value of other resources

Ex16 **On 1 January 20X1, SME B issues 150,000 ordinary shares in exchange for 1,000 ounces of gold. The par value of the shares is CU2 per share and on 1 January 20X1 gold is trading at CU800 per ounce.**

Journal entries on 1 January 20X1:

Dr Gold (asset)	CU800,000	
Cr Share capital (equity)		CU300,000
Cr Share premium (equity)		CU500,000

To recognise the 150,000 shares issued in exchange for 1,000 ounces of gold with a fair value of CU800,000.

Example—deferred payment

Ex17 **On 1 January 20X1, SME B issues 150,000 ordinary shares at CU6 per share. The par value of the shares is CU2 per share. The cash consideration is payable to SME B on 31 December 20X2. The shares are to be held in an escrow account until payment is received. However, the shareholders are eligible to vote and earn dividends on the shares during 20X1 and 20X2. Assume that the appropriate discount rate is 5%. SME B has a 31 December year-end.**

Journal entries on 1 January 20X1:

Dr Receivable for shares (financial asset presented as an offset to equity)	CU816,327 (a)	
Cr Share capital (equity)		CU300,000
Cr Share premium (equity)		CU516,327

To recognise the issue of 150,000 shares at the present value of the deferred consideration (ie fair value).

Journal entries on 31 December 20X1:

Dr Receivable for shares (financial asset presented as an offset to equity)	CU40,816	
Cr Interest income (profit or loss)		CU40,816

To recognise the unwinding of the discount on the receivable in 20X1 (ie CU816,327 x 5%).

Notes

The amount recognised for share capital and share premium is not adjusted for the unwinding of the discount.

The 'receivable for shares' is adjusted for the unwinding of the discount. However, that adjustment is recognised in profit or loss.

Journal entries on 31 December 20X2:

Dr Receivable for shares (financial asset presented as an offset to equity)	CU42,857	
Cr Interest income (profit or loss)		CU42,857

To recognise the unwinding of the discount on the receivable in 20X2 (ie (CU816,327+CU40,816) x 5%).

Dr Cash (financial asset)	CU900,000	
Cr Receivable for shares (financial asset presented as an offset to equity)		CU900,000

To recognise the settlement of the receivable.

(a)

$$PV = \frac{900,000}{(1.05)^2} = 816,327$$

22.9 An entity shall account for the transaction costs of an equity transaction as a deduction from equity. **Income tax** relating to the transaction costs shall be accounted for in accordance with Section 29 *Income Tax.*

Notes

An entity may incur costs in issuing or acquiring its own equity instruments. Such costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity. Transaction costs are incremental costs that are directly attributable to the transaction that otherwise would have been avoided.

Example—issue costs

Ex18 **SME A issues 200,000 ordinary shares at CU1.25 per share. The par value of the ordinary shares of the entity is CU1 per share. The shares are issued for cash and CU1,000 share issue costs are incurred.**

Journal entries:

Dr Cash (financial asset)	CU249,000	
Cr Share capital (equity)		CU200,000
Cr Share premium (equity)(3)		CU49,000

To recognise the issue of the 200,000 shares.

22.10 How the increase in equity arising on the issue of shares or other equity instruments is presented in the statement of financial position is determined by applicable laws. For example, the par value (or other nominal value) of shares and the amount paid in excess of par value may be required to be presented separately.

Notes

The examples supporting paragraphs 22.7–22.9 illustrate the use of a share premium account (sometimes called capital surplus). This is one common way in which the par value (or other nominal value) of shares and the amount paid in excess of par value may be presented separately.

---

(3) Deducting the share issue costs of CU1,000 from the share premium in accordance with the legislation of the jurisdiction in which the entity operates.

Sale of options, rights and warrants

22.11 An entity shall apply the principles in paragraphs 22.7-22.10 to equity issued by means of sales of options, rights, warrants and similar equity instruments.

Notes

A share option is an instrument that gives the holder the right, but not the obligation to buy a certain number of shares in the company. If the holder exercises the option and new shares are issued, the company increases its share capital when it issues the shares to the option holder. Section 22 only covers accounting for share options issued to parties acting in their capacity as owners. Share options issued to employees or suppliers for services or goods are accounted for under Section 26 *Share-based Payment*.

Another form of an option is a warrant. A difference between a warrant and an option is that a warrant is more commonly issued by a company and linked to another form of financing. For example, warrants may be given to a lender as part of a loan agreement to obtain funding at a lower interest rate. Warrants may also be given to a holder of preference shares as an incentive to encourage the holder's investment.

A rights issue is an issue of new shares where existing shareholders are given the right to purchase an additional number of shares in proportion to their current shareholding. If all shareholders exercise their rights and take up the shares, each individual shareholder's percentage ownership in the company will remain unchanged. Shareholders have the choice of either accepting or rejecting the rights. They may also have the option of selling their rights to another party (for example, to another shareholder).

Examples—share options and rights

Ex19 **SME A has a 31 December year-end. On 1 January 20X1 SME A has ordinary share capital of CU100,000, which was contributed at par on incorporation of SME A. The par value of the shares of the entity is CU1 per share.**

On 1 January 20X1, the entity issues a further 150,000 ordinary shares at CU5 per share. The shares are issued for cash.

Also on 1 January 20X1, as an incentive to encourage investment, each shareholder is permitted to buy one share option for every share purchased on 1 January 20X1 at CU0.5 per option. Each option allows the holder to buy one share on 31 January 20X2 at CU4 per share. 100,000 share options are purchased.

On 31 January 20X2, 95,000 share options are converted into ordinary shares and 5,000 options lapse.

Journal entries on 1 January 20X1:

Dr Cash (financial asset)	CU750,000	
Cr Share capital (equity)		CU150,000
Cr Share premium (equity)		CU600,000

To recognise the issue of 150,000 shares for cash.

Dr Cash (financial asset)	CU50,000	
Cr Option reserve (equity)		CU50,000

To recognise the issue of 100,000 share options for cash. The share options meet the requirement for equity classification because the only obligation of the entity is to issue a fixed number of shares for a fixed amount of cash.

On 31 December 20X1, no further journal entries are made in respect of the options, because they are equity instruments and, consequently, the options are not remeasured to fair value at each reporting date.

Journal entries on 31 January 20X2:

Dr Cash (financial asset)	CU380,000	
Dr Option reserve (equity)	CU47,500	
Cr Share capital (equity)		CU95,000
Cr Share premium (equity)		CU332,500

To recognise the issue of shares for the 95,000 options exercised.

Dr Option reserve (equity)	CU2,500	
Cr Share Premium (equity)(4)		CU2,500

To recognise the lapse of 5,000 options.

On 31 January 20X2, SME A has the following items in its statement of financial position:

	CU
…	
Equity	
Share capital	345,000
Share premium	935,000
Option reserve	0
Retained earnings	xxx
Total equity attributable to owners of the parent	XXX

Ex20 **On 1 January 20X1, SME C has the following items in its statement of financial position:**

	CU
…	
Equity	
Share capital (50,000 shares at CU10 par value each)	500,000
Share premium	2,000,000
Retained earnings	3,600,000
Total equity attributable to owners of the parent	6,100,000

---

(4) The transfer of the option reserve to share premium relating to the 5,000 options that lapsed to share premium in accordance with the legislation of the jurisdiction in which the entity operates.

On 2 February 20X1, SME C declares a rights issue of one new ordinary share for each five outstanding ordinary shares.

- **exercise price: CU55**
- **last date to exercise the rights: 1 March 20X1.**

The following journal entries record the above transaction, assuming all rights are taken up:

Note: in this example there are no entries until the rights are exercised.

Dr Cash (financial asset)	CU550,000	
Cr Share capital (equity)		CU100,000
Cr Share premium (equity)		CU450,000

To recognise the issue of 10,000 shares at CU55 each in a rights issue.

Capitalisation or bonus issues of shares and share splits

22.12 A capitalisation or bonus issue (sometimes referred to as a stock dividend) is the issue of new shares to shareholders in proportion to their existing holdings. For example, an entity may give its shareholders one dividend or bonus share for every five shares held. A share split (sometimes referred to as a stock split) is the dividing of an entity's existing shares into multiple shares. For example, in a share split, each shareholder may receive one additional share for each share held. In some cases, the previously outstanding shares are cancelled and replaced by new shares. Capitalisation and bonus issues and share splits do not change total equity. An entity shall reclassify amounts within equity as required by applicable laws.

Example—bonus issues and share splits

Ex21 **On 31 December 20X0, SME A's statement of financial position included the following items.**

	CU
…	
Equity	
Share capital (10,000 shares at CU10 par value each)	100,000
Share premium	20,000
Retained earnings	1,080,000
Total equity attributable to owners of the parent	1,200,000

On 1 January 20X1, SME A gave its existing shareholders one bonus share for every two shares held. The commercial law to which the entity is subject requires bonus issues to first be accounted for as a depletion of share premium, if any.

The bonus issue could be recognised by the entity on 1 January 20X1 as follows:

Dr Share premium (equity)(5)	CU20,000	
Dr Retained earnings (equity)	CU30,000	
Cr Share capital (equity)		CU50,000

To recognise 5,000 bonus shares issued.

---

(5)Note: a jurisdiction might require, permit or prohibit use of the share premium in this way.

Disclosure of equity in the statement of financial position:

Extract from SME A's statement of financial position

	After bonus issue (1 January 20X1)	*Before bonus issue (31 December 20X0)*
	CU	*CU*
…		
Equity		
Share capital	150,000	100,000
Share premium	–	20,000
Retained earnings	1,050,000	1,080,000
Total equity attributable to owners of the parent	1,200,000	1,200,000

Note: there is no change in total equity as a result of the bonus issue. However, components within equity are reclassified.

Ex22 **The facts are the same as in Example 21. However, in this example, on 1 January 20X1, instead of a bonus issue, the entity declared a share split of its existing shares at two for one. Every share of par value CU10 is converted to two shares of CU5 each.**

It is not necessary to recognise any adjustment to the classifications within equity. This adjustment to classifications will only have an impact on disclosures—presentation in the notes to the financial statements. Total amount of equity will remain unchanged.

Disclosure of equity in the statement of financial position:

Extract from SME A's statement of financial position

	After share split (1 January 20X1)	*Before share split (31 December 20X0)*
	CU	*CU*
…		
Equity		
Share capital	100,000	100,000
Share premium	20,000	20,000
Retained earnings	1,080,000	1,080,000
Total equity attributable to owners of the parent	1,200,000	1,200,000

Note: on 1 January 20X1, there are 20,000 shares in issue with a par value of CU5 each. Prior to the share split, on 31 December 20X0, there were 10,000 shares in issue with a par value of CU10 each.

Convertible debt or similar compound financial instruments

22.13 On issuing convertible debt or similar **compound financial instruments** that contain both a liability and an equity component, an entity shall allocate the proceeds between the liability component and the equity component. To make the allocation, the entity shall first determine the amount of the liability component as the fair value of a similar liability that does not have a conversion feature or similar associated equity component. The entity shall allocate the residual amount as the equity component. Transaction costs shall be allocated between the debt component and the equity component on the basis of their relative fair values.

Notes

The terms of a financial instrument may be structured in such a way that it contains both equity and liability components (ie the instrument is neither entirely a liability nor entirely an equity instrument). Such instruments are known as compound financial instruments. The liability and equity components of a compound financial instrument are accounted for separately (this bifurcation is sometimes called 'split accounting'). Split accounting is consistent with the economic substance of the compound financial instrument (ie it can be regarded as if it were two instruments—one liability instrument and one equity instrument). From the perspective of the issuer, such an instrument comprises two components:

- a contractual obligation to deliver cash (financial liability), for example, a requirement to make payments of interest and principal on a loan, which exist until the loan is converted; and
- a call option granting the holder the right, for a specified time, to convert the loan into a fixed number of ordinary shares of the entity (equity instrument).

The economic effect of issuing such an instrument is substantially the same as issuing simultaneously:

- a debt instrument with an early settlement provision; and
- warrants to purchase ordinary shares.

Accordingly, the issuing entity presents the liability and equity components separately in its statement of financial position.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is equal to the total proceeds from issuing the convertible instrument. No gain or loss is recognised on initially recognising the components of the instrument separately. First the carrying amount of the liability component is determined by measuring the fair value of a similar liability that does not have an associated equity component. The carrying amount of the equity instrument is then determined by deducting the fair value of the financial liability from the total proceeds from issuing the compound financial instrument.

Compound financial instruments can also be issued with embedded features such as rights that investors might possess to sell a specified amount of their equity instruments at a set price within a specified time. The fair value of any such derivative feature embedded in the compound financial instrument other than the equity component is included in the liability component (which is accounted for under Section 12).

On conversion of a convertible instrument (for example, at maturity), the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss in accounting for the conversion of the instrument.

Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction are allocated to those transactions by using a rational basis that is consistent with similar transactions.

22.14 The entity shall not revise the allocation in a subsequent period.

Notes

Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercising the option may appear to have become economically disadvantageous to some holders. The entity's contractual obligation to make future payments remains outstanding until it is extinguished (for example, through conversion or maturity of the instrument).

22.15 In periods after the instruments were issued, the entity shall account for the liability component as follows:

(a) in accordance with Section 11 *Basic Financial Instruments* if the liability component meets the conditions in paragraph 11.9. In these cases, the entity shall systematically recognise any difference between the liability component and the principal amount payable at maturity as additional interest **expense** using the **effective interest method** (see paragraphs 11.15-11.20).

(b) in accordance with Section 12 *Other Financial Instrument Issues* if the liability component does not meet the conditions in paragraph 11.9.

Notes

For application of the requirements of paragraphs 22.13–22.15 see Appendix to Section 22 *Example of the issuer's accounting for convertible debt*.

Example—calculations for convertible bonds

Ex23 **An entity issues 5,000 convertible bonds on 1 January 20X1. The bonds have a five-year term and are issued at par with a nominal value of CU1,000 per bond (ie total proceeds from the issue on 1 January 20X1=CU5,000,000). Interest is payable annually in arrears at 5%. Each bond is convertible at the option of the holder at any time up to maturity into 100 equity shares with a par value of CU1. When the bonds were issued, the prevailing market interest rate for similar debt instruments without a conversion feature is 8%.**

On 1 January 20X1 (at initial recognition), the liability component is first measured at the fair value of a similar liability that does not have a conversion feature (see paragraph 22.13). Then the equity component is measured at the difference between the proceeds of the bond issue and the liability component. The fair value of the liability component at the time of issuing the instrument is calculated at the present value of the cash flows of a similar liability that does not have a conversion feature, discounted using the market interest rate for similar bonds that have no conversion rights (in this example 8%), as follows:

	CU
Present value of principal = 5,000,000 ÷ $(1.08)^5$	3,402,916
Present value of the interest (note 1)	998,178
Total liability component	4,401,094
Equity component (residual component, convertible loan reserve)	598,906
Proceeds from the issue	5,000,000

Note 1: Present value of the interest:

$250{,}000/1.08 + (250{,}000/1.08^2) + (250{,}000/1.08^3) + (250{,}000/1.08^4) + (250{,}000/1.08^5) = 998{,}178$

Alternatively, the following formula can be used to calculate the present value of consistent interest payments over a regular period. In the formula, future payments (C) are discounted by the periodic rate of interest (i) over the number of periods (n):

$$PV = \frac{C}{i} \times \left[1 - \frac{1}{(1+i)^n}\right] = C \times \left[\frac{1-(1+i)^{-n}}{i}\right]$$

From 20X1 to 20X5, the entity recognises the difference between the liability component (CU4,401,094) and the principal amount payable at maturity (CU5,000,000) as additional interest expense by using the effective interest method as shown below unless the bond is converted prior to maturity:

Year	*Liability at the beginning of the year* *CU*	*Effective interest (8%)* *CU*	*Interest paid annually (5%)* *CU*	*Liability at the end of the year* *CU*
20X1	4,401,094	352,087	(250,000)	4,503,181
20X2	4,503,181	360,254	(250,000)	4,613,435
20X3	4,613,435	369,075	(250,000)	4,732,510
20X4	4,732,510	378,601	(250,000)	4,861,111
20X5	4,861,111	388,889	(250,000)	5,000,000

Ex24 **The facts are the same as in Example 23. On 31 December 20X1, 2,000 bonds are converted into shares. The remaining 3,000 bonds are converted into shares on 31 December 20X5 (maturity).**

Journal entries for the year ended 31 December 20X1:

Dr Finance costs (profit or loss)	CU352,087	
Cr Convertible loan (liability element)		CU352,087

To recognise the unwinding of the discount in the convertible loan in 20X1.

31 December 20X1:

Dr Convertible loan (liability element)	CU250,000	
Cr Cash (financial asset)		CU250,000

To recognise the cash outflow for 'interest' paid to holders of convertible instruments.

Dr Convertible loan (liability element)	CU1,801,272	
Dr Convertible loan reserve (equity element)	CU239,562	
Cr Share capital (equity) [200,000 shares at CU1 par value]		CU200,000
Cr Share premium (equity)		CU1,840,834

To recognise the conversion of 2,000 of the 5,000 bonds into 200,000 shares. The carrying amount of the liability element attributable to the 2,000 bonds of CU1,801,272 (=4,503,181 x 2/5) is converted to equity with no gain or loss on conversion. It is added to CU239,562 (=2/5 x 598,906), which is the amount attributable to the 2,000 bonds already sitting in equity.

During 20X2 to 20X5, the interest is charged to expense using the effective interest method, in accordance with paragraph 22.15, as shown below for the remaining bonds (note that the numbers presented in the table below are derived by applying a factor of 3/5 to the numbers presented in table in example 23).

Year	*Liability at the beginning of the year CU*	*Effective interest (8%) CU*	*'Interest' paid (5% per year) CU*	*Liability at the end of the year CU*
20X2	2,701,909	216,152	(150,000)	2,768,061
20X3	2,768,061	221,445	(150,000)	2,839,506
20X4	2,839,506	227,161	(150,000)	2,916,667
20X5	2,916,667	233,333	(150,000)	3,000,000

The journal entries to recognise interest paid and the unwinding of the discount during years' 20X2 to 20X4 are not shown here to avoid repetition because they are easily determined from the table above.

Journal entries for the year ended 31 December 20X5:

Dr Finance costs (profit or loss)	CU233,333	
Cr Convertible loan (liability element)		CU233,333

To recognise the unwinding of the discount in the convertible loan in 20X5.

31 December 20X5:

Dr Convertible loan (liability element)	CU150,000	
Cr Cash (financial asset)		CU150,000

To recognise the cash outflow for 'interest' paid to holders of convertible instruments.

Dr Convertible loan (liability element)	CU3,000,000	
Dr Convertible loan reserve (equity element)	CU359,344	
Cr Share capital (equity) [300,000 shares at CU1 par value]		CU300,000
Cr Share premium (equity)		CU3,059,344

To recognise the conversion of the remaining 3,000 bonds into 300,000 shares. The carrying amount of the liability element attributable to the 3,000 bonds of CU3,000,000 is converted to equity with no gain or loss on conversion. It is added to the remaining CU359,344 (= 3/5 x 598,906) in equity.

Extinguishing financial liabilities with equity instruments

22.15A An entity may renegotiate the terms of a financial liability with a creditor of the entity with the result that the entity extinguishes the liability fully or partially by issuing equity instruments to the creditor. Issuing equity instruments constitutes consideration paid in accordance with paragraph 11.38. An entity shall measure the equity instruments issued at their fair value. However, if the fair value of the equity instruments issued cannot be measured reliably without undue cost or effort, the equity instruments shall be measured at the fair value of the financial liability extinguished. An entity shall derecognise the financial liability, or part of the financial liability, in accordance with paragraphs 11.36-11.38.

22.15B If part of the consideration paid relates to a modification of the terms of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part that remains outstanding. This allocation should be made on a reasonable basis. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the **recognition** of a new liability as required by paragraph 11.37.

22.15C An entity shall not apply paragraphs 22.15A-22.15B to transactions in situations in which:

(a) the creditor is also a direct or indirect shareholder and is acting in its capacity as direct or indirect existing shareholder;

(b) the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity; or

(c) extinguishing the financial liability by issuing equity instruments is in accordance with the original terms of the financial liability (see paragraphs 22.13-22.15).

Notes

Paragraphs 22.15A and 22.15B provide requirements on the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability (a debt-for-equity swap).

Paragraph 11.38 requires the difference between the carrying amount of the financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid (ie issue of shares) to be recognised in profit or loss.

The notes below paragraph 22.18A later in this module discuss considerations when applying an undue cost or effort exemption, such as the exemption in paragraph 22.15A. If an entity uses the undue cost or effort exemption for measuring the fair value of the equity instruments issued in accordance with paragraph 22.15A, the entity shall disclose that fact and the reasons why applying the requirement in paragraph 22.15A would involve undue cost or effort (see paragraph 2.14D).

Ex25 **SME A has a loan from a third party, eg a bank. On 31 December, 20X0 SME A renegotiates the terms of the loan with the third party with the result that SME A issues 1,000 shares to the third party with a par value of CU1 to extinguish the loan in full. SME A estimates that the shares issued have a fair value of CU9,500. The carrying amount of the loan on 31 December 20X0 is CU9,000 (amortised cost).**

Journal entries to record the extinguishment of the loan in exchange for shares on 31 December 20X0:

Dr Loan (financial liability)	CU9,000	
Dr Loss on extinguishment (profit or loss)	CU500	
Cr Share capital (equity)		CU1,000
Cr Share premium (equity)		CU8,500

To derecognise the loan and recognise the issue of shares.

Ex26 **The facts are the same as in Example 25, except management of SME A cannot measure the fair value of the shares reliably without undue cost or effort. The entity estimates that the fair value of the loan on 31 December 20X0 before renegotiation is CU8,880 based on the present value of the future cash flows under the existing loan.**

If the fair value of the equity instruments issued cannot be measured reliably without undue cost or effort, the equity instruments are measured at the fair value of the financial liability extinguished.

Journal entries to record the extinguishment of the loan in exchange for shares on 31 December 20X0:

Dr Loan (financial liability)	CU9,000	
Cr Gain on extinguishment (profit or loss)		CU120
Cr Share capital (equity)		CU1,000
Cr Share premium (equity)		CU7,880

To derecognise the financial liability and record the issue of shares.

Ex27 **SME A has a loan from a third party. On 31 December 20X0, SME A renegotiates the terms of the loan with the third party with the result that SME A issues 500 shares with a par value of CU1 to the third party in exchange for the following changes to the terms of the loan:**

- **extinguishment of 50% of the loan; and**
- **a reduction in the interest rate for the remaining term of the loan.**

SME A estimates that the shares issued have a fair value of CU4,750. The carrying amount of the loan on the date of extinguishment is CU9,000. The entity estimates that the fair value of the loan on 31 December 20X0 before renegotiation is CU8,880. The fair value of the remaining part of the modified loan on 31 December 20X0 after renegotiation at a lower interest rate is CU4,150 based on the present values of future cash flows.

The entity determines that part of the consideration paid relates to the reduction in the interest rate for the remaining part of the loan. Consequently, the entity allocates the consideration of CU4,750 between the part of the liability extinguished and the part that remains outstanding. A reasonable basis to make this allocation might be to consider the fair value of the part of the loan extinguished. Consequently, SME A could allocate the consideration as follows:

- fair value of the 50% of the loan extinguished CU4,440 (=8,880 x 50%). Allocate CU4,440 of the consideration to this.
- allocation of remaining consideration to the modification of the remaining part of the loan CU310 (=4,750-4,440).

Journal entries to record the extinguishment of 50% of the loan in exchange for shares on 31 December 20X0:

Dr Loan (financial liability)	CU4,500	
Cr Gain on extinguishment (profit or loss)		CU60
Cr Equity		CU4,440

To derecognise 50% of the carrying amount of the loan of CU4,500 (=9,000x50%).

In accordance with paragraphs 11.37 and 22.15B, journal entries to record the modification of the remaining part of the loan in exchange for shares on 31 December 20X0 assuming that the remaining part of the loan is not considered substantially modified:

Dr Loan (financial liability)	CU310	
Cr Equity		CU310

To recognise the modification of the loan. Note: A new effective interest rate would be calculated based on the revised carrying amount of the loan of CU4,190 (=4,500-310) in accordance with Section 11.

In accordance with paragraphs 11.37 and 22.15B, journal entries to record the modification of the remaining loan in exchange for shares on 31 December 20X0 assuming that the remaining part of the loan is considered substantially modified:

Dr Loan (financial liability)	CU4,500	
Cr Gain on extinguishment (profit or loss)		CU40
Cr Loan (financial liability)		CU4,150
Cr Equity		CU310

To recognise the modification of the remaining part of the loan as the extinguishment of the original liability and the recognition of a new liability.

Note the total amount recognised in equity in this example might be recorded as follows:

Cr Share capital	CU500
Cr Share premium	CU4,250
	CU4,750

Treasury shares

22.16 Treasury shares are the equity instruments of an entity that have been issued and subsequently reacquired by the entity. An entity shall deduct from equity the fair value of the consideration given for the treasury shares. The entity shall not recognise a **gain** or loss in profit or loss on the purchase, sale, issue or cancellation of treasury shares.

Notes

Treasury shares are an entity's own equity instruments, held by the entity or other members of the consolidated group (ie any consolidated subsidiaries). Treasury shares are not recognised as a financial asset of the entity regardless of the reason for which they are reacquired.

Example—treasury shares

Ex28 **On 31 December 20X0, SME A's statement of financial position included the following:**

	CU
…	
Equity	
Share capital (10,000 shares at CU10 par value each)	100,000
Share premium	500,000
Retained earnings	600,000
Total equity attributable to owners of the parent	1,200,000

On 1 January 20X1, SME A reacquires 4,000 shares from its shareholders for cash consideration of CU75 per share.

The treasury shares could be presented in SME A's statement of financial position as follows:

Extract from SME A's statement of financial position

	After reacquisition (1 January 20X1)	*Before reacquisition (31 December 20X0)*
	CU	*CU*
…		
Equity		
Share capital	100,000	100,000
Share premium	500,000	500,000
Treasury shares	(300,000)	–
Retained earnings	600,000	600,000
Total equity attributable to owners of the parent	900,000	1,200,000

Note: the fair value of the consideration given for the shares reacquired (CU300,000 cash) is deducted from equity and there is no impact on profit or loss for the year.

Ex29 **The facts are the same as in Example 28. On 1 June 20X1, SME A sold 2,000 of the treasury shares in exchange for CU100 per share.**

Journal entries to record the sale on 1 June 20X1:

Dr Cash (financial asset)	CU200,000	
Cr Treasury shares (equity)		CU150,000
Cr Retained earnings (equity)[6]		CU50,000

To recognise the sale of 2,000 treasury shares.

The treasury shares could be presented in the statement of financial position as follows:

Extract from SME A's statement of financial position on 1 June 20X1

	After sale	*Before sale*
	CU	*CU*
…		
Equity		
Share capital	100,000	100,000
Share premium	500,000	500,000
Treasury shares	(150,000)	(300,000)
Retained earnings	650,000	600,000
Total equity attributable to owners of the parent	1,100,000	900,000

Distributions to owners

22.17 An entity shall reduce equity for the amount of distributions to its owners (holders of its equity instruments). Income tax relating to distributions to owners shall be accounted for in accordance with Section 29.

Notes

Distributions to holders of an equity instrument are debited by the entity directly to equity. An entity may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends (see paragraph 29.34). Legal requirements in an entity's jurisdiction may have specific requirements from where in equity the distributions can or must be debited. Distributions are often taken out of retained earnings (sometimes called accumulated profits).

A liability to pay a dividend is recognised when the dividend is appropriately approved and authorised and is no longer at the discretion of the entity. This is the date:

- when the declaration of the dividend is approved by the relevant authority, (eg the shareholders), if such approval is required (eg by the jurisdiction or by the entity's governing documents); or
- when the dividend is declared (eg by management or the board of directors) if further approval is not required.

---

[6] Another component of equity might also be used by an entity depending on the legal requirements in the entity's jurisdiction.

Example—distributions to shareholders

Ex30 **In 20X1 SME A declares and pays a dividend of CU0.50 per share to the owners of SME A in respect of the year ended 31 December 20X1. SME A has 100,000 ordinary shares in issue.**

Journal entries to record the dividend on the date it is declared (once the dividend is declared SME A has a financial liability):

Dr Retained earnings (equity)	CU50,000	
Cr Dividend payable (financial liability)		CU50,000

To recognise the present obligation arising from declaring the dividend.

The payment of the dividend is recorded as follows:

Dr Dividend payable (financial liability)	CU50,000	
Cr Cash (financial asset)		CU50,000

To derecognise the liability for dividends declared when settled in cash.

22.18 Sometimes an entity distributes assets other than cash to its owners (‘non-cash distributions’). When an entity declares such a distribution and has an obligation to distribute non-cash assets to its owners, it shall recognise a liability. It shall measure the liability at the fair value of the assets to be distributed unless it meets the conditions in paragraph 22.18A. At the end of each **reporting period** and at the date of settlement, the entity shall review and adjust the **carrying amount** of the dividend payable to reflect changes in the fair value of the assets to be distributed, with any changes recognised in equity as adjustments to the amount of the distribution. When an entity settles the dividend payable, it shall recognise in profit or loss any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable.

Notes

Sometimes an entity distributes assets other than cash (ie non-cash assets) to its owners acting in their capacity as owners. For example, non-cash assets such as investments (eg shares in another entity), inventory, or property, plant or equipment may be distributed. In those situations, an entity may also give its owners a choice of receiving either non-cash assets or a cash alternative.

Paragraph 22.18 requires an entity to measure the liability to distribute non-cash assets as a dividend to its owners at fair value of the assets to be distributed unless the fair value cannot be measured reliably without undue cost or effort (see paragraph 22.18A). Measuring the obligation to distribute non-cash assets to its owners at the fair value of the assets to be distributed faithfully presents the economic substance of the distribution. The financial information reflects the reality that, on distribution, the assets available to meet existing lenders’ claims against the entity will be reduced by the fair value of the assets to be distributed.

Examples—non-cash dividend

Ex31 **On 31 December 20X1, SME A declares and distributes to its owners a tract of land (classified as property, plant and equipment) with a carrying amount of CU1,000 and a fair value of CU100,000. The land is allocated to the owners in proportion to their shareholding (for example, an owner that holds 5% of the share capital would receive 5% of the land).**

Initial recognition of the dividend on 31 December 20X1:

Dr Retained earnings (equity)	CU100,000	
Cr Dividend payable (liability)		CU100,000

To recognise the settlement of the obligation to 'pay' the dividend on 31 December 20X1:

Dr Dividend payable (liability)	CU100,000	
Cr Gain on realisation of land (profit or loss)		CU99,000
Cr Property, plant and equipment—land (asset)		CU1,000

Ex32 **On 1 September 20X1, SME A declares that it will distribute to its four owners (who each own 25% of SME A) four cars no longer used in the business.
On 1 September 20X1 the combined carrying amount of the four cars is CU55,000 and their combined fair value, measured with reference to the published prices of used cars, is CU56,000.**

On 31 December 20X1 (SME A's reporting date), the fair value of the cars is estimated to be CU56,800 and the carrying amount is CU54,500.

On 10 April 20X2 the cars are distributed to the owners when their fair value is estimated to be CU55,000 and their carrying amount is CU54,000.

Initial recognition of the dividend on 1 September 20X1:

Dr Retained earnings (equity)	CU56,000	
Cr Dividend payable (liability)		CU56,000

Because the distribution has not been made at the end of the reporting period, SME A remeasures the liability at 31 December 20X1:

Dr Retained earnings (equity)	CU800	
Cr Dividend payable (liability)		CU800

SME A is required to remeasure the liability at the date of its settlement (10 April 20X2). The first journal entry below shows the remeasurement and the second journal entry shows the distribution:

Dr Dividend payable (liability)	CU1,800	
Cr Retained earnings (equity)		CU1,800

Dr Dividend payable (liability)	CU55,000	
Cr Property, plant and equipment (asset)		CU54,000
Cr Gain on disposal of cars (profit and loss)		CU1,000

22.18A If the fair value of the assets to be distributed cannot be measured reliably without undue cost or effort, the liability shall be measured at the carrying amount of the assets to be distributed. If prior to settlement the fair value of the assets to be distributed can be measured reliably without undue cost or effort, the liability is remeasured at fair value with a corresponding adjustment made to the amount of the distribution and accounted for in accordance with paragraph 22.18.

Notes

Considering whether determining the fair value of assets to be distributed would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement in assessing the costs and benefits. This judgement requires consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information (see paragraph 2.14B of Section 2 *Concepts and Pervasive Principles*). If an SME already has or could easily and inexpensively acquire the information necessary to comply with a requirement, any related undue cost or effort exemption would not be applicable. If the information is readily available or easily obtained, the benefits to the users of the financial statements would be expected to exceed any further cost or effort by the SME. Assessing whether a requirement would involve undue cost or effort on initial recognition in the financial statements, for example, at the date of the transaction, should be based on information about the costs and benefits of the requirement at the time of initial recognition. If the undue cost or effort exemption also applies subsequent to initial recognition, for example, to a subsequent measurement of an item, a new assessment of undue cost or effort should be made at that subsequent date, based on information available at that date (see paragraph 2.14C). Where an entity uses the undue cost or effort exemption for non-cash distributions, the entity shall disclose that fact and the reasons why a reliable fair value measurement would involve undue cost or effort (see paragraphs 2.14D and 22.20).

Ex33 **The facts are the same as in Example 31. However, in this example, the fair value of land cannot be measured reliably without undue cost or effort.**

Initial recognition of the dividend on 31 December 20X1:

Dr Retained earnings (equity)	CU1,000	
Cr Dividend payable (liability)		CU1,000

To recognise the settlement of the obligation to 'pay' the dividend on 31 December 20X1:

Dr Dividend payable (liability)	CU1,000	
Cr Property, plant and equipment—land (asset)		CU1,000

22.18B Paragraphs 22.18-22.18A do not apply to the distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution. This exclusion applies to the separate, individual and consolidated financial statements of an entity that makes the distribution.

Notes

An SME might be controlled by a single party, for example by another company or an individual, or a group of parties that collectively control an entity under contractual arrangement. Any distributions of non-cash assets to that party (or parties) would be ultimately controlled by the same party before and after the distribution. Consequently, paragraphs 22.18−22.18A would not apply to such distributions.

A distribution of non-cash assets to a parent entity (for example, distribution of a business) is often made for the purpose of group restructuring. After the distribution the asset is still controlled by the same party or parties. The requirement of paragraphs 22.18−22.18A do not apply to such distributions.

Example—common control transaction

Ex34 **The facts are the same as in Example 31. However, in this example SME A only has one owner who owns 100% of SME A.**

Paragraphs 22.18-22.18A do not apply to the distribution of the land to the owner because the land is ultimately controlled by the same party before and after the distribution (ie the owner).

In the absence of specific guidance in the *IFRS for SMEs* Standard on accounting for such a transaction, SME A could still apply the requirements in paragraph 22.18−22.18B by analogy to this transaction. However, other accounting treatments would also be permitted, provided they are determined in accordance with paragraphs 10.4−10.6 of the *IFRS for SMEs* Standard.

Non-controlling interest and transactions in shares of a consolidated subsidiary

22.19 In consolidated financial statements, a **non-controlling interest** in the net assets of a subsidiary is included in equity. An entity shall treat changes in a **parent**'s controlling interest in a subsidiary that do not result in a loss of **control** as transactions with owners in their capacity as owners. Accordingly, the carrying amount of the non-controlling interest shall be adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of the consideration paid or received, if any, shall be recognised directly in equity and attributed to owners of the parent. An entity shall not recognise gain or loss on these changes. Also, an entity shall not recognise any change in the carrying amounts of assets (including **goodwill**) or liabilities as a result of such transactions.

Notes

When a parent increases or decreases its stake in an existing subsidiary without losing control, no adjustment is made to goodwill or to any other assets or liabilities, and no gain or loss is recognised in profit or loss. Examples 35 and 36 show the journal entries required. To assist understanding, the detailed journal entries are illustrated in Examples 37 and 38.

Example—changes in a parent's interest without loss of control

Ex35 **Since SME Z was formed it has been owned 75% by SME A and 25% by SME B.**

On 31 December 20X5, when the carrying amount of SME Z's net assets was CU100,000, SME A reduced its holding in SME Z to 60% by selling 15% of SME Z's shares to SME B for CU20,000.

The journal entry on 31 December 20X5 to recognise in SME A's consolidated financial statements the sale of shares in SME Z is as follows:

Dr Cash (financial asset)	CU20,000	
Cr Non-controlling interests (equity)		CU15,000
Cr Equity (eg retained earnings)		CU5,000

Because SME A had owned the shares in SME Z from the date on which SME Z was incorporated, it is assumed that the group carrying amounts of SME Z's assets and its liabilities would be measured at the same amounts in SME Z's financial statements and in SME A's consolidated financial statements.

Ex36 **The facts are the same as in Example 35. However, in this example, SME A increased its holding in SME Z to 90% by buying 15% of SME Z's shares from SME B for CU20,000.**

The journal entry on 31 December 20X5 to recognise in SME A's consolidated financial statements the purchase of additional SME Z shares is as follows:

Dr Non-controlling interests (equity)	CU15,000	
Dr Equity (eg retained earnings)	CU5,000	
Cr Cash (financial asset)		CU20,000

Ex37 **On 1 January 20X8, SME A acquires 85% of SME B for CU70 and obtains control.**

SME A estimates the useful life of the goodwill arising on acquisition to be ten years.

The statements of financial position of SME A and SME B and SME A's consolidated statement of financial position as at 1 January 20X8 are as follows (note that the assets and liabilities of SME B have already been adjusted to their fair values under Section 19 *Business Combinations and Goodwill*):

	SME A (parent) CU	*SME B (subsidiary) CU*	*SME A Group(consolidated) CU*
Current assets	700	50	**750**
Investment in SME B	70		**–** (a)
Other non-current assets	500	30	**530**
Goodwill			**27.5** (b)
Total assets	**1,270**	**80**	**1,307.5**
Current liabilities	70	30	100
Total liabilities	**70**	**30**	**100**
Shareholders' equity			
Issued equity			
100 ordinary shares	100		100
10 ordinary shares		10	- (c)
Share premium	500		500
Retained earnings	600	40	600 (d)
Non-controlling interest			7.5 (e)
Total shareholders' equity	**1,200**	**50**	**1,207.5**
Total liabilities and shareholders' equity	**1,270**	**80**	**1,307.5**

(a) The investment of CU70 is eliminated on consolidation.

(b) Goodwill of CU27.5=(CU70 less 85%×CU50) arises on acquisition of SME B, ie the excess of the consideration paid for SME B over the proportion of net assets acquired.

(c) Share capital of SME B is eliminated upon consolidation.

(d) The retained earnings balance of SME B of CU40 as at 1 January 20X8 arose pre-acquisition and is eliminated upon consolidation.

(e) The non-controlling interest (NCI) in SME B is CU7.5=15% × (CU50); ie the proportion of net assets held by the NCI in SME B.

For the year ended 31 December 20X8 SME A earns a profit of CU100 and SME B earns a profit of CU50.

On 31 December 20X8, SME A acquires an additional 10% interest in SME B for CU10.

The statements of financial position of SME A and SME B and SME A's consolidated statement of financial position as at 31 December 20X8 are as follows:

	SME A (parent) CU	*SME B (subsidiary) CU*	*SME A Group (consolidated) CU*
Current assets	790	100	890
Investment in SME B	80 (a)	-	- (b)
Other non-current assets	500	30	530
Goodwill			24.75 (c)
Total assets	**1,370**	**130**	**1,444.75**
Current liabilities	70	30	100
Total liabilities	**70**	**30**	**100**
Shareholders' equity			
Issued equity			
100 ordinary shares	100		100
10 ordinary shares		10	- (d)
Share premium	500		500
Retained earnings—SME A	700		700
Retained earnings—SME B		90	39.75 (e, f)
Group retained earnings			**739.75** (g)
Non-controlling interest			5 (h)
Total shareholders' equity	**1,300**	**100**	**1,344.75**
Total liabilities and shareholders' equity	**1,370**	**130**	**1,444.75**

(a) On 31 December 20X8, SME A made an additional investment of CU10 in SME B. The investment balance as at 31 December 20X8 in SME A's statement of financial position is CU80 (=CU70 + CU10).

(b) The investment of CU80 is eliminated on consolidation.

(c) After one year of amortisation goodwill is equal to CU24.75 (=27.5 minus 10% × 27.5).

(d) Share capital of SME B is eliminated upon consolidation.

(e) Of the CU90 retained earnings balance of SME B, the CU40 relating to pre-acquisition profits is eliminated upon consolidation.

(f) CU39.75 represents SME A's share in the profits earned by SME B after control is established, ie CU42.5 (=85% x CU50) less the amortisation of goodwill of CU2.75 (=10% × CU27.5). Although 95% is held at the year-end, 85% was held for the whole year until 31 December 20X8, so the share of profits is 85%.

(g) The difference between the amount by which the NCI is adjusted because of SME A's additional investment and the fair value of the consideration is CU0 ((15% × CU100 minus 5% × CU100) minus CU10).

(h) The NCI in SME B is CU5 (=5% × CU100); ie the proportion of net assets held by the NCI in SME B at December 31 20X8. This could also be determined as CU7.5 (NCI at 1 January 20X8) + CU7.5 (NCI's share of SME B's profit for the year, CU50 x 15%) – CU10 (reduction in NCI % of net assets at the end of the year, CU100 x 10%).

Journal entry for (g)

An appropriate journal entry on 31 December 20X8 to recognise the additional investment is as follows:

Dr Non-controlling interests (equity)	CU10	
Dr Equity (eg retained earnings)	CU0	
Cr Cash (financial asset)		CU10

Ex38 **The facts are the same as in Example 37 except that, in this example, on 31 December 20X8 SME A acquired the additional 10% interest in SME B for CU25.**

The statements of financial position of SME A and SME B and SME A's consolidated statement of financial position as at 31 December 20X8 are as follows:

	SME A (parent) CU		*SME B (subsidiary) CU*	*SME A Group (consolidated) CU*	
Current assets	775		100	875	
Investment in SME B	95	(a)		-	(b)
Other non-current assets	500		30	530	
Goodwill				24.75	(c)
Total assets	**1,370**		**130**	**1,429.75**	
Current liabilities	70		30	100	
Total liabilities	**70**		**30**	**100**	
Shareholders' equity					
Issued equity					
100 ordinary shares	100			100	
10 ordinary shares			10	-	(d)
Share premium	500			500	
Retained earnings—SME A	700			700	
Retained earnings—SME B			90	39.75	(e, f)
Retained earnings—adjustment				(15)	(g)
Group retained earnings				**724.75**	
Non-controlling interest				5	(h)
Total shareholders' equity	**1,300**		**100**	**1,329.75**	
Total liabilities and shareholders' equity	**1,370**		**130**	**1,429.75**	

(a) On 31 December 20X8 SME A made an additional investment of CU25 in SME B. The investment balance as at 31 December 20X8 in SME A's statement of financial position is CU95 (CU70 + CU25).

(b) The investment of CU95 is eliminated on consolidation.

(c) After one year of amortisation goodwill is equal to CU24.75 (=27.5 minus 10% × 27.5).

(d) Share capital of SME B is eliminated upon consolidation.

(e) Of the CU90 retained earnings balance of SME B, the CU40 relating to pre-acquisition profits is eliminated upon consolidation.

(f) CU39.75 represents SME A's share in the profits earned by SME B after control is established, ie CU42.5 (=85% × CU50) less the amortisation of goodwill of CU2.75 (=10% × CU27.5).

(g) The difference between the amount by which the NCI is adjusted and the fair value of the consideration is CU15 ((15% × CU100 minus 5% × CU100) minus CU25).

(h) The NCI in B is CU5=5% × (CU100), which is the proportion of net assets held by the NCI in SME B at December 31 20X8.

Journal entry for (g)

An appropriate journal entry on 31 December 20X8 to recognise the additional investment is as follows:

Dr	Non-controlling interests (equity)	CU10	
Dr	Equity (eg retained earnings)	CU15	
	Cr Cash (financial asset)		CU25

Ex39 **The facts are the same as in Example 37 except, in this example, on 31 December 20X8 SME A sold 10% of SME B for CU12.**

The statements of financial position of SME A and SME B and SME A's consolidated statement of financial position as at 31 December 20X8 are as follows:

	SME A (parent) CU	*SME B (subsidiary) CU*	*SME A Group (consolidated) CU*	
Current assets	812	100	912	
Investment in SME B	61.76 (a)		-	(b)
Other non-current assets	500	30	530	
Goodwill			24.75	(c)
Total assets	**1,370**	**130**	**1,466.75**	
Current liabilities	70	30	100	
Total liabilities	**70**	**30**	**100**	
Shareholders' equity				
Issued equity				
100 ordinary shares	100		100	
10 ordinary shares		10	-	(d)
Share premium	500		500	
Retained earnings—SME A	703.76(a)		700 (a)	
Retained earnings—SME B		90	39.75	(e, f)
Retained earnings—adjustment			2	(g)
Group retained earnings			**741.75**	
Non-controlling interest			25	(h)
Total shareholders' equity	**1,300**	**100**	**1,366.75**	
Total liabilities and shareholders' equity	**1,370**	**130**	**1,466.75**	

(a) On 31 December 20X8 SME A disposed of 10% SME B for CU12. The investment balance as at 31 December 20X8 in SME A is CU61.76 (=CU70 x 75%/85%). A gain on sale would be recognised for CU3.76 (=CU12 minus ((=CU70 x 10%/85%) in SME A's individual financial statements but would be eliminated on consolidation.

(b) The investment of CU61.76 is eliminated on consolidation.

(c) Goodwill of CU24.75=27.5 minus 10% × 27.5 less amortisation.

(d) Share capital of SME B is eliminated upon consolidation.

(e) Of the CU90 retained earnings balance of SME B, the CU40 relating to pre-acquisition profits is eliminated upon consolidation.

(f) CU39.75 represents SME A's share in the profits earned by SME B after control is established, ie CU42.5 (=85% × CU50) less the amortisation of goodwill of CU2.75 (=10% × CU27.5).

(g) The difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration is CU2 (= (25% × CU100 minus 15% × CU100) minus CU12).

(h) The NCI in SME B is CU25 (=25% × (CU100); ie the proportion of net assets held by the NCI in SME B at 31 December 20X8.

Journal entry for (g)

An appropriate journal entry on 31 December 20X8 to recognise the additional investment is as follows:

Dr Cash (financial asset)	CU12	
Cr Non-controlling interests (equity)		CU10
Cr Equity (eg retained earnings)		CU2

Disclosures

22.20 If the fair value of the assets to be distributed as described in paragraphs 22.18-22.18A cannot be measured reliably without undue cost or effort, the entity shall disclose that fact and the reasons why a reliable fair value measurement would involve undue cost or effort.

Appendix to Section 22
Example of the issuer’s accounting for convertible debt

The Appendix accompanies, but is not part of, Section 22. It provides guidance for applying the requirements of paragraphs 22.13–22.15.

On 1 January 20X5 an entity issues 500 convertible bonds. The bonds are issued at par with a face value of CU100 per bond and are for a five-year term, with no transaction costs. The total proceeds from the issue are CU50,000. Interest is payable annually in arrears at an annual interest rate of 4 per cent. Each bond is convertible, at the holder’s discretion, into 25 ordinary shares at any time up to maturity. At the time the bonds are issued, the market interest rate for similar debt that does not have the conversion option is 6 per cent.

When the instrument is issued, the liability component must be valued first, and the difference between the total proceeds on issue (which is the fair value of the instrument in its entirety) and the fair value of the liability component is assigned to the equity component. The fair value of the liability component is calculated by determining its present value using the discount rate of 6 per cent. These calculations and journal entries are illustrated:

	CU
Proceeds from the bond issue (A)	50,000
Present value of principal at the end of five years (see calculations)	37,363
Present value of interest payable annually in arrears for five years	8,425
Present value of liability, which is the fair value of liability component (B)	45,788
Residual, which is the fair value of the equity component (A) – (B)	4,212

The issuer of the bonds makes the following journal entry at issue on 1 January 20X5:

Dr Cash	CU50,000	
Cr Financial Liability - Convertible bond		CU45,788
Cr Equity		CU4,212

The CU4,212 represents a discount on issue of the bonds, so the entry could also be shown ‘gross’:

Dr Cash	CU50,000	
Dr Bond discount	CU4,212	
Cr Financial Liability - Convertible bond		CU50,000
Cr Equity		CU4,212

After issue, the issuer will amortise the bond discount according to the following table:

	(a) **Interest payment (CU)**	**(b)** **Total interest expense (CU) = 6% x (e)**	**(c)** **Amortisation of bond discount (CU) = (b) – (a)**	**(d)** **Bond discount (CU) = (d) – (c)**	**(e)** **Net liability (CU) = 50,000 – (d)**
1/1/20X5				4,212	45,788
31/12/20X5	2,000	2,747	747	3,465	46,535
31/12/20X6	2,000	2,792	792	2,673	47,327
31/12/20X7	2,000	2,840	840	1,833	48,167
31/12/20X8	2,000	2,890	890	943	49,057
31/12/20X9	2,000	2,943	943	0	50,000
Totals	10,000	14,212	4,212		

At the end of 20X5, the issuer would make the following journal entry:

Dr Interest expense	CU2,747	
Cr Bond discount		CU747
Cr Cash		CU2,000

Calculations

Present value of principal of CU50,000 at 6 per cent

CU50,000/(1.06)^5 = CU37,363

Present value of the interest annuity of CU2,000 (= CU50,000 × 4 per cent) payable at the end of each of five years

The CU2,000 annual interest payments are an annuity—a cash flow stream with a limited number (n) of periodic payments (C), receivable at dates 1 to n. To calculate the present value of this annuity, future payments are discounted by the periodic rate of interest (i) using the following formula:

$$PV = \frac{C}{i} \times [1 - \frac{1}{(1+i)^n}]$$

Therefore, the present value of the CU2,000 interest payments is
(2,000/.06)×[1–[(1/1.06)^5]] = CU8,425

This is equivalent to the sum of the present values of the five individual CU2,000 payments as follows:

	CU
Present value of interest payment at 31 December 20X5 = 2,000/1.06	1,887
Present value of interest payment at 31 December 20X6 = 2,000/1.06^2	1,780
Present value of interest payment at 31 December 20X7 = 2,000/1.06^3	1,679
Present value of interest payment at 31 December 20X8 = 2,000/1.06^4	1,584
Present value of interest payment at 31 December 20X9 = 2,000/1.06^5	1,495
Total	8,425

Yet another way to calculate this is to use a table of present value of an ordinary annuity in arrears, five periods, interest rate of 6 per cent per period. (Such tables are easily found on the Internet.). The present value factor is 4.2124. Multiplying this by the annuity payment of CU2,000 determines the present value of CU8,425.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Classification

An entity's equity is the residual interest in the assets of that entity after deducting all its liabilities. In most cases, little difficulty is encountered in determining whether a financial instrument issued by an entity is an equity instrument or a financial liability of that entity. However, judgement may be required to classify some instruments appropriately when it is difficult to identify whether an obligation exists—either to deliver cash or another financial asset or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the issuer. Judgement will need to be applied considering any legal or other requirements in the jurisdiction and the specific terms and conditions of the instruments. For example:

- partnerships—classification depends on how the partnership agreements are structured.
- member's shares and other financial instruments in co-operative entities—whether they represent the residual interest in the net assets of the entity.
- preference shares—classification depends upon the specific contractual or other obligations.

Judgement may need to be applied to determine whether a financial instrument with the legal form of a single instrument has the substance of two instruments—one liability and one equity instrument (ie it is a compound financial instrument—see notes relating to paragraph 22.13). For compound financial instruments, further judgements and estimates may be necessary in separating the instrument into its equity and liability components.

Measurement

An entity is generally required to measure equity instruments at the fair value of the cash or other resources received or receivable, net of transaction costs. When non-cash resources are received, an entity might have to estimate the fair value of the resource (eg the fair value of services or equipment received). In doing the estimate, the entity may be required to use valuation techniques that use inputs that are not based on observable data.

Sometimes an entity distributes assets other than cash as dividends to its owners. An entity might have to estimate the fair value of non-cash assets (eg an item of plant and equipment or unlisted shares in another entity)

When an entity extinguishes financial liabilities with equity instruments, significant estimation might be required to measure the fair value of the equity instruments issued.

COMPARISON WITH FULL IFRS STANDARDS

When classifying financial instruments as either liabilities or equity and accounting for equity instruments issued to investors for periods beginning on 1 January 2017, the main differences between the requirements of full IFRS Standards (see IAS 32 *Financial Instruments: Presentation, IFRIC 17 Distributions of Non-cash Assets to Owners* and IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*) and the *IFRS for SMEs* Standard (see Section 22 *Equity*) are:

The requirements for classifying financial instruments as either liabilities or equity and accounting for equity instruments issued to investors as set out in full IFRS Standards (see IAS 32 *Financial Instruments: Presentation*) differ from those requirements in the *IFRS for SMEs* Standard (see Section 22 *Equity*), as issued on 9 July 2009, in the following ways:

- The *IFRS for SMEs* Standard is drafted in simpler language than that used in full IFRS Standards.
- The *IFRS for SMEs* Standard includes some additional requirements to IAS 32 for the recognition of the issue of shares or other equity instruments. Such guidance is generally consistent with practice under full IFRS Standards, apart from the requirement in paragraph 22.7(a) that if equity instruments are issued before cash is received, the entity presents the amount receivable as an offset to equity. The full IFRS Standards provide no explicit guidance on how to account for amounts received before equity instruments are issued and many entities present the amount receivable as an asset instead of as an offset to equity.
- The *IFRS for SMEs* Standard contains fewer detailed requirements than IAS 32 on classifying puttable financial instruments and obligations arising on liquidation that meet the definition of a liability but that may represent the residual interest in the net assets of the entity. Differences may arise in practice because of the simplified classification requirements under Section 22.
- Full IFRS Standards contain detailed requirements regarding when financial assets and financial liabilities are offset. The *IFRS for SMEs* Standard includes a general requirement in paragraph 2.52 that an entity shall not offset assets and liabilities or income and expenses unless required or permitted by the *IFRS for SMEs* Standard. Section 22 has no offset requirements.
- The *IFRS for SMEs* Standard includes an undue cost or effort exemption from the requirement to measure own equity instruments at fair value in the scenario when the entity renegotiates the terms of a financial liability and, by issuing equity instruments to the creditor, extinguishes the liability fully or partially. Full IFRS Standards require such equity instruments to be measured at fair value if that fair value can be measured reliably.
- The *IFRS for SMEs* Standard also includes an undue cost or effort exemption from the requirement for an entity to measure the liability to distribute a non-cash asset to its owners (that is not ultimately controlled by the same party or parties before and after the distribution) at the fair value of the non-cash assets to be distributed. Full IFRS Standards always require fair value measurement.
- Full IFRS Standards include additional requirements for some types of instruments that SMEs are unlikely to encounter. For example, foreign currency denominated pro rata rights issues, financial instruments with contingent settlement provisions and derivative financial instruments with settlement options.

Module 22 – Liabilities and Equity

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for classifying financial instruments as either liabilities or equity and accounting for equity instruments issued to investors applying the *IFRS for SMEs* Standard by answering the questions provided.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those set out beneath it.

Mark the box next to the most correct statement.

Question 1

Equity is the:

☐ (a) total amount due by an entity to its creditors.

☐ (b) residual interest in the assets of the entity after deducting all its liabilities.

☐ (c) total amount of cash contributed by the owners of the entity.

Question 2

Equity instruments other than those issued as part of a business combination (or those accounted for in accordance with paragraphs 22.15A and 22.15B on extinguishment of a financial liability) are measured by the issuer on initial recognition at the:

☐ (a) fair value of the cash or other resources received or receivable. Any transaction costs of issuing the equity are recognised as an expense in profit or loss.

☐ (b) fair value of the cash or other resources received or receivable plus transaction costs of issuing the equity.

☐ (c) fair value of the cash or other resources received or receivable net of transaction costs of issuing the equity.

Question 3

In the parent's consolidated financial statements, the non-controlling interest in a subsidiary is presented in the statement of financial position:

☐ (a) within equity.

☐ (b) as a separate line item between liabilities and equity.

☐ (c) within liabilities.

Question 4

On 31 December 20X0, SME A declares that it will distribute some items of inventory with a carrying amount (cost) of CU500 to its shareholders. The fair value of the inventory on 31 December 20X0 is CU600. The inventory will be transferred to shareholders on 25 January 20X1.

How should the dividend payable be recorded on 31 December 20X0?

☐ (a)

Dr Retained earnings	CU600	
Dr Inventory	CU100	
Cr Dividend payable (non-cash)		CU600
Cr Profit on disposal (profit or loss)		CU100

☐ (b)

Dr Inventory	CU500	
Dr Loss on disposal (profit or loss)	CU100	
Cr Dividend payable (non-cash)		CU600

☐ (c)

Dr Retained earnings	CU600	
Cr Dividend payable (non-cash)		CU600

Question 5

The facts are the same as in question 4. What journal entries should be recorded on transfer of the inventory on 25 January 20X1? Assume that the fair value of the inventory on 25 January 20X1 is CU590.

☐ (a)

Dr Dividend payable	CU600	
Cr Retained earnings		CU600

☐ (b)

Dr Dividend payable	CU600	
Cr Profit on disposal (profit or loss)		CU100
Cr Retained earnings		CU500

☐ (c)

Dr Dividend payable	CU600	
Cr Profit on disposal (profit or loss)		CU90
Cr Inventory		CU500
Cr Retained earnings		CU10

☐ (d)

Dr Dividend payable	CU600	
Cr Inventory		CU500
Cr Retained earnings		CU100

Question 6

Treasury shares are:

☐ (a) an entity’s own equity instruments held by the entity or other members of the consolidated group.

☐ (b) an entity’s own equity instruments that are held in escrow for another entity.

☐ (c) an entity’s own equity instruments held by an entity outside the consolidated group.

Module 22 – Liabilities and Equity

Question 7

On 31 December 20X2, a parent disposes of 10% of its wholly owned subsidiary for CU400 when the group carrying amount of the subsidiary's net assets is CU2,500.

What, in the group's consolidated financial statements, is the correct accounting treatment for recognising the difference between the consideration received (CU400) and the increase in non-controlling interest (CU250) in respect of the disposal?

☐ (a) recognise the gain of CU150 in profit or loss.

☐ (b) recognise the loss of CU150 in profit or loss.

☐ (c) recognise the CU150 as an adjustment to the equity (eg retained earnings) attributed to owners of the parent.

☐ (d) recognise the CU150 as an adjustment to in equity attributed to non-controlling interests.

Question 8

SME A declares a share split (sometimes referred to as a stock split). The total equity of SME A will:

☐ (a) increase.

☐ (b) decrease.

☐ (c) not change.

Question 9

Entity A buys back 1,000 of its own equity shares for CU50 per share. Entity A assesses the fair value of the shares on purchase to also be CU50. The shares will be held as treasury shares to enable Entity A to satisfy its obligations under its employee share option scheme. Entity A should recognise the following journal entries:

(a)	Dr financial asset	50,000	
	Cr cash		50,000
(b)	Dr treasury shares (equity)	50,000	
	Cr cash		50,000
(c)	Dr liability	50,000	
	Cr cash		50,000

Question 10

When an entity renegotiates the terms of a financial liability with the result of extinguishing the liability fully or partially by issuing equity instruments to the creditor, the equity instruments are measured:

☐ (a) at the carrying amount of the financial liability extinguished.

☐ (b) always at the fair value of the equity instruments issued.

☐ (c) always at the fair value of the financial liability extinguished.

☐ (d) at the fair value of the equity instruments issued unless that fair value cannot be measured reliably without undue cost or effort in which case the equity instruments are measured at the fair value of the financial liability extinguished.

Module 22 – Liabilities and Equity

Question 11

On 31 December 20X0, SME A issues equity instruments with a fair value of CU10,000 to extinguish the whole of a liability with a carrying amount of CU9,000. SME A should recognise the following journal entries.

(a)	Dr financial liability	9,000	
	Cr equity		9,000
(b)	Dr financial liability	10,000	
	Cr equity		10,000
(c)	Dr financial liability	9,000	
	Dr profit or loss	1,000	
	Cr equity		10,000
(d)	Dr financial liability	9,000	
	Dr retained earnings	1,000	
	Cr equity		10,000

Module 22 – Liabilities and Equity

Answers

Q1	(b) paragraph 22.3
Q2	(c) paragraph 22.8
Q3	(a) paragraph 22.19
Q4	(c) paragraph 22.18
Q5	(c) paragraph 22.18
Q6	(a) definition of treasury shares in the Glossary
Q7	(c) paragraph 22.19
Q8	(c) paragraph 22.12
Q9	(b) paragraph 22.16
Q10	(d) paragraph 22.15A
Q11	(c) paragraphs 22.15A and 11.38

Module 22 – Liabilities and Equity

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for classifying financial instruments as either liabilities or equity and accounting for equity instruments issued to investors applying the *IFRS for SMEs* Standard by completing the case studies provided.

Once you have completed a case study, check your answers against those set out beneath it.

Case study 1

The following are several different types of financial instruments that may be issued by entities to obtain financing or are transactions related to those instruments. In the table below identify whether the instruments are equity or financial liability, and why.

Description of instrument	**Equity or financial liability?**	**Reason**
Ordinary shares. Discretionary dividends.		
A five-year bank loan with fixed interest payable annually in arrears.		
Two different classes of ordinary shares—class one and class two. Dividends are discretionary in both classes. Class two shareholders have reduced voting rights, but rank ahead of class one ordinary shareholders on the winding up of the entity.		
Ordinary shares. Dividends are discretionary. Shareholders pay tax at a low rate to encourage investment. The entity must redeem the shares for par if there is a change in tax law, meaning that shareholders will be required to pay tax on dividends at the normal rate in the future. It is possible that tax rates may be increased in the future.		
Preference shares that entitle the holder to redeem the shares if the entity's average profit over the past three years falls below a particular level determined applying the *IFRS for SMEs* Standard.		
A bank loan at a fixed annual interest rate with the option for the holder to convert the loan into a fixed number of shares of the entity.		
Members' shares in co-operative entities that are redeemable at the holder's request. Assume that the exemption in paragraph 22.4 is not applicable.		
Cash dividend once declared.		
Shares puttable at fair value. The shares are not the most subordinate.		
Shares puttable at a pro rata share of net assets on liquidation. The shares are the most subordinate. There is a fixed discretionary dividend. No other obligations exist.		

Module 22 – Liabilities and Equity

Answer to case study 1

Description of instrument	**Equity or financial liability?**	**Reason**
Ordinary shares. Discretionary dividends.	Equity.	No contractual obligation to pay dividends or redeem the shares.
A five-year bank loan with fixed interest payable annually in arrears.	Financial liability to be accounted for in accordance with Sections 11/12.	The entity (the issuer) has a contractual obligation to pay annual interest and repay the principal in five years.
Two different classes of ordinary shares—class one and class two. Dividends are discretionary on both classes. Class two shareholders have reduced voting rights, but rank ahead of class one ordinary shareholders on the winding up of the entity.	Both classes are equity.	The entity has no contractual obligation to pay dividends or redeem the shares.
Ordinary shares. Dividends are discretionary. Shareholders pay tax at a low rate to encourage investment. The entity must redeem the shares for par if there is a change in tax law, meaning that shareholders will be required to pay tax on dividends at the normal rate in the future. It is possible that tax rates may be increased in the future.	Financial liability to be accounted for in accordance with Sections 11/12.	Neither the holder nor the entity has control over tax payable on dividends. The settlement provision is contingent. Because the entity cannot avoid redeeming the shares if tax rates increase to the normal rate, the entity does not have the unconditional right to avoid repayment.
Preference shares that entitle the holder to redeem the shares if the entity's average profit over the past three years falls below a particular level determined applying the *IFRS for SMEs* Standard.	Financial liability to be accounted for in accordance with Sections 11/12.	Neither the holder nor the entity can prevent the entity's profits from falling below the predetermined level. The settlement provision is contingent. As the entity cannot avoid redeeming the shares if its profits fall below the predetermined level, the entity does not have the unconditional right to avoid repayment.
A bank loan at a fixed annual interest rate with the option for the holder to convert the loan into a fixed number of shares of the entity.	Convertible loan. Split into liability and equity components in accordance with Section 22. The loan component is subsequently accounted for in accordance with Sections 11/12. The equity component is accounted for in accordance with Section 22.	The substance of the instrument is that both a financial liability and an equity instrument exist: a financial liability to deliver cash (by making scheduled interest payments and repaying the principal), which exists as long as the bond is not converted; and a written call option granting the holder the right to convert the loan into a fixed number of ordinary shares of the entity.
Members' shares in co-operative entities that are redeemable at the holder's request. Assume that the exemption in paragraph 22.4 is not applicable.	Financial liability to be accounted for in accordance with Sections 11/12.	The issuer has a contractual obligation to redeem the shares for cash at the request of the holder. The issuer cannot avoid this obligation.
Cash dividend once declared.	Financial liability to be accounted for in accordance with Sections 11/12.	The entity has a contractual obligation to settle the amount payable in cash.
Shares puttable at fair value. The shares are not the most subordinate class of the entity's	Financial liability to be accounted for in accordance with	The entity has a contractual obligation to settle the amount payable in cash.

instruments.	Sections 11/12.	
Shares puttable at a pro rata share of net assets on liquidation. The shares are the most subordinate class of the entity's instruments. There is a fixed discretionary dividend. No other obligations exist.	Equity (see the exception in paragraph 22.4).	Although the shares meet the definition of a financial liability the specific exemption in paragraph 22.4 requires such an instrument to be classified as equity.

Case study 2

The carrying amount of SME A's equity at 1 January 20X6 was:

Equity	***CU***
Ordinary share capital comprising 120,000 shares of CU10 par value each	1,200,000
Share premium	4,800,000
Share option reserve	300,000
Retained earnings	18,000,000
Total equity	**24,300,000**

SME A enters into the following transactions in 20X6.

Date	**Additional information**
2 February 20X6	Issues 2,000 additional ordinary shares for CU120,000.
31 March 20X6	Declares 1:1 bonus issue of 122,000 shares out of retained earnings.
30 June 20X6	Issues 50,000 non-redeemable preference shares at par of CU5 per share with a 6% fixed dividend on the par value payable annually (assume that 6% is the market rate of interest for this type of instrument).
31 December 20X6	Grants options to employees with a vesting period of three years starting from the grant date (grant date is 31 December 20X6). The fair value of the options at the grant date is CU60,000. In addition, a share-based payment expense of CU50,000 for vested options granted to employees in an earlier period accountable for in 20X6 relates to employee service in 20X6. No options were exercised by employees during 20X6.
31 December 20X6	Reacquires 200 SME A equity shares at CU70 per share.
31 December 20X6	Issues convertible debt with a face value of CU1,000,000. The debt has a three-year term. Interest is payable yearly in arrears at 3% per year (annual rate) and the loan is convertible in full, at the holder's discretion, at any time up to maturity into 250 ordinary shares. It is unlikely that the holder will convert. When the loan is issued, the market interest rate for similar debt without any conversion option is 4%.
31 December 20X6	Makes a profit of CU2,000,000 for 20X6.
15 January 20X7	Declares a dividend of CU0.5 per share for ordinary shareholders for the year ended 31 December 20X6.

Prepare accounting entries to record the equity transactions in the accounting records of SME A for the year ended 31 December 20X6.

Note: the measurement of some transactions above is outside the scope of Section 22 and only the identification of such transactions is required here.

Answer to case study 2

The carrying amount of SME A's equity at 31 December 20X6 is:

Equity	***CU***	***Workings***
Ordinary share capital comprising 244,000 shares of CU10 par value each	2,440,000	(1,200,000 + 20,000 (W1) + 1,220,000 (W2)
Share premium	4,900,000	(4,800,000 + 100,000 (W1)
Treasury shares	(14,000)	(W4)
Convertible bond reserve	27,751	(W5)
Share option reserve	350,000	(300,000 + 50,000 (W3)
Retained earnings	18,780,000	(18,000,000 – 1,220,000 (W2) + 2,000,000 profit for 20X6)
Total equity	**26,483,751**	

Journal entries to recognise the transactions are as follows:

(W1) 2 February 20X6

Dr	Cash (financial asset)	CU120,000	
	Cr Share capital (equity)		CU20,000
	Cr Share premium (equity)		CU100,000

To recognise the par value and premium received upon issue of 2,000 shares at CU60 per share.

(W2) 31 March 20X6

Dr	Retained earnings (equity)	CU1,220,000	
	Cr Share capital (equity)		CU1,220,000

To recognise the 1:1 bonus issue of 122,000 shares at CU10 par value.

30 June 20X6

Dr	Cash (financial asset)	CU250,000	
	Cr Preference shares (financial liability)		CU250,000

To recognise the 50,000 preference shares at CU5 par value.

Note: the issuer has assumed a contractual obligation to make a future stream of 6% interest payments, so the preference shares are a financial liability, not equity. The net present value of the interest payments is CU250,000 and represents the fair value of the liability. The measurement of preference shares classified as financial liabilities is specified in Section 12 but is included here for completeness.

31 December 20X6

Dr	Finance costs (profit or loss)	CU7,500	
	Cr Preference shares (financial liability)		CU7,500

To recognise the finance cost on the preference share liability.

Note: because the preference shares are recognised as a financial liability, the dividend that accumulates for the six months is a finance cost that is recognised in profit or loss (=6% x 250,000 x 6/12).

(W3)

Dr	Share-based payment expenses (profit or loss)	CU50,000	
	Cr Share option reserve (equity)		CU50,000

To recognise vested options granted to employees in an earlier period.

Note: no entry would be recorded in 20X6 for the fair value of the share options granted as at 31 December 20X6. The fair value will be recognised in 20X7 to 20X9.

Share options issued to employees are within the scope of Section 26 *Share-based Payment* and not within the scope of Section 22. They have been included here only for completeness. See Module 26 *Share-based Payment* for the measurement of fair value and for the reasons for this journal entry.

(W4)

Dr	Treasury shares (equity)	14,000	
	Cr Cash (financial asset)		14,000

To recognise the reacquisition of 200 of the entity's own shares at CU70 per share.

(W5)

Dr	Cash (financial asset)	1,000,000	
	Cr Convertible bond (financial liability)		972,249
	Cr Convertible bond (equity)		27,751

To recognise the liability component and the equity component that arise from issuing convertible debt in exchange for CU1,000,000.

Note: when the instrument is issued, the liability component must be valued first, and the difference between the total proceeds on issue (which is the fair value of the instrument in its entirety) and the fair value of the liability component is assigned to the equity component. The fair value of the liability component is calculated by determining its present value using the discount rate of 4%. The calculations and journal entries are illustrated on the following page.

15 January 20X7

The dividend to shareholders is declared after 31 December 20X6 (the end of the reporting period). Consequently, the entity did not have a present obligation for the dividend at 31 December 20X6 and does not recognise a liability at 31 December 20X6. However, the dividend would be disclosed in the notes to the financial statements.

Calculations for convertible bond:

	CU	**CU**	
Proceeds from the bond issue (A)		1,000,000	
Present value of liability, which is the fair value of liability component (B)			
Present value of principal at the end of three years (see calculations below)	888,996		
Present value of interest payable annually in arrears for three years	83,253	972,249	
Residual, which is the fair value of the equity component (A)–(B)		27,751	(W5)

After issue, the issuer will amortise the bond discount according to the following table:

	Liability at the beginning of the year (CU)	**Effective interest (4%) (CU)**	**'Interest' paid (3%) (CU)**	**Liability at the end of the year (CU)**
20X7	972,249	38,890	(30,000)	981,139
20X8	981,139	39,246	(30,000)	990,385
20X9	990,385	39,615	(1,030,000)	-

Calculations

Present value of principal of CU1,000,000 at 4%

CU1,000,000 ÷ $(1.04)^3$ = 888,996

Present value of the interest annuity of CU30,000 (=CU1,000,000 × 3%) payable at the end of each of three years

(CU30,000 ÷ .04)×[1 minus [$(1 \div 1.04)^3$] = 83,253

This is equivalent to the sum of the present values of the five individual CU30,000 payments, as follows:

	CU
Present value of interest payment at 31 December 20X5=30,000 ÷ 1.04	28,846
Present value of interest payment at 31 December 20X6=30,000 ÷ 1.04^2	27,737
Present value of interest payment at 31 December 20X7=30,000 ÷ 1.04^3	26,670
Total	**83,253**