PROPOSED FINANCIAL REPORTING STANDARD	ED/FRS

Exposure Draft of Proposed Amendments to

FRS 32 *Financial Instruments: Presentation* and FRS 1 *Presentation of Financial Statements*

FINANCIAL INSTRUMENTS PUTTABLE AT FAIR VALUE AND OBLIGATIONS ARISING ON LIQUIDATION

Comments to be received by 23 September 2006

This exposure draft (ED) contains proposed amendments to FRS 32 *Financial Instruments: Presentation* and FRS 1 *Presentation of Financial Statements—Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*.

This ED should be read in the context of the Preface to Financial Reporting Standards published by the Council on Corporate Disclosure and Governance (CCDG).

This ED is issued by CCDG for comment only and does not necessarily represent the views of CCDG.

Since this ED may be modified as a result of comments received, CCDG would like to hear both from those who agree with the proposals contained in the ED and from those who do not.

Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, clearly explain the problem and provide a suggestion for alternative wording with supporting reasoning.

Comments should be submitted in writing, so as to be received by **23 September 2006**, preferably by email to: accounting_stds@acra.gov.sg or addressed to:

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Introduction

1 This Exposure Draft contains proposals to amend FRS 32 *Financial Instruments: Presentation* to classify as equity financial instruments puttable at the fair value of a pro rata share of the net assets of the entity (financial instruments puttable at fair value) and instruments with obligations for a pro rata share of the net assets of the entity on its liquidation (obligations arising on liquidation), provided specified criteria are met.

2 Under FRS 32, equity classification of a financial instrument depends upon specified conditions being met; one of those conditions is that the instrument does not include a contractual obligation to deliver cash or another financial asset to another entity. An instrument with such an obligation is a financial liability.

3 Some entities have issued financial instruments puttable at the fair value of a pro rata share of the net assets of the entity. After the revised FRS 32 was issued, constituents raised concerns about the consequences of applying FRS 32 and FRS 39 *Financial Instruments: Recognition and Measurement* to financial instruments puttable at fair value. For example, those standards require an entity to recognise such instruments as a liability and to measure them at an amount not less than the amount payable on demand, i.e. the fair value of the puttable instruments. This can result in the entire market capitalisation of an entity being recognised as a liability. Such an entity is likely to report negative net assets, because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

4 Issues similar to those raised by constituents relating to the classification of financial instruments puttable at fair value also apply to the classification of ordinary shares in a limited life entity. The entity is obliged to liquidate because it has a limited life. Therefore, FRS 32 requires these shares to be classified as financial liabilities because the entity has an obligation to transfer cash or another financial asset to the shareholders. Hence, a limited life entity would have no equity. Similar issues also apply to some partnerships that are required to liquidate upon the exit of a partner (e.g. on retirement or death).

5 The objective of this Exposure Draft is to develop a limited scope, short-term solution to improve the financial reporting of financial instruments puttable at fair value and instruments with obligations arising on liquidation that have characteristics similar to ordinary shares, pending the outcome of a longer-term project on liabilities and equity.

Features of this Exposure Draft

6 The Exposure Draft proposes amendments that would require:

(a) a financial instrument puttable at fair value to be classified as equity, provided specified criteria are met;

(b) an instrument that imposes an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation to be classified as equity, provided specified criteria are met;

(c) disclosures about

(i) financial instruments puttable at fair value classified as equity, including the fair values of these instruments; and

(ii) the reclassification of financial instruments puttable at fair value and instruments with obligations arising on liquidation between financial liabilities and equity; and

(d) these amendments to be applied in annual periods beginning on or after a date to be determined after exposure, with early adoption encouraged. These amendments are to be applied retrospectively (with one exception permitted relating to compound instruments).

Invitation to Comment

CCDG invites comments on the amendments to FRS 32 and FRS 1 proposed in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated;

(b) indicate the specific paragraph or group of paragraphs to which they relate;

(c) contain a clear rationale; and

(d) include any alternative for consideration, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional issues that, in their view, warrant consideration.

CCDG is not requesting comments on matters in FRS 32 and FRS 1 not addressed in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than **23 September 2006**.

Question 1 – Financial instruments puttable at fair value

The Exposure Draft proposes that financial instruments puttable at fair value should be classified as equity, provided that specified criteria are met.

Do you agree that it is appropriate to classify as equity financial instruments puttable at fair value? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification of financial instruments puttable at fair value, why?

Question 2 – Obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation

The Exposure Draft proposes that an instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation should be classified as equity, provided that specified criteria are met (e.g. ordinary shares issued by a limited life entity).

Do you agree that it is appropriate to classify as equity these types of instruments? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification for these types of instruments, why?

Question 3 – Disclosures

The Exposure Draft proposes disclosures about financial instruments puttable at fair value classified as equity, including the fair values of these instruments, and the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity.

(a) Do you agree that it is appropriate to require additional information about financial instruments puttable at fair value classified as equity, including the fair values of these instruments? If so, do you agree that the fair value disclosures should be required at every reporting date? If not, why? What changes do you propose, and why?

(b) Do you agree that it is appropriate to require disclosure of information about the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity? If not, why? What changes do you propose, and why?

Question 4 – Effective date and transition

The proposed changes would be required to be applied retrospectively, from a date to be determined after exposure (with one exception permitted relating to compound instruments). Earlier application would be encouraged.

Are the transition provisions appropriate? If not, what do you propose, and why?

Proposed Amendments to FRS 32
Financial Instruments: Presentation

In the Introduction to FRS 32, the footnote to paragraph IN1 and paragraphs IN6, IN7 and IN10 are amended (new text is underlined and deleted text is struck through). Paragraphs IN1–IN5, IN8, IN9 and IN11 are included here for convenience but are not amended.

Introduction

Reasons for revising FRS 32

IN1 Financial Reporting Standard 32 *Financial Instruments: Disclosure and Presentation* (FRS 32)[1] replaces FRS 32 *Financial Instruments: Disclosure and Presentation* (issued in 2003), and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is permitted. The Standard also replaces the following Interpretations and draft Interpretation[2]:

- INT FRS 5 *Classification of Financial Instruments—Contingent Settlement Provisions*;
- INT FRS 16 *Share Capital—Reacquired Own Equity Instruments (Treasury Shares)*;
- INT FRS 17 *Equity—Costs of an Equity Transaction*; and
- Draft ED/INT 31 *Financial Instruments—Instruments or Rights Redeemable by the Holder*.

IN2 This revised FRS 32 was part of the project to improve FRS 32 and FRS 39 *Financial Instruments: Recognition and Measurement*. The objective of the project was to reduce complexity by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of the Interpretations of FRS and FRS 39 implementation guidance.

IN3 For FRS 32, the main objective was a limited revision to provide additional guidance on selected matters—such as the measurement of the components of a compound financial instrument on initial recognition, and the classification of derivatives based on an entity's own shares—and to locate all disclosures relating to financial instruments in one Standard.[*] The fundamental approach to the presentation and disclosure of financial instruments contained in FRS 32 was not considered.

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[1] This Introduction refers to FRS 32 as revised in July 2004. In January 2006, FRS 32 was amended by relocating all disclosures relating to financial instruments to FRS 107 *Financial Instruments: Disclosures*. Also, in [month and year to be inserted], FRS 32 was amended by requiring particular types of financial instruments (e.g. financial instruments puttable at fair value) to be classified as equity, provided that specified conditions are met.

[2] The draft Interpretation was previously issued by the Institute of Certified Public Accountants of Singapore.

[*] All disclosures relating to financial instruments had been relocated to FRS 107 *Financial Instruments: Disclosures*.

The main changes

IN4 The main changes from the previous version of FRS 32 are described below.

Scope

IN5 The scope of FRS 32 has, where appropriate, been conformed to the scope of FRS 39.

Principle

IN6 In summary, when an issuer determines whether a financial instrument is a financial liability or an equity instrument, the instrument is an equity instrument if, and only if, both conditions (a) and (b) are met.

(a) The instrument includes no contractual obligation either~~:~~

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

~~(ii)~~ to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer~~;~~. For this purpose, a contractual obligation does not include:

(i) an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, provided that all financial instruments (or components of financial instruments) in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation; or

(ii) an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity are financial instruments puttable at fair value.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, the issuer's own equity instruments do not include financial instruments puttable at fair value, instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, or instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

IN7 In addition, when an issuer has an obligation to purchase its own shares for cash or another financial asset, there is a liability for the amount that the issuer is obliged to pay (except when that obligation is excluded from the definition of a financial liability).

IN8 The definitions of a financial asset and a financial liability, and the description of an equity instrument, are amended consistently with this principle.

Classification of contracts settled in an entity's own equity instruments

IN9 The classification of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments has been clarified consistently with the principle in paragraph IN6 above. In particular, when an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (e.g. a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability.

Puttable instruments

IN10 FRS 32 incorporates the guidance previously proposed in draft ED/INT 31 *Financial Instruments—Instruments or Rights Redeemable by the Holder*. Consequently, a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability of the issuer (with one exception, which relates to financial instruments puttable at fair value). In response to comments received on the Exposure Draft, the Standard provides additional guidance and illustrative examples for entities that, because of this requirement, have no equity or whose share capital is not equity as defined in FRS 32.

Contingent settlement provisions

IN11 FRS 32 incorporates the conclusion previously in INT FRS 5 *Classification of Financial Instruments—Contingent Settlement Provisions* that a financial instrument is a financial liability when the manner of settlement depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder. Contingent settlement provisions are ignored when they apply only in the event of liquidation of the issuer or are not genuine.

In the Standard, paragraph 11 is amended (new text is underlined and deleted text is struck through). In paragraph 11, the definitions of a financial asset and a financial liability are amended, and two new definitions are added immediately after the definition of fair value. The definitions of a financial instrument, an equity instrument and fair value are included here for convenience but are not amended.

Financial Reporting Standard 32
Financial Instruments: Presentation

Definitions (see also paragraphs AG3–AG24)

11 The following terms are used in this Standard with the meanings specified:

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

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

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

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include financial instruments puttable at fair value, instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that ~~is:~~ meets either of the following conditions.

(a) It is a contractual obligation~~:~~ either

~~(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~~;~~. For this purpose, a contractual obligation does not include:

(i) an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, provided that all financial

instruments (or components of financial instruments) in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation; or

(ii) **an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the most subordinated class of instruments with a claim to the assets of the entity are financial instruments puttable at fair value.** ~~or~~

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

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include financial instruments puttable at fair value, instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

***Fair value* is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

A *financial instrument puttable at fair value* has all of the following features:

(a) its issue price is the fair value of the instrument holder's entitlement to a pro rata share of the net assets of the entity;

(b) it entitles the holder to require the entity to repurchase or redeem the instrument for the fair value of a pro rata share of the net assets of the entity;

(c) it entitles the holder to a pro rata share of the net assets of the entity in the event of the liquidation of the entity; and

(d) other than a contractual obligation that arises from the entitlement set out in (b) and a contractual obligation that may arise from the entitlement set out in (c), it does not contain a contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

A financial instrument that entitles the holder to a *pro rata share of the net assets of the entity* has all of the following features:

(a) the financial instrument is in the most subordinated class of financial instruments with a claim to the assets of the entity. The claims of a financial instrument with this entitlement have no priority over other claims to the assets of the entity, in terms of either the calculation of the amount due on liquidation or the timing of payment of that amount. A financial instrument that must be

converted into another instrument to be in the most subordinated class of financial instruments does not possess this feature.

(b) **the financial instrument is entitled to a proportionate share of the residual interest in the assets of the entity that remains after deducting all other claims to the assets of the entity. A proportionate share is one that is determined by:**

  (i) **dividing the total amount of the residual interest in the assets of the entity into units of equal amount; and**

  (ii) **multiplying that unit amount by the ratio of the number of the units held by the financial instrument holder to the total number of units.**

(c) **the financial instrument does not contain any preferential right upon liquidation of the entity.**

(d) **the financial instrument's right to a pro rata share of the net assets of the entity is neither limited nor guaranteed, to any extent, before or at liquidation, through the terms and conditions of either (i) the instrument, (ii) another financial instrument issued by the entity (to either the instrument holder or another party), or (iii) a related contract between the entity and the instrument holder.**

Paragraph 16 is amended (new text is underlined and deleted text is struck through). After paragraph 16, paragraph 16A is inserted. Paragraph 15 is included here for convenience but is not amended.

Presentation

Liabilities and equity (see also paragraphs AG25–AG29)

15 **The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.**

16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation~~:~~ either

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

  ~~(ii)~~ to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer. For this purpose, a contractual obligation does not include:

  (i) an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, provided that all financial instruments (or components of financial instruments) in the most subordinated class of instruments with a claim to the assets of the entity impose such an obligation; or

  (ii) an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the most subordinated class

of instruments with a claim to the assets of the entity are financial instruments puttable at fair value.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments specified in paragraph 16A, or instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

16A A financial instrument puttable at fair value and a financial instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation are classified as equity when these instruments meet the specified criteria for exclusion from the definition of a financial liability (see subparagraphs (a)(i) and (ii) of the definition of a financial liability in paragraph 11).

Paragraphs 17–19 are amended (new text is underlined and deleted text is struck through). After paragraph 17, paragraph 17A is inserted. Paragraph 20 is included here for convenience but is not amended.

No contractual obligation to deliver cash or another financial asset (paragraph 16(a))

17 Except as stated in paragraph 17A, a~~A~~ critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

17A However, for the purposes of this Standard, a 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) does not include those specifically excluded from the definition of a financial liability (see subparagraphs (a)(i) and (ii) of the definition of a financial liability in paragraph 11).

18 The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

(a) 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.

(b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability (except as stated in paragraph 16A). This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease~~, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer~~. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability (except as stated in paragraph 16A). For example, open-ended mutual funds, unit trusts, partnerships and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash ~~equal to their proportionate share of the asset value of the issuer~~, which results in the unitholders' or members' interests being classified as financial liabilities (except as stated in paragraph 16A). However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no contributed equity (such as some mutual funds and unit trusts, see Illustrative Example 7) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not (see Illustrative Example 8).

19 If an entity does not have 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 (except as stated in paragraph 17A). For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

20 A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

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

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21).

Paragraphs 22 and 23 are amended (new text is underlined and deleted text is struck through). After paragraph 22, paragraph 22A is inserted. Paragraphs 21 and 24 are included here for convenience but are not amended.

Settlement in the entity's own equity instruments (paragraph 16(b))

21 A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (e.g. an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100,[*] and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

22 Except as stated in paragraph 22A, a~~A~~ contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

22A If the entity's own equity instruments to be (received or) delivered by the entity upon settlement of a derivative are financial instruments puttable at fair value, or instruments that impose on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, the derivative is a (financial asset or) financial liability. This includes a derivative that will be settled by the entity (receiving or) delivering a fixed number of such equity instruments in exchange for a fixed amount of cash or another financial asset.

23 Except as stated in paragraph 16A, a~~A~~ contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under FRS 39, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with FRS 39. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (e.g. a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

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[*] In this Standard, monetary amounts are denominated in 'currency units' (CU).

24 A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold.

After paragraph 25, a heading and paragraph 25A are added. Paragraph 25 is included for convenience but is not amended.

Contingent settlement provisions

25 A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

Settlement on liquidation of the entity

25A Typically, a financial instrument that entitles the holder to a pro rata share of the net assets of the entity on liquidation of the entity does not impose an obligation on the entity to deliver cash or another financial asset of the entity (or otherwise to settle it in such a way that it would be a financial liability) because the entity is not obliged to liquidate. However, in some cases, an entity may be obliged to liquidate (e.g. the entity may be required to liquidate at the end of a fixed period or the instrument holder may have the ability to require the entity to liquidate). Instruments, or components of instruments, in the most subordinated class of instruments issued by an entity that must be liquidated at the end of a fixed period are not precluded from being classified as equity solely because the entity has an obligation to pay the holders of those instruments a pro rata share of its net assets on liquidation. Similarly, instruments, or components of instruments, are not precluded from being classified as equity solely because the holder, in common with all other holders of financial instruments in the most subordinated class of instruments with a claim to the assets of the entity, can require the entity to liquidate and pay the holder a pro rata share of the net assets of the entity (see paragraph 16A).

After paragraph 96, paragraph 96A is inserted and after paragraph 97, paragraph 97A is inserted. Paragraph 97 is included here for reference but is not amended.

96A ***Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*** **(Amendments to FRS 32 and FRS 1), issued in [date to be inserted after exposure], amended the definition of a financial liability and a financial asset, and included new definitions for a financial instrument puttable at fair value and a financial instrument that entitles the holder to a pro rata share of the net assets of the entity in paragraph 11, amended paragraphs 16, 17–19, 22, 23, AG13, AG14 and AG27, and inserted paragraphs 16A, 17A, 22A, 25A, 97A, AG14A–AG14G and AG29A. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is encouraged. If an entity applies these changes for an**

earlier period, it shall disclose that fact and apply the related amendments to FRS 1 and FRS 39 at the same time.

97 This Standard shall be applied retrospectively.

97A When applying the amendments described in paragraph 96A, an entity is required to split a compound financial instrument with an obligation for a pro rata share of the net assets of the entity upon its liquidation into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of those amendments to FRS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, an entity need not separate these two portions if the liability component is no longer outstanding at the date of application of the amendments.

In the Appendix *Application Guidance*, paragraphs AG13 and AG14 are amended (new text is underlined). After paragraph AG14, a heading, paragraphs AG14A–AG14C, another heading and paragraphs AG14D–AG14G are added.

Appendix
Application Guidance

Definitions (paragraphs 11–14)

Equity instruments

AG13 Examples of equity instruments include non-puttable ordinary shares, some types of preference shares (see paragraphs AG25 and AG26), some financial instruments puttable at fair value (see paragraph 16A) and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. An entity's obligation to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity (except as stated in paragraph 22A). However, if such a contract contains an obligation for the entity to pay cash or another financial asset (other than a contractual obligation of the type that is excluded from the definition of a financial liability), it also gives rise to a liability for the present value of the redemption amount (see paragraph AG27(a)). An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

AG14 A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is not a financial asset of the entity (except as stated in paragraph 22A). Instead, any consideration paid for such a contract is deducted from equity.

Financial instruments puttable at fair value

AG14A For a financial instrument to be a financial instrument puttable at fair value, the issue price received, or the redemption or repurchase price paid by the entity for the financial instrument is its fair value, determined in accordance with the requirements of FRS 39 paragraph 48A and paragraphs AG69–AG82. However, entities that

(a) have not filed, or are not in the process of filing, their financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or

(b) do not hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity,

are permitted to use a formula to determine the fair value of financial instruments puttable at fair value on their issue, redemption or repurchase, provided that the formula is intended to approximate the fair value of the financial instruments. The instrument's pro rata share of the book value of the net assets of the entity is a formula that would approximate the fair value of the instrument only when there is no material difference between the book value of the entity's net assets and the fair value of its net assets (both recognised and unrecognised). An entity may change the basis of determining the fair value of financial instruments puttable at fair value if, and only if, the change results in an estimate that is more representative of the fair value of the financial instruments puttable at fair value in the circumstances.

AG14B One feature of a financial instrument puttable at fair value is that its issue price must be the fair value of its pro rata share of the net assets of the entity. Financial instruments puttable at fair value are issued at fair value only if the fair value of the consideration received equals the fair value of the instruments issued. For example, an entity may issue a convertible bond, which is convertible into the entity's ordinary shares that are puttable at fair value. Upon conversion, the fair value of the convertible bond tendered in exchange for the puttable shares will reflect both the fair value of the option and the fair value of the bond. Hence, typically the fair value of the convertible bond will equal the fair value of the puttable shares. If so, the puttable shares are issued at fair value for the purposes of determining whether those shares meet the definition of a financial instrument puttable at fair value.

AG14C In the case of the convertible bond described in paragraph AG14B, FRS 32 requires the option embedded in the bond to be recognised separately from the host instrument (bond). Typically, the option embedded in a convertible bond would be accounted for as an equity instrument and not remeasured. However, in the case of an option on a financial instrument puttable at fair value, the embedded option is a derivative and, consistently with the treatment of all derivatives on financial instruments puttable at fair value, is classified as a financial liability. Therefore, the option shall be measured at fair value at each balance sheet date and on the date of conversion in accordance with FRS 39.

Financial instruments that entitle the holders to a pro rata share of the net assets of the entity

AG14D One feature of a financial instrument that entitles the holder to a pro rata share of the net assets of the entity is that the financial instrument is in the most subordinated class of instruments with a claim to the assets of the entity. A financial instrument is in the most subordinated class of financial instruments if, and only if, on liquidation the amount due to the holders of the financial instruments is calculated after deducting all other claims to the assets of the entity and the instrument holders are paid out last, after payments are made to all other claimants to the assets of the entity.

AG14E When determining whether an instrument is in the most subordinated class, an instrument's claim on liquidation is evaluated as if the entity were to liquidate on the date the classification decision for the instrument in question is made (the assessment date). The classification decision shall be reassessed if there is a change in circumstances relevant to the classification of the financial instrument. For example, if the entity issues or redeems another financial instrument, this may affect whether the instrument in question is in the most subordinated class.

AG14F An instrument that has a preferential right on liquidation of the entity is not an instrument with an entitlement to a pro rata share of the net assets of the entity. 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 net assets of the entity, when other instruments in the most subordinated class with a right to a pro rata share of the net assets of the entity do not have the same right on liquidation.

AG14G For an instrument to have an entitlement to a pro rata share of the net assets of the entity, the terms and conditions of the instrument shall not, to any extent, have the effect of providing the instrument holder with an entitlement to a pro rata share of the entity's net assets that:

(a) is a fixed or specified amount;

(b) changes over time, so as to provide the instrument holder with a fixed or specified amount; or

(c) is unaffected by changes in the value of the net assets of the entity.

Similarly, if terms and conditions that have these effects are included in another instrument issued by the entity (either to the instrument holder or another party), or in a related contract between the entity and the instrument holder, the instrument does not have an entitlement to a pro rata share of the net assets of the entity.

Paragraph AG27 is amended (new text is underlined) and after paragraph AG29, paragraph AG29A is added. Paragraphs AG25, AG26, AG28 and AG29 are included here for convenience but are not amended.

Presentation

Liabilities and equity (paragraphs 15–27)

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

AG25 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

AG26 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

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

AG27 The following examples illustrate how to classify different types of contracts on an entity's own equity instruments:

(a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity (except as stated in paragraph 22A). One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount (except as stated in paragraph 16A). One example is an entity's obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.

(b) An entity's obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem (except as stated in paragraph 16A). One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.

(c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity (except as stated in paragraph 16A). One example is a net cash-settled share option.

(d) A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (e.g. a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent settlement provisions (paragraph 25)

AG28 Paragraph 25 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Treatment in consolidated financial statements

AG29 In consolidated financial statements, an entity presents minority interests—i.e. the interests of other parties in the equity and income of its subsidiaries—in accordance with FRS 1 *Presentation of Financial Statements* and FRS 27 *Consolidated and Separate Financial Statements*. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues

a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

AG29A The definition of a financial liability excludes some contractual obligations (provided the specified conditions are met) that oblige the entity to deliver to another party a pro rata share of the net assets of the entity upon its liquidation (or upon redemption or repurchase of a financial instrument puttable at fair value). One of the features of a financial instrument that entitles the holder to a pro rata share of the net assets of the entity is that the instrument is in the most subordinated class of financial instruments with a claim to the assets of the entity. In the consolidated financial statements, the financial instruments held by minority interests are not in the group's most subordinated class of instruments. This is because, if the group were to liquidate, the claims of minority interest holders to the net assets of the subsidiary have to be satisfied before the parent's share of the net assets of the subsidiary can be distributed to claimants to the assets of the parent. Therefore, in all cases, a contractual obligation of the group to deliver cash or another financial asset to a minority interest holder (or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the group) is classified as a financial liability in the consolidated financial statements.

In the Illustrative Examples, paragraph IE1 is amended (new text is underlined).

Illustrative Examples

Accounting for contracts on equity instruments of an entity

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

In Example 8, paragraph IE33 is amended (new text is underlined).

Example 8: Entities with some equity

IE33 The following example illustrates an income statement and balance sheet format that may be used by entities whose share capital is not equity as defined in FRS 32 because the entity has an obligation to repay the share capital on demand at a fixed price. Other formats are possible.

Income statement for the year ended 31 December 20X1

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

Balance sheet at 31 December 20X1

		20X1		**20X0**
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with FRS 1)	908		830	
Total non-current assets		908		830
Current assets (classified in accordance with FRS 1)	383		350	
Total current assets		383		350
Total assets		1,291		1,180
LIABILITIES				
Current liabilities (classified in accordance with FRS 1)	372		338	
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 FRS 1)	187		196	
		(187)		(196)

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

RESERVES[a]

Reserves e.g. revaluation reserve, retained earnings etc	530		485	
		530		485
		717		681

MEMORANDUM NOTE – Total members' interests

Share capital repayable on demand	202	161
Reserves	530	485
	732	646

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

Proposed Amendments to FRS 1
Presentation of Financial Statements

In the Standard, after paragraph 11, paragraph 11A is inserted as follows:

11A The following terms are defined in paragraph 11 of FRS 32 *Financial Instruments: Presentation* and are used in this Standard with the meaning specified in FRS 32:

- financial instrument puttable at fair value
- a financial instrument that entitles the holder to a pro rata share of the net assets of the entity.

After paragraph 75, paragraph 75A is inserted as follows:

75A If an entity has reclassified:

(a) a financial instrument puttable at fair value; or

(b) an instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation;

between financial liabilities and equity, it shall disclose the amount reclassified into and out of each category (financial liabilities or equity), and the timing and reason for that reclassification.

After paragraph 124C, a new heading and paragraphs 124D and 124E are inserted as follows. Paragraph 126 is amended (new text is underlined and deleted text is struck through). Paragraph 125 is not amended but is included here for convenience.

Financial instruments puttable at fair value

124D For financial instruments puttable at fair value classified as equity, an entity shall disclose (to the extent not disclosed elsewhere):

(a) summary quantitative data about the amount classified as equity;

(b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

(c) the fair value of that class of financial instruments in a way that permits it to be compared with its carrying amount; and

(d) information about how fair value was determined, consistently with the requirements of FRS 107 *Financial Instruments: Disclosures* paragraph 27(a)–(c), to the extent applicable.

124E If an entity uses a formula to determine the price received or paid by the entity upon issue, redemption or repurchase of financial instruments puttable at fair value that are classified as equity (as permitted by paragraph AG14A of FRS 32), it shall:

(a) disclose that fact; and

(b) use that formula, and disclose information about the formula, for the purposes of complying with paragraph 124D(c) and (d).

Other disclosures

125 An entity shall disclose in the notes:

(a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to equity holders during the period, and the related amount per share; and

(b) the amount of any cumulative preference dividends not recognised.

126 An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

(a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);

(b) a description of the nature of the entity's operations and its principal activities; ~~and~~

(c) the name of the parent and the ultimate parent of the group~~.~~<u>; and</u>

<u>(d) if it is a limited life entity, information regarding the length of its life.</u>

After paragraph 127B, paragraph 127C is inserted as follows:

127C ***Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*** **(Amendments to FRS 32 and FRS 1), issued in [date to be inserted after exposure], amended paragraph 126 and inserted paragraphs 11A, 75A, 124D and 124E. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to FRS 32 and FRS 39.**

Appendix
Amendments to other FRS

The amendments in this appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies the [draft] amendments to FRS 32 and FRS 1 for an earlier period, these amendments shall be applied for that earlier period. In the amended paragraphs, new text is underlined and deleted text is struck through.

1 FRS 39 *Financial Instruments: Recognition and Measurement* is amended as described below.

Paragraph 2 is amended as follows:

Scope

2 **This Standard shall be applied by all entities to all types of financial instruments except:**

…

(d) financial instruments issued by the entity that meet the definition of an equity instrument in FRS 32 (including options ~~and~~, warrants and the instruments specified in paragraph 16A of FRS 32). However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.

…