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Project	Conceptual Framework		
Paper topic	Draft Discussion paper Elements of financial statements: definition of equity and distinction between liabilities and equity instruments		
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This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

What does this section cover?

This section discusses:

- How should the conceptual framework define equity?
- Should the definition of a liability be used to distinguish liabilities from equity instruments?

Why is this section important? What problems will this section help address?

This section addresses the following problems with the treatment of equity instruments and with the distinction between liabilities and equity instruments:

- Financial statements do not show users clearly how higher ranking equity instruments affect possible future cash flows to users.
- Existing IFRSs do not apply the definition of a liability consistently in distinguishing financial liabilities from equity instruments.
  - The exceptions are complex, difficult to understand and difficult to apply, and cause many requests for interpretations.
  - Inconsistency makes financial statements less understandable, and creates opportunities for structuring.

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What are the IASB's preliminary views?

- An entity should remeasure at the end of each reporting period each class of equity claim, other than the existing holdings of the most residual claims.
- An entity should recognise those remeasurements in the statement of changes in equity, as a transfer of wealth between classes of equity claim.
- Obligations to issue equity instruments are not liabilities.
- Obligations that will arise only on liquidation of the reporting entity are not liabilities.
- If an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity instrument, with suitable disclosure. Identifying whether to use such an approach, and if so when, would still be a standards level decision.

Definition of equity

1. The existing framework defines equity as the residual interest in the assets of the entity after deducting all its liabilities.[1] This paper proposes no change to that definition.
2. This paper uses the following terms for convenience, without defining them formally:
   (a) equity claim: a claim that:
      (i) may enable the holder to receive distributions of equity, or
      (ii) may permit or require the holder to receive or deliver an equity instrument
   (b) equity instrument: an issued financial instrument that creates equity claims but creates no liability.
3. Examples of equity instruments:
   (a) Equity instruments that may enable the holder to receive distributions of equity:
      (i) Ordinary shares

[1] 4.4(c)

(ii) Other classes of shares (eg preferred, deferred)

(iii) Non-controlling interests (NCI) in a subsidiary

(b) Equity instruments that may permit or require the holder to receive or deliver another equity instrument:

(i) Forward contracts to buy an entity's own shares

(ii) Options to buy or sell an entity's own shares

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

5. The rest of this section discusses:

(a) Classes of equity (paragraphs 6-11)

(b) Measuring equity claims (paragraph 12)

(c) Non-controlling interests (paragraph 13)

(d) Distinguishing liabilities from equity instruments (paragraphs 14-41)

Classes of equity

6. Existing and potential investors need information to help them assess the prospects for future net cash inflows to an entity.[2] In addition, information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against it.[3] In other words, (existing and potential) investors need information about both:

(a) the future net cash inflows to the entity; and

(b) the claims on those net cash inflows.

7. Some believe that the best way to provide that information is to define equity instruments narrowly to include only existing holders of the most residual class of

[2] OB3

[3] OB13

equity instrument. However, that approach would treat as liabilities many instruments that do not create an obligation to transfer economic resources. Users need information about both:

(a) future outflows of cash or other economic resources from the entity, and

(b) the effect on the user's investment of prior claims on the cash flows that support that investment.

8. Thus, this paper proposes a different approach: an entity should provide the information that investors need as follows:

(a) information to help investors assess the amount timing and uncertainty of future net cash inflows to the entity: in the statements of financial position, comprehensive income and cash flows, and in the notes.

(b) information about the claims on those net cash inflows: in the statement of changes in equity. This statement, with related notes, should be designed in a way to enable equity holders to understand:

(i) the claims of all higher ranking equity holders (equity holders with a higher claim on the entity's total equity); and

(ii) the changes during the period in those claims.

9. This could be achieved by designing the statement in the following way:

(a) An entity would remeasure at the end of each period each class of instrument, other than the most residual class. Paragraph 12 discusses what measures might be appropriate for this purpose. An entity would not remeasure the most residual class, because that would require a measurement of the entity as a whole, which is not the purpose of general purpose financial statements.

(b) Remeasurements would result in transfers between the amounts attributed to different classes of equity. These represent transfers of wealth between those classes.

(c) The statement of changes in equity would display a separate column for each class of equity instrument.

(d) If equity includes different components, such as share capital or reserves, the entity would allocate those components to classes of

equity on a basis consistent with legal and other requirements governing the entity. In many cases, such components would be allocated to the most residual class of equity (eg existing holders of ordinary shares).

10. Remeasuring equity claims would be a new feature of IFRSs. Many commentators have stated that IFRSs do not currently remeasure equity instruments. That is only partly true:

    (a) IFRSs do not permit entities to remeasure items classified as equity instruments *through profit or loss*. There is no existing obstacle to remeasuring equity instruments through equity (and reporting those remeasurements in the statement of changes in equity).

    (b) IFRSs require entities to remeasure non-controlling interests (NCI) to reflect NCI's share in profit or loss, in other comprehensive income and in other equity movements.

11. Introducing a *requirement* to remeasure equity claims through the statement of changes in equity would bring a new feature into IFRSs. It would achieve two objectives:

    (a) It would give equity holders a clearer and more systematic view of how other equity claims affect them.

    (b) As discussed later, starting at paragraph 14, it would provide a way to resolve some liability/equity classification issues that have proved problematic over the years.

Measuring equity claims

12. The IASB would need to decide at a standards level what measure to use for particular classes of instruments, considering how best to convey how the claims of that class affect the holders of other classes that rank below (are subordinated to) that class. For example, the IASB might decide:

    (a) to use amortised cost if the claims of that class result, in total, in a fixed payout at a fixed date.

    (b) to use fair value:

(i) if the claims of that class result in payout that is highly variable.

(ii) if the claims of that class result from an option.

(iii) if users would be likely to value the most residual class of shares by valuing the entity as a whole and then subtracting the fair value of higher ranking equity claims.

(c) To use an allocation of the underlying net assets if another measure would result in a significant inconsistency with the measure of the underlying net assets. For example, this basis is used currently for non-controlling interests.

Non-controlling interests

13. The approach described in paragraphs 8-9 is largely consistent with, and an extension of, the way that IFRSs treat non-controlling interest (NCI) in a subsidiary. NCI does not meet the existing or proposed definition of a liability, because the entity has no obligation to transfer economic resources. Therefore, IFRSs treat NCI as part of equity, not as a liability. IAS 1 already requires entities to display prominently the NCI's share in equity, in profit or loss and in comprehensive income. An entity would display NCI as a separate column in the statement of changes in equity. The treatment proposed in paragraph 8-9 would extend that requirement for a prominent display to all other categories of equity instrument, other than the most junior.

Distinguishing liabilities from equity instruments

14. This section discusses how to apply the definitions of a liability and of equity in distinguishing between liabilities and equity instruments. This distinction has several effects:

(a) These two categories are classified separately in the statement of financial position. If distinguished strictly in accordance with the framework's definition of a liability, the classification will distinguish those items that oblige the entity to deliver cash or other economic resources from those items that create no such obligation.

(b) The statement of comprehensive income:

   (i) includes income and expense arising from financial liabilities (interest and, if applicable, remeasurement and gain or loss on settlement)

   (ii) does not report as income or expense the changes, if any, in the carrying amount of the entity's own equity instruments.

   (iii) includes expenses arising from services acquired in exchange for financial liabilities or equity instruments (IFRS 2 *Share-based payment*).

(c) In the statement of financial position:

   (i) the carrying amount of financial liabilities changes over time, because of the passage of time (and other factors, if the liability is measured at fair value).

   (ii) the amount reported for equity instruments does not typically change after initial recognition (except for NCI).

(d) The statement of changes in equity:

   (i) Includes changes in the carrying amount of liabilities implicitly (because it includes comprehensive income). Thus it shows, albeit implicitly, how those liabilities affect the cash flows to equity holders.

   (ii) Shows NCI's share of comprehensive income and NCI's interest in recognised net assets.

   (iii) Does not currently show how changes in the value of each class of equity (other than NCI) affect the value of, or possible cash flows to, more subordinated classes of equity. Thus, it does not currently show wealth transfers between different classes of equity holder.

15. The distinction between financial liabilities and equity instruments is currently governed by IAS 32 *Financial Instruments: Presentation* and by IFRS 2 *Share-based Payment*. In both standards, the starting point is to determine whether the entity has an obligation to transfer economic resources, but there are exceptions to that basic principle. The following table summarises the approaches.

Table 1 Summary of classification under IAS 32 and IFRS 2
The following summary is highly condensed.

	IAS 32	*IFRS 2*
Liabilities	• obligation to deliver cash or another financial asset[4] • obligation (in a derivative or non-derivative) to deliver a variable number of the entity's own equity instruments • obligation (in a derivative only) that may or must be settled by exchanging a fixed number of the entity's own equity instruments for a variable amount of cash or other financial assets • derivative obligation that allows either the holder or issuer to elect whether the holder is to settle in cash or in shares	• obligation to transfer cash or other assets
Equity	• no obligation to deliver cash or other financial assets (and none of the above features present) • put option in a puttable instrument that entitles the holder to a pro rata share of net assets on liquidation, or earlier repurchase • obligation to deliver a pro rata share of net assets only on liquidation of the entity • derivative that must be settled by exchanging a fixed number of the entity's own equity instruments for a fixed amount of cash or other financial assets	• no obligation to transfer cash or other assets • no obligation for the entity at all because another group entity or other related party will settle the obligation

[4] or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable

16. As the above summary shows, the distinction in IFRS 2 (between cash-settled and equity-settled share-based payment transactions) relies almost entirely on the conceptual framework's definition of a liability. IFRS 2 makes one adjustment to that definition, to address transactions for which the obligation rests with another group entity or other related party. In contrast, IAS 32 overrides that definition with complex exceptions for:

    (a) some obligations that require an entity to deliver its own equity instruments, or that permit an entity to elect to deliver its own equity instruments instead of delivering cash or other economic resources (see paragraphs 20-37)

    (b) some puttable instruments (paragraphs 38-41)

    (c) some obligations payable on liquidation. As noted in agenda paper 3C, this draft discussion paper proposes that no liability (ie no present obligation to transfer economic resources) results from payments that would arise only on liquidation, even if the reporting entity has a pre-determined limited life (or even if another party can compel liquidation).

17. In their project on financial instruments with characteristics of equity (FICE), suspended in 2010, the IASB and the US Financial Accounting Standards Board (FASB) tentatively adopted an approach that classifies, as IAS 32 does:

    (a) some instruments as equity instruments, even though they create obligations to transfer economic resources.

    (b) some other instruments as financial liabilities, even though they create no obligations to transfer economic resources.

18. Thus, both IAS 32 and the FICE project started with the definition of a liability and overrode it with several exceptions. Such approaches have significant disadvantages:

    (a) The exceptions are complex, difficult to understand and difficult to apply, as evidenced by a stream of requests for interpretations.

(b) Inconsistency with the definitions in the conceptual framework makes financial statements less internally consistent, and as a result, less understandable.

(c) Inconsistencies in approach may create opportunities to structure transactions to achieve a more favourable accounting result without changing the economics of a transaction significantly.

(d) The approach is inconsistent with the approach used for share-based payment in IFRS 2. This creates further opportunities for lack of comparability and for structuring, and makes it more important to establish whether particular obligations are within the scope of IAS 32 or within the scope of IFRS 2.

(e) Further inconsistencies arise because under IFRS 2, cash -settled transactions are remeasured but equity-settled transactions are not remeasured. This puts pressure on the distinction between these two types of settlement, and means that investors receive different information about the effect of these transactions on their own investments, depending on the form of settlement.

19. The following paragraphs discuss whether there is a conceptual basis underlying the exceptions developed in IAS 32 and the FICE project, and whether those exceptions indicate a need to amend the conceptual framework. Paragraphs 20-37 discuss obligations to deliver equity instruments and paragraphs 38-41 discuss puttable instruments.

Obligations to deliver equity instruments (equity claims)

20. An equity instrument is not an obligation of the issuer. Accordingly, an obligation for an entity to deliver its own equity instruments is not an obligation to deliver economic resources. Hence, it does not meet the current or proposed definition of a liability. Such an obligation is one form of 'equity claim', as defined informally in paragraph 2(a).

21. IAS 32 classifies some equity claims as liabilities and others as equity instruments. It classifies them as liabilities if an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of

shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price). The *Basis for Conclusions* on IAS 32 explains that the IASB adopted this approach for the following reasons:

(a) Because the entity has an obligation for a specified amount rather than a specified equity interest. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and the entity may not even know whether it will receive its own shares or deliver them.

(b) Precluding equity treatment for such a contract limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. For example, the IASB believed that an entity should not obtain equity treatment for a transaction simply by including a share settlement clause when the contract is for a specified value, rather than a specified equity interest.

22. This paper identifies two ways to simplify the distinction between liabilities and equity, a one-step approach and a two-step approach. The one step approach would:

(a) Classify as equity only current and future holders of the most residual existing class of equity instrument issued by the parent.

(b) Classify as liabilities all other instruments, such as:

(i) instruments that create no obligation to transfer assets

(ii) non-controlling interests (NCI)

(iii) forwards and options on the instruments classified as equity by the criterion in (a)).

(c) Recognise interest on all instruments classified as financial liabilities, and all gains and losses on them in profit or loss.

23. The one-step approach underlies some of the exceptions in IAS 32. It depicts the entity directly through the eyes of holders of the most residual existing class of equity, by categorising all prior claims on the entity's net assets as fundamentally different from those residual claims. Among other things, it would be one way to show the similarity between some instruments that have a similar effect on returns

to the most residual class of equity, regardless of whether those instruments create an obligation for an entity to deliver economic resources (assets).

24. In contrast, the two-step approach depicts the entity in two steps. The first step depicts the entity as a whole through the eyes of all providers of capital. It does this by identifying resources, obligations to deliver resources, and changes in those resources and obligations. The second step depicts the entity further through the eyes of the holders of each class of equity claim by identifying prior (higher ranking) equity claims.

25. The two-step approach would:

    (a) classify as liabilities only obligations to deliver economic resources. Thus, the statement of financial position would show the entity's resources and obligations, and the statement of comprehensive income would show changes in those resources and obligations (an entity perspective).

    (b) classify as equity all equity claims, in other words:

        (i) all claims that may enable the holder to receive distributions of equity

        (ii) all obligations to deliver equity instruments.

    (c) as suggested in paragraph 9, remeasure all equity claims, other than the most residual. Thus:

        (i) the equity section of the statement of financial position would show how all equity claims affect other claims.

        (ii) the statement of changes in equity would show wealth transfers between different classes of equity claims.

26. Both the one-step approach and the two-step approach would account in the same way for services acquired in exchange for issuing equity instruments: the services received are an asset; when the entity consumes that asset, it recognises an expense. In many cases, an entity consumes that asset immediately; if so, the

entity recognises the expense at the same time as it recognises the related increase in equity.[5]

27. This paper proposes the two-step approach because it has the following advantages:

    (a) It would provide a clearer, more understandable, more consistent, less complex and more easily implementable distinction between equity and liabilities.

    (b) It is consistent with the existing definition of a liability, and with the existing treatment of non-controlling interest.

    (c) It would separate more clearly two important distinctions:

        (i) Does the entity have an obligation to transfer economic resources?

        (ii) Does an instrument affect the returns to existing holders of the most residual class of equity instrument?

    (d) Remeasurement of all equity claims, other than the most residual, will provide equity holders with clearer and more prominent information about the effects of other equity claims.

    (e) It would eliminate the inconsistency between IAS 32 and IFRS 2.

    (f) It would require remeasurement for all share-based payment, thus removing one source of complexity from IFRS 2.

28. Most of the discussion in this section has focussing on equity claims that result in an obligation to deliver equity instruments. However, similar considerations apply to rights for the entity to claim delivery of its own equity instruments, such as a purchased call option on its own shares or a forward repurchase of its own shares.

29. Appendix A illustrates a one-step approach (as in IAS 32) and a two-step approach.

30. Appendix B summarises how the two-step approach would treat different types of instrument.

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

31. Appendix C summarises the rights and obligations arising under options and forwards on an entity's own shares.

32. In previous work, the IASB considered some other approaches developed by the FASB and discussed in 2008 in the IASB's discussion paper *Financial Instruments with Characteristics of Equity*. Those approaches included approaches labelled as the basic ownership approach, the ownership-settlement approach and the revised expected outcomes approach. The IASB did not find those approaches fruitful and this paper does not discuss them further.

33. In applying the concepts discussed above at a standards level, the IASB might need to address some other issues, including:

    (a) Whether and when to separate single instruments into two or more components, for example whether to separate compound instruments into a liability component and an equity component, as IAS 32 requires in some cases. Similarly, whether to link two or more separate instruments into a single instrument for accounting purposes.

    (b) Whether some obligations within a subsidiary would be reclassified from liability to equity, or vice versa, on consolidation.

    (c) Whether any specific guidance is needed on contractual terms that lack commercial substance, for example an option that is deeply in the money or deeply out of the money, with no genuine possibility that this will change before expiry.

    (d) How to measure written put options on an entity's own shares. Paragraphs 34-37 discuss some things that would need to be considered in deciding how to measure written puts on an entity's shares, and written puts on non-controlling interest.

Measuring written puts on own shares

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

(a) The present value of the redemption amount, the existing requirement in IAS 32.[6] This measure is simple, and conveys information about the possible outflow of economic resources, but it has the following disadvantages:

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

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

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

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

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

(ii) this measure would require estimates of the probabilities, which would require subjective estimates or models. One approach would be to use the probabilities that are implied in a fair value measurement of the entire option.

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

[6] IAS 32 paragraph 23

NCI puts

36. One example of an instrument subject to the requirement noted in paragraph 33 is a written put option that obliges a parent to purchase shares of its subsidiary that are held by a non-controlling-interest shareholder (an NCI put). In May 2012 the IFRIS Interpretations Committee addressed NCI puts in a draft IFRIC interpretation *Put Options Written on Non-controlling Interests*. Under the draft interpretation, changes in the measurement of NCI puts would, in the parent's consolidated financial statements, be recognised in profit or loss. The Interpretations Committee reached that conclusion because it reasoned that changes in the measurement of NCI puts do not change the relative interests of the parent and the non-controlling-interest shareholder and therefore are not equity transactions (ie they are not transactions with owners in their capacity as owners).

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

Puttable instruments

38. IAS 32 requires an entity to classify some puttable instruments as equity instruments, even though they create an obligation to transfer assets, and thus they meet the definition of a financial liability. To summarise some complex and detailed requirements, this applies to financial instruments that:

    (a) give the holders a pro rata residual interest in the entity's net assets, after deducting all its liabilities, but also

    (b) oblige the entity to deliver cash or other assets to the holders on liquidation, or on early redemption at an amount broadly equivalent to that pro rata share.

    Examples of entities that issue such instruments are some cooperative and mutual organisations.

39. The basis for conclusions on IAS 32 provides the following explanation for classifying these puttable instruments as equity instruments:

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

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

(b) Changes in the carrying amount of the liability are recognised in profit or loss. This results in counter-intuitive accounting (if the redemption value is linked to the performance of the entity) because:

(i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss is recognised.

(ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain is recognised.

(c) It is possible, again depending on the basis for which the redemption value is calculated, that the entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

(d) The issuing entity's statement of financial position portrays the entity as wholly, or mostly, debt funded.

(e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not performance.

40. The exception in IAS 32 treats some puttable instruments as if they were equity instruments. This paper suggests that the IASB's reasons for creating that exception are still valid. To reflect that suggestion, the conceptual framework should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments. This might arise if the obligations are the most subordinated class of instruments issued by an entity that would otherwise report no equity.

41. Identifying whether to use such an approach, and if so when, would continue to be a standards level decision. For example, one topic that might require analysis in a standards level project is whether an obligation could be treated as if it were an

equity claim if would arise only on the liquidation of a subsidiary of the reporting entity.

Questions for the IASB
Do you agree that: 1. An entity should: a. remeasure at the end of each reporting period each class of equity claim, other than the existing holdings of the most residual claims? b. recognise those remeasurements in the statement of changes in equity, as a transfer of wealth between classes of equity claim? 2. Obligations to issue equity instruments are not liabilities? 3. Obligations that will arise only on liquidation of the reporting entity are not liabilities? 4. If an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so when, would still be a standards level decision.

Appendix A – Illustrative example of proposed presentation in the statement of changes in equity

Note additional illustrative examples may be added in later drafts

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

Fact pattern

A1. Entity A agrees to pay CU1,000 for legal services received on 1 January 20X1. Its contract with the provider requires it to pay on 31 December 20X2 by issuing shares whose aggregate fair value on 31 December 20X2 is CU1,210, representing principal of CU1.000 plus interest at a market rate of 10%.

IAS 32 approach

A2. Applying the (one-step) approach required by IAS 32, Entity A would present the following in its statement of financial position, statement of comprehensive income and statement of changes in equity:

[see next page]

IAS 32 Approach

Statement of financial position

	1 Jan 20X1	31 Dec 20X1	31 Dec 20X2
Liability	-1000	-1100	0
Net assets	-1000	-1100	0
Share capital	0	0	1210
Retained earnings	-1000	-1100	-1210
	-1000	-1100	0

Statement of comprehensive income

	31 Dec 20X1	31 Dec 20X2
Legal expenses	-1000	0
Interest expense	-100	-110
Loss	-1100	-110

Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders
Opening 1 Jan 20X1	0	0	0
Loss for X1	0	-1100	-1100
31 December 20X1	0	-1100	-1100
Loss for X2	0	-110	-110
New shares issued	1210	0	1210
31 December 20X2	1210	-1210	0

Proposed approach

A3. Applying the (two-step) approach proposed in this paper, Entity A would present the following:

Statement of financial position

	1 Jan 20X1	31 Dec 20X1	31 Dec 20X2
Liability	0	0	0
Net assets	0	0	0
Share capital	0	0	1210
Retained earnings	-1000	-1100	-1210
Future shareholders	1000	1100	0
	0	0	0

Statement of comprehensive income

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

Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders	Future shareholders	Total
Opening 1 Jan 20X1	0	0	**0**	0	**0**
Loss for X1	0	-1000	**-1000**	0	**-1000**
Wealth transfer	0	-100	**-100**	100	**0**
	0	-1100	**-1100**	100	**-1000**
Obligation to issue new shares	0	0	**0**	1000	**1000**
31 December 20X1	0	-1100	**-1100**	1100	**0**
Loss for X2	0	0	**0**	0	**0**
Wealth transfer	0	-110	**-110**	110	**0**
	0	-110	**-110**	110	**0**
New shares issued	1210	0	**1210**	-1210	**0**
31 December 20X2	1210	-1210	**0**	0	**0**

Appendix B –Effect of two-step approach on different classes of instrument

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

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

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

Instrument	*Current treatment*	*Effect of two-step approach*
Forward contract to repurchase own shares, settled gross	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss
Written put option on own shares, settled gross	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss	Liability at [to be determined, see paragraphs 34-37] Subsequent measurement at [to be determined]
Written put option on non-controlling interest (NCI put), settled gross for a cash payment equal to the fair value of the underlying NCI.	Liability at present value of the gross redemption amount (ie fair value of the underlying NCI). Subsequent changes in that amount in profit or loss.[7]	Liability at [to be determined, see paragraphs 34-37] Subsequent measurement at [to be determined]
Purchased call option to repurchase own shares, settled gross	No asset or liability. Recognise in equity, initial measurement net at proceeds received. No remeasurement [if not fixed for fixed, then derivative]	No asset or liability. Equity claim to receive shares, initial measurement net at proceeds received. Subsequent remeasurement (net) to fair value through SCE.

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

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

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

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

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