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Project	Conceptual Framework		
Paper topic	Draft Discussion paper Distinction between liabilities and equity instruments: commentary on examples of written put options on own shares		
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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.

**Purpose of this appendix**

1. Paragraphs 14-41 of the [draft] discussion paper [agenda paper 3D for the February IASB meeting] discuss an approach for distinguishing liabilities from equity. That paper included one example illustrating that approach. This paper, intended as a draft of an appendix for the forthcoming discussion paper, contains further illustrations. For ease of reference, the illustrations are split into:
  - (a) the examples themselves (agenda paper 5F).
  - (b) commentary on the examples (this paper)
2. The rest of this appendix:
  - (a) discusses the three examples in agenda paper 5F (paragraphs 4-14)
  - (b) discusses how an entity should measure written put options on the entity's own share (paragraph 15-17) and how it should account for changes in their carrying amount (paragraphs 18-19)
  - (c) notes some implications for the treatment of written put options held by holders of non controlling interests (NCI puts) (paragraph 20-21)

- (d) identifies some other issues the IASB would need to consider in standards level decisions (paragraph 22)
3. Examples A-C illustrate how the approach described in this [draft] discussion paper would apply for different types of written put option:
- (a) Example A: Written put option, settlement net in cash
  - (b) Example B: Written put option, settlement net in shares
  - (c) Example C: Written put option, settlement gross (cash for shares)

***Example A: Written put option, settlement net in cash***

4. Example A illustrates how both IAS 32 and the approach described in this [draft] discussion paper would treat a written put option that must be settled net in cash (in other words, if the strike price exceeds the share price at expiry, the issuer must pay cash equal to that excess). In both approaches, the issuer treats the contract as a derivative financial liability because the issuer has an obligation to deliver an economic resource (cash):
- (a) At inception (1 February 20X2), it recognises cash of CU5,000 and a derivative liability of CU5,000.
  - (b) At 31 December 20X2, it remeasures the derivative liability to its new fair value of CU4,000, recognising a gain of CU1,000 in profit or loss.
  - (c) At 31 January 20X3, the issuer:
    - (i) remeasures the derivative liability to its new fair value of CU3,000, recognising a gain of CU1,000 in profit or loss.
    - (ii) pays cash of CU3,000 to settle its liability.

***Example B: Written put option, settlement net in shares***

5. Example B considers how to account for a written put option that will be settled net in shares (in other words, if the strike price exceeds the share price at expiry, the issuer must issue shares with an aggregate fair value at that date equal to that excess.) Under IAS 32, the issuer treats the obligation to deliver a variable

number of shares as a liability (because the issuer is, in effect, using its own shares as currency):

- (a) at 31 January 20X1 and 31 December 20X2, the issuer accounts for that option in the same way as in example A.
- (b) At 31 January 20X3, the issuer:
  - (i) remeasures the derivative liability to its new fair value of CU3,000, recognising a gain of CU1,000 in profit or loss, as in example A.
  - (ii) issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.<sup>1</sup> At that date, it holds cash of CU5,000 and its equity is CU5,000.

6. Under the approach proposed in this [draft] discussion paper, the obligation to issue shares is not an obligation to transfer economic resources. Therefore, it is an equity claim, not a liability. Thus, the issuer would account for the transaction in example B as follows.

- (a) At inception (1 February 20X2), the issuer recognises:
  - (i) cash of CU5,000 and,
  - (ii) within equity, an equity claim of CU5,000. That equity claim represents the issuer's obligation to stand ready to issue its own shares if the holder exercises its option.
- (b) At 31 December 20X2, the issuer remeasures the equity claim to its new fair value of CU4,000, recognising in the statement of changes in equity a wealth transfer of CU1,000 from the column labelled 'obligation to issue shares' (which represents the interest of option holders) to the section for existing shareholders. For illustration, the example shows that transfer as a transfer to retained earnings, but other classifications would be possible, provided that the statement identifies clearly which class of equity holder benefits from the transfer.<sup>2</sup>

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<sup>1</sup> The example assumes fractional shares are possible.

<sup>2</sup> 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

- (c) At 31 January 20X3:
- (i) the issuer remeasures the equity claim to its new fair value of CU3,000, recognising in the statement of changes in equity a further wealth transfer of CU1,000 from the option holders to shareholders.
  - (ii) the issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.<sup>3</sup> At this point, the issuer transfers CU3,000 from the column labelled ‘obligation to issue shares’ to the section for existing shareholders. Example B assumes that the entire amount of CU3,000 is transferred to share capital, rather than to some other category attributable to existing shareholders.
  - (iii) if the option expires unissued, the issuer transfers any remaining balance from the column labelled ‘obligation to issue shares’ to the section for existing shareholders.

7. The following comments can be made about examples A and B:

- (a) The treatment in IAS 32 at 1 February 20X2 and 31 December 20X2 does not depict in a faithful and understandable manner the fact that these two examples will cause different effects on the resources of the issuer. In example A, the issuer suffers a cash outflow of CU3,000. In example B, no cash outflow can occur. In contrast, the approach in the [draft] discussion paper does depict that difference.
- (b) Both approaches depict the fact that both examples cause the same degree of dilution to those remaining shareholders (ie the shareholders who do not hold the put options):
  - (i) IAS 32 depicts this similarity by generating the same profit or loss in both examples.
  - (ii) The approach in the [draft] discussion paper depicts this similarity in the statement of changes in equity in the line

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reporting entity’s governing constitution. IAS 1 requires an entity to disclose a description of the nature and purpose of each reserve within equity.

<sup>3</sup> The example assumes fractional shares are possible.

labelled 'Change in net assets', in the column labelled 'Total existing shareholders'.

**Example C: Written put option, settlement gross in shares**

8. Example C illustrates a written put option that must be settled by delivering a fixed number of shares for a fixed amount of cash. IAS 32 would treat this instrument as follows:
- (a) On issuing the option, the issuer:
    - (i) recognises a cash receipt of CU5,000.
    - (ii) recognises a liability of CU95,000, equal to the present value of the strike price of CU98,000 that the issuer will need to pay if the holder exercises its option.
    - (iii) recognises a reduction of CU90,000 in equity. This is the difference between the initial carrying amount of the liability (CU95,000) and the premium received in cash (CU5,000). IAS 32 does not specify which category of equity should be used to record this transaction. For illustration, this example records this transaction in retained earnings, but other approaches might be possible.
  - (b) The issuer recognises interest expense on the liability to pay the strike price: CU2,750 for the 11 months to 31 December 20X2 and a further CU250 for the 1 month to 31 January 20X3. As a result, the carrying amount of the liability is CU97,750 on 31 December 20X2, and CU98,000 on 31 January 20X3, immediately before exercise or expiry.
  - (c) At 31 January 20X3, the holder exercises its option. As a result, the issuer must pay in cash the strike price of CU98,000.
  - (d) At 31 January 20X3, when the holder exercises its option it delivers 1,000 shares to the issuer, reducing by 1,000 the number of shares in circulation.<sup>4</sup> IFRSs do not prescribe which classes of equity an issuer should use to present such a transaction, because determining which

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<sup>4</sup> That reduction occurs, regardless of whether the shares are cancelled or are held 'in treasury' for possible re-issue.

categories are most relevant to users may depend on local legislation and on the reporting issuer's governing constitution. IAS 1 requires an issuer to disclose a description of the nature and purpose of each reserve within equity. For illustration, the example assumes that the issuer records this receipt by transferring CU95,000 from share capital to retained earnings.<sup>5</sup>

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

#### *Proposed approach*

- 9. To illustrate the approach proposed in this [draft] discussion paper, the example needs to take a position on two questions for which the discussion paper does not propose answers, because these appear to be questions to be resolved at the standards level, rather than in the conceptual framework:
  - (a) How to measure the rights and obligations that arise under a written put option (see paragraphs 10 and 15-17); and
  - (b) Whether changes in liabilities arising under a written put option result in income or expense, or in a wealth transfer between holders of different classes of equity (see paragraphs 18-19).
- 10. As discussed in paragraph 15, various approaches might be considered for measuring the issuer's obligation under the written put option. For ease of illustration, this example uses an expected value approach, as described in paragraph 15(c), to measure the issuer's contractual rights and obligations, which are:
  - (a) An obligation to stand ready to pay the strike price if the holder exercises the option. This is an obligation to transfer economic

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<sup>5</sup> For simplicity, the example ignores any other shares the issuer has in circulation, and ignores the issuer's other assets and liabilities.

resources, and hence a liability. The issuer measures that obligation at the expected present value of the amount that the issuer will have to pay on exercise by the holder.

- (b) A right of the issuer to receive its own shares if the holder exercises the option. That right is an equity claim, not an asset. Accordingly, the issuer recognises it within equity. The issuer measures that equity claim at the expected present value of the shares that the holder will have to deliver to the issuer if the holder exercises its put option.

11. In the fact pattern assumed for the example, at inception, the implied<sup>6</sup> probability of exercise is 60%. The total exercise price is CU98,000. The present value of that amount is CU95,000. The expected (ie probability-weighted) value of that amount is CU57,000 (ie 60% of CU95,000). Similarly, the implied expected value of the shares (if exercise occurs) is CU53,642.<sup>7</sup> The present value of that amount is CU52,000. The fair value of the option is CU5,000 (CU57,000 – CU52,000).

12. Using the expected value approach described in the previous paragraph, example C applies the approach proposed in this [draft] discussion paper as follows:

- (a) On issuing the option, the issuer:
- (i) recognises a cash receipt of CU5,000. This amount is also the fair value of the option.
  - (ii) recognises a liability of CU57,000, as calculated above. This is the expected present value of the strike price of CU98,000 that the issuer will need to pay if the holder exercises its put option, and reflects the implied probability of exercise (60%).
  - (iii) recognises in equity an equity claim of CU52,000, as calculated above. The illustration records this claim in a separate class of equity labelled ‘right to receive own

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<sup>6</sup> The term ‘implied probability’ means that the probabilities are consistent with observed market prices. Strictly speaking, it is a simplification to view these ‘implied probabilities’ as probabilities. They reflect not only how likely exercise is to occur, but also capture the extra weight, implicit in observed market prices, that risk-averse market participants place on adverse outcomes.

<sup>7</sup> In this example, the implied expected value is the amount necessary to be consistent with the fair value of the option. That fair value is given in the fact pattern assumed in this example.

shares'. A more complete description is: 'right to receive own shares if holders of written put options exercise their options'. That claim is an equity claim, not an asset, because it does not entitle the issuer to receive any economic benefits and so is not an economic resource.

- (b) At 31 December 20X2, the issuer remeasures both its obligation to stand ready to pay the strike price, and its equity claim. The fair value of the option is now CU4,000, a decrease of CU1,000 since inception. The example assumes the implied probability of exercise is now 80%. As a result, the issuer:
- (i) remeasures its liability to by CU21,200 to CU78,200 (= CU57,000 +CU21,200).
  - (ii) remeasures the right to receive its own shares by CU22,200 to CU74,200 (= CU54,200 +CU22,000)
  - (iii) recognises a wealth transfer of CU1,000 from the holders of the option to the existing shareholders. That amount equals the reduction in the fair value of the option from CU5,000 to CU4,000 (an economic gain for existing shareholders and an economic loss for option holders). The fair value of CU4,000 equals the difference between carrying amounts of the liability (CU78,200) and of the right to receive own shares (CU74,200).
- (c) For the 11 months to 31 December 20X2, the issuer recognises no interest (see paragraph 13(g) for discussion of this point).
- (d) At 31 January 20X3, the implied probability of exercise is now 100% because the strike price is above the share price and exercise is now imminent. Accordingly, the issuer:
- (i) remeasures its liability by CU19,800 to CU98,000 (= CU78,200 +CU19,800).
  - (ii) remeasures the right to receive its own shares by CU20,800 to CU95,000 (= CU74,200 +CU20,800). This is the current market price of the shares that issuer will receive on exercise.



- (iii) recognises a further wealth transfer of CU1,000 from the holders of the option to the existing shareholders. That amount equals the reduction in the fair value of the option from CU4,000 to CU3,000. The fair value equals the difference between carrying amounts of the liability (CU98,000) and of the right to receive own shares (CU95,000).
- (e) At 31 January 20X3, the holder exercises its option. As a result, the issuer must pay in cash the strike price of CU98,000. In exchange, it receives 1,000 shares, reducing by 1,000 the number of shares in circulation. At that time, the issuer transfers CU95,000 from the column labelled 'right to receive own shares' to one of the columns labelled as attributable to the remaining shareholders. For illustration, the example uses the column 'share capital' for this purpose. The issuer does not recognise any income or expense on exercise of the option.
- (f) If the share price at 31 January 20X2 were above the strike price of CU98 per share, the holder would not exercise its option, which would expire. At that time, the issuer would remeasure to zero both the right to receive its shares and its obligation under the put option. The net effect of that remeasurement is the change in fair value of the option (down to zero) and represents a final wealth transfer from option holders to existing shareholders.

### **Comments on examples C and D**

13. Several comments can be made about examples C and D:
- (a) This approach proposed in this [draft] discussion paper separates more clearly than IAS 32 two important distinctions:
    - (i) Does the issuer have an obligation to transfer economic resources? (yes for examples A and C, no for example B. IAS 32 shows this for examples A and C, but implies incorrectly that such an obligation exists in example B.)
    - (ii) Does an instrument affect the returns to existing holders of the most residual class of equity instrument? (yes for all

three examples. IAS 32 shows this for examples A and B, but not for example C)

- (b) The approach described in this [draft] discussion paper, as illustrated in these examples, shows that each of the three fact patterns (net cash settlement, net share settlement, gross share settlement) results in the same dilution of existing shareholders. This can be seen from the fact that the remeasurements of the fair value of the written put option (CU1,000 to 31 December 20X2 and a further CU1,000 to 31 January 20X3) appear in the statement of changes in equity as a component of the line ‘Change in net assets’.<sup>8</sup> In contrast, the approach in IAS 32 shows this similarity between examples A and B, but does not show this similarity with example C.
- (c) As example C shows, the approach in IAS 32 does not distinguish between options that are highly likely to be exercised and options that are highly unlikely to be exercised.
- (d) In contrast, the expected value approach illustrated in example C weights the cash flows that would occur on exercise by the probability that exercise will occur. This approach:
- (i) distinguishes between options that are highly likely to be exercised and options that are highly unlikely to be exercised.
  - (ii) shortly before expiry generates measurements that are close to the amount, if any, that will be paid. This is because the probabilities will tend towards 100% (if exercise is likely) or 0% (if exercise is unlikely). At earlier dates, the probability-weighted amounts may differ materially from the amounts, if any that will ultimately be paid, but over time, the probabilities will converge towards either 100% or 0%.
- (e) The probabilities used in example C are intended to be consistent with models used to determine the fair values of the options. If those fair values are determined using models, those probabilities (or information

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<sup>8</sup> Example A does not include a separate line labelled ‘Change in net assets’ because, in that

needed to derive them) should already be available. However, if those fair values are observed directly from market prices or if those fair values are immaterial, a model would be needed solely to determine the implied probabilities. In some cases, entities already need to determine fair values for measurement or disclosure. For example, IFRS 7 *Financial Instruments: Disclosures* requires an issuer to disclose the fair value of financial instruments not carried at fair value.<sup>9</sup>

- (f) Under IAS 32 and IFRS 9, if the strike price is a fixed amount, the issuer would typically use amortised cost to measure its liability to stand ready to pay the strike price. (In some cases, the issuer might be required, or elect, to measure it at fair value). As a result, the issuer would:
- (i) recognise interest expense in profit or loss.
  - (ii) report interest expense on the entire present value of the strike price. That information may be relevant if the option is highly likely to be exercised, but is less likely to be relevant or understandable if exercise is less likely.
- (g) The illustration in example C of the approach described in this [draft] discussion paper does not report any interest on the strike price. It would be possible to calculate interest on the carrying amount of the liability. However, as that carrying amount changes over the life of the option, the amount of interest would also change. Furthermore, because it would be calculated on a different base each period, the cumulative interest recognised over the life of the option would not have a clearly describable meaning. Therefore, the illustration in example C of the proposed approach does not attempt to identify an interest component of the change in carrying amount of the liability to stand ready to pay the strike price.
- (h) In addition, the illustration in example C of the proposed approach treats the entire change in the carrying amounts of the liability, and of

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example, the profit or loss is the only such change.

<sup>9</sup> IFRS 7, paragraph 25

the right to receive shares, as a wealth transfer between different classes of equity holder, rather than as income or expense. Paragraphs 18-19 discuss this topic.

- (i) To a number of commentators, the approach in IAS 32 seems particularly problematic for written put options on the issuer's own shares (and NCI puts, see paragraph 20) with a strike price equal to fair value (fair value puts). For these instruments, the requirement in IAS 32 means that:
  - (i) the strike price would be recognised as a liability, and measured at fair value.
  - (ii) changes in the fair value of the liability would be recognised in profit or loss. Part of those changes arises from changes in the value of unrecognised assets, such as goodwill. A number of commentators believe this does not result in relevant or understandable information for users.
  - (iii) Measurement of the liability is equal to the strike price, as if exercise were certain to occur, even if exercise is highly unlikely.
- (j) In contrast, under the approach described in this [draft] discussion paper:
  - (i) changes in the carrying amount of the liability would be recognised in the statement of changes in equity as a wealth transfer between option holders and shareholders.
  - (ii) using the expected value approach illustrated in example C, the measurement of the liability reflects the probability that the option will be exercised - if exercise is highly unlikely, the carrying amount of the liability would be correspondingly low.

### ***Overall comment on the examples***

14. The following table summarises how the two approaches depict the three transactions shown in the above examples. Bold text highlights two instances

where the IAS 32 approach does not appear to depict faithfully the substance of the transaction.

Example	A	B	C
Does the issuer have an obligation to pay cash (or transfer other economic resources)?	Yes	No	Yes
Does the IAS 32 approach report such an obligation?	Yes	<b>Yes</b>	Yes
Does the proposed approach report such an obligation?	Yes	No	Yes
Do changes in the fair value of the instrument cause a wealth transfer between holders of different classes of instrument?	Yes	Yes	Yes
Does the IAS 32 approach report these transfers in a timely manner?	Yes	Yes	<b>No</b>
Does the proposed approach report these transfers in a timely manner?	Yes	Yes	Yes

### ***Measuring written puts on own shares***

15. How should an issuer 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.<sup>10</sup> 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,

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<sup>10</sup> IAS 32 paragraph 23

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 issuer 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, as illustrated in example C.
  - (d) The intrinsic value of the option (ie zero if the option is currently out of the money, and the present value of the strike price if it is currently in the money). This approach would be simpler than the expected value approach illustrated in example C, but it would ignore the time value of the option (ie the possibility that an option currently out of the money may come into the money).
  - (e) The present value of the strike price if the issuer expects exercise, and zero if the issuer does not expect exercise. This approach would be simpler than the expected value approach illustrated in example C, but it would ignore the time value of the option.
16. The expected value approach described in paragraph 15(c) has some similarities with an approach described as the ‘revised expected outcomes’ approach (REO) developed by the FASB and discussed in 2008 in the IASB’s discussion paper

*Financial Instruments with Characteristics of Equity.* The FASB and IASB rejected REO, partly because they viewed it as too complex. One important difference between REO and the expected value approach illustrated in example C is the following:

- (a) In example C, changes in the carrying amount of the liability are recognised in the statement of changes in equity as wealth transfers between classes of equity holder.
- (b) In REO, changes in the carrying amount of the liability are recognised in profit or loss.

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

### ***Changes in carrying amount of written put options on own shares***

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

- (a) View A: those changes relate to a financial liability, and should therefore be recognised in profit or loss.
- (b) View B: the settlement of the obligation relates to a distribution of equity. Therefore, increases in the carrying amount of that obligation are distributions of equity and decreases in that carrying amount are contributions of equity.

19. Example C illustrates view B. Arguably, deciding which view to adopt in particular cases is a matter for standards level decisions, not for the conceptual framework. Therefore, this [draft] discussion paper does not investigate this issue further. (One topical case where this issue is relevant is for NCI puts, see paragraph 20).

### ***Implications for NCI puts***

20. Paragraph 15(a) refers to the requirement in IAS 32 that the issuer of a written put on its own shares should measure its liability at the present value of the redemption amount. One instrument subject to that requirement is a written put

option that obliges a parent to purchase shares of its subsidiary that are held by a non-controlling-interest shareholder (an NCI put). In May 2012 the IFRS 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). It follows that the NCI put is a financial liability, and thus within the scope of IFRS 9 *Financial Instruments*, so that the gains and losses would be recognised in profit or loss.

21. 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.

### **Other issues**

22. 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
    - (i) whether to separate compound instruments into a liability component and an equity component, as IAS 32 requires in some cases.
    - (ii) whether to separate some derivatives on an entity's own shares into separate components in some cases when that would produce a different result. For example, a forward contract can be viewed as a combination of a purchased option and a written option. The forward might be viewed as creating an obligation to settle that does not exist in the case of the purchased option.
    - (iii) whether puttable equity instruments should be separated into an equity host and an embedded put option. One driver for the gross presentation required by IAS 32 was to



achieve consistency between the treatments of puttable equity instruments and stand-alone written put options.

- (b) Similarly, whether to link two or more separate instruments into a single instrument for accounting purposes.
- (c) Whether some obligations within a subsidiary would be reclassified from liability to equity, or vice versa, on consolidation.
- (d) 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.

#### Questions for the IASB

1. Do you have any comments on this draft appendix?
2. Should the conceptual framework contain conclusions on the following matters, or should the IASB reach these conclusions at the standards level:
  - a. how to measure obligations under a written put option?
  - b. whether changes in the carrying amount of obligations under a written put option should be recognised in profit or loss, or as a wealth transfer between classes of equity holder?