# Financial Instruments with Characteristics of Equity
# Obligations to redeem own equity instruments

## Objective

1 The objective of the session is to provide an update on the IASB's discussions on the IASB's project Financial Instruments with Characteristics of Equity (FICE).

## What is the issue

2 Issuers of financial instruments have identified a variety of challenges with applying IAS 32 to obligations to redeem own equity instruments. There is also evidence of diversity in practice in the application of the requirements in paragraph 23 of IAS 32. This is related to the fact that IAS 32 provides limited guidance on the accounting for obligations to redeem own equity instruments.

3 Paragraph 23 of IAS 32 requires a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset to be recognised as a financial liability. The financial liability is recognised initially at the present value of the redemption amount and is reclassified from equity.

4 However, paragraph 23 of IAS 32 does not, for example, specify which component of equity should be used. Several other issues are detailed below.

*What the initial debit entry is when the present value of the redemption amount is reclassified from equity and the interaction with other IFRS Accounting Standards;*

5 As mentioned above, paragraph 23 of IAS 32 requires the financial liability to be reclassified from equity but does not specify which component of equity.

6 This is a challenging issue for which there is diversity in practice in how the related equity is classified (i.e. non-controlling interest (NCI) or equity of the parent).

*Are changes in the carrying amount of the financial liability recognised in profit or loss or in equity?*

7 The most significant diversity in practice exists with regard to whether subsequent changes are recognised in profit or loss or in equity. This arises due to the conflict between subsequent measurement requirements in IFRS 9 and the requirements in IFRS 10. Some believe that changes in the measurement of the financial liability should be recognised in profit or loss while others believe that these changes should be recognised directly in equity.

*How should an entity account for NCI puts and forwards?*

8 The majority of past discussions are related to written put options and forwards contracts on non-controlling interests (NCI puts). The challenges include:

(a) Whether the contra to the liability recognised for the put option is a derecognition of NCI or a general reduction in equity (i.e. equity attributable to owners of the company);

(b) whether the parent recognises a financial liability for the present value of the option exercise price (on a gross basis) or a derivative liability (on a net basis at fair value);

(c) Whether the subsequent measurement changes in the redemption amount is recognised in profit or loss or in equity (similarly to other transactions between equity holders).

(d) How an entity accounts for puts and forwards held by non-controlling interests that expire unexercised. Also, how to account for the settlement or exercise of an NCI Put.

(e) how an entity accounts for a written put option over non-controlling interests in its consolidated financial statements when the NCI put has a strike price that will, or may, be settled by the exchange of a variable number of the parent's own equity instruments. The question relates to whether the parent should account for the NCI put as a financial liability for the present value of the option's strike price on a gross basis, or as a derivative liability on a net basis

(f) whether dividends are recognised in profit or loss or equity when dividends are paid to the NCI shareholder after the parent entity has recorded the debit entry against NCI on initial recognition of the NCI put.

(g) the accounting within equity when an entity has an obligation to extinguish its own equity (e.g. the premium received for an NCI put and the accounting for when the holder exercises the put or when it expires)

**IASB's proposals in the Discussion Paper**

9 In its Discussion Paper *Financial Instruments with Characteristics of Equity* (the DP), the IASB made proposals to address the challenges that preparers identified on accounting for put options written on equity instruments, including those on non-controlling interests.

10 It is worth noting that the IASB's preferred approach in the DP represented a change to current guidance on the accounting within equity, particularly for written puts:

(a) the redemption amount would be the present value of the strike price of the option (in accordance with IAS 32);

(b) the derecognition from equity would be based on the fair value of the ordinary shares at the date the written put is issued (a change to IAS 32);

(c) the equity component would the sum of the premium received and the difference between the two amounts calculated above (a change to IAS 32).

11 This would result in an outcome similar to a written call option or conversion option in a convertible bond (a change to IAS 32). That is, the equity component would be accounted for as a conversion option in a convertible bond. Currently, the equity component reflects the premium received from the written put.

12 The redemption requirement would also apply to written put options where an entity repurchases equity instruments by transferring a variable amount of cash equal to the value of the underlying shares (e.g. fair value written puts). If the derivative requires the entity to transfer economic resources other than at liquidation, then it was a liability under the IASB's preferred approach. The equity component would be nil and all of the returns on the claim would be captured by the liability component (this would result in the shares being, in substance, shares redeemable at fair value).

13 In the DP the IASB also clarified that its proposals for the accounting within equity for a written put option would also apply to NCI. Thus, applying the IASB's preferred approach, the accounting for put options over NCI in the consolidated financial statements would involve:

(a) recognition of a liability component at the redemption amount, which would be subsequently remeasured in accordance with IFRS 9;

(b) derecognition of the NCI on which put options are written, at the fair value of the ordinary shares of the subsidiary at the date the put options are issued; and

(c) recognition of the residual as an equity component for the implicit written call option on the subsidiary's shares.

14 The carrying amount of the equity component would be updated over time through the attribution of comprehensive income, to help users assess the allocation of the residual returns. At maturity, the carrying amounts of the equity component and the liability, would be transferred to ordinary shares.

15 If the put option expired unexercised, then the carrying amounts of the redemption amount and the conversion option would be reclassified to NCI.

16 For fair value NCI puts, the DP clarified that the treatment as described in paragraph 13 would also apply to NCI puts with a strike price at fair value, where the equity component would be nil and all of the returns on the claim would be captured by the liability component and related returns recognised in OCI (i.e. require separate presentation of income and expenses in OCI for liabilities with amounts linked to share price, for example, shares that the entity may be required to redeem or repurchase at fair value).

17 The IASB argued that such accounting treatment achieved consistent classification outcomes for arrangements with similar economic effects on the issuer (eg convertible bonds and written put options).

**EFRAG Comment Letter**

18 EFRAG supported the requirements in paragraph 23 of IAS 32 to recognise a 'gross' liability for instruments that contain an obligation for an entity to purchase its own equity instruments for cash or another financial asset. EFRAG therefore welcomed the DP's proposal to retain gross liability accounting for redemption obligations.

19 EFRAG agreed in principle that instruments with the same economic substance, but different structures should be accounted for in the same way. However, EFRAG was not convinced that a written put option on own shares combined with the previously issued ordinary shares has the same economic substance as a convertible bond.

20 Regarding the derecognition of the NCI on which put options are written, EFRAG noted that current practice is mixed as some consider it logical to derecognise the NCI while others consider such derecognition as inappropriate. This could be the case when a put option is not at a fixed price which some interpret as that the NCI continue to have equity-type exposure and that the NCI should continue to be recognised. Neither approach is currently forbidden by paragraph 23 of IAS 32. Nonetheless, EFRAG expressed the same concerns as to recognising an equity component that represents an implicit call option as compared to the put option.

21 Whilst the DP clarifies that the component of equity (whether shares issued or NCI) is derecognised, it does not deal with certain conceptual issues that have been raised in the past or certain related application issues. For example:

(a) why changes to the redemption amount (especially for written puts at fair value) should fall under the principles in IFRS 9 around recognition in profit or loss rather than those in IFRS 10 and IAS 1 around transactions between equity holders;

(b) the treatment of profit allocation and dividends paid to NCI under IFRS 10 when the NCI have been derecognised;

(c) the impact of the changes on other topics such as earnings per share, i.e. derecognised shares means that subsidiary's income is fully included, but

derecognised shares may need to be considered for fully diluted EPS. This may be different from the current situation;

(d) whether the accounting should differ based on whether the written put forms part of a business combination or whether it was entered separately; and

(e) the treatment when there is uncertainty around how many shareholders would exercise a cash option in allocation rights as per ESMA's enforcement decision EECS/0214-03.

22 Therefore, EFRAG concluded that there are various conflicts that have to be resolved on the basis of derecognition of the equity component.

23 In addition, EFRAG had concerns about the recognition of a conversion option in a NCI put that reflects a call option of a convertible bond (see paragraph 78 above).

## IASB discussions

24 The IASB discussed the problems that arise when entities apply paragraph 23 of IAS 32 in July and September 2022 to. The IASB also discussed possible clarifications it could develop to help resolve these problems.

*Feedback received by the IASB on its DP*

25 In general, there was no support from constituents for the IASB to pursue the classification approach proposed in the 2018 DP.

26 The feedback analysis on the 2018 DP also included the following key messages:

(a) there were mixed views on the proposed accounting for redemption obligation arrangements (including NCI puts). This was largely based on whether or not respondents believed own shares and a written put option on own shares was fundamentally and economically different from a convertible bond. Most respondents expressed concerns about the proposed derecognition of own shares, particularly when they represent NCI, and the potential impacts on the consolidated financial statements when applying other IFRS Accounting Standards.

(b) some respondents were also concerned with the grossing up of the NCI put liability—even though this is already required by IAS 32. However, there was no clear consensus in support of either gross or net accounting for the redemption obligation.

(c) a few respondents expressed concerns over recognising a new equity component that represents an implicit written call option in the same way as a conversion option in a convertible bond, particularly questioning the usefulness, complexity and whether it reflects the substance of the instruments.

*IASB tentative decisions*

27 In September 2022, after considering the feedback received from its constituents and the IASB Staff analysis, the IASB tentatively decided to propose amendments to IAS 32 on the accounting for financial instruments containing obligations for an entity to redeem its own equity instruments (including written put options on non-controlling interests).

28 In particular, the IASB decided to clarify:

(a) that paragraph 23 applies also to an obligation to redeem an entity's own equity instruments that is required to be settled in a variable number of a different type of the entity's own equity instruments.

(b) the accounting on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not already have access to the returns associated with an ownership interest.

 (i) If the obligation involves non-controlling interests, the debit entry is recognised against a component of equity other than non-controlling interests.

 (ii) In the case of an entity's other obligations to purchase its own shares, the debit entry is recognised against a component of equity other than issued share capital.

(c) that on expiry of a written put option on an entity's own equity instruments:

 (i) the financial liability is reclassified to the same component of equity as that from which it was reclassified on initial recognition of the put option; and

 (ii) the cumulative amount in retained earnings related to remeasuring the financial liability could be reclassified to another component of equity but is not reversed in profit or loss.

29 The IASB also tentatively decided to clarify that written put options and forward purchase contracts on an entity's own equity instruments are required to be presented gross, instead of net, in order:

(a) to align the accounting for these instruments with the accounting for other obligations that are conditional on events or choices that are beyond the entity's control; and

(b) to assist users of financial statements in assessing the entity's exposure to liquidity risk.

**EFRAG Secretariat analysis/recommendation**

30 In general, the EFRAG Secretariat welcomes the IASB's tentative decision to clarify the accounting for obligations to redeem own equity instruments in IAS 32.

31 The EFRAG Secretariat also welcomes that the IASB is not following an approach similar to the IASB's preferred approach in the DP as it represented a change in practice and EFRAG was not convinced that a written put option on own shares combined with the previously issued ordinary shares had the same economic substance as a convertible bond.

32 The IASB's tentative decisions seem to be aligned with the current objective of the FICE project (clarifications to the underlying principles in IAS 32) and address many of the issues that arise in practice (as identified in paragraphs 5 to 8 above).

33 Nonetheless, the EFRAG Secretariat highlights that in its tentative decisions, the IASB seems to not address the issue on whether the **subsequent measurement changes in the redemption amount is recognised in profit or loss or in equity** (similarly to other transactions between equity holders). It is implicit in the IASB's tentative decisions that subsequent measurement changes in the redemption amount is recognised in profit or loss. Nonetheless the EFRAG Secretariat would welcome clarifications on this area or at least a question to constituents in the forthcoming Exposure Draft (with the pros and cons of measuring changes profit or loss or equity)

34 In terms of accounting for **obligations to redeem an entity's own equity instruments that is required to be settled in a variable number of a different type of the entity's own equity instruments**, the EFRAG Secretariat welcomes the IASB's tentative decision however it would suggest clarifying that it is only applicable when an entity uses a variable number of own shares (even if from another type) as currency to settle its obligation.

35 The EFRAG Secretariat also highlights that improvements to presentation and disclosures are currently needed and constitute a significant part, or even the most important part, of this project to help users better understand the accounting and movements within equity. More specifically, EFRAG Secretariat considers that it would be useful to require separate presentation in the statement of financial position of the equity components of compound instruments and derivatives on own equity (e.g., within a subclass) to help users better understand where the different components of complex financial instruments are presented. Such presentation should be supported by relevant disclosures that explain the accounting treatment, including reclassifications and expirations.

**Questions for EFRAG FR TEG members**

36 Do EFRAG FR TEG have any comments on the IASB tentative decision on the obligation to redeem an entity's own equity instruments that is required to be settled in a variable number of a different type of the entity's own equity instruments?

37 Do EFRAG FR TEG have any comments on the IASB tentative decision on the accounting on initial recognition of the obligation to redeem an entity's own equity instruments?

38 Do EFRAG FR TEG have any comments on the IASB tentative decision on expiry of a written put option on an entity's own equity instruments?

39 Do EFRAG FR TEG have any comments on the IASB tentative decision to clarify that written put options and forward purchase contracts on an entity's own equity instruments are required to be presented gross, instead of net?