STAFF PAPER

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Project	Conceptual Framework		
Paper topic	Draft Discussion paper Distinction between liabilities and equity instruments: examples of written put options on own shares		
CONTACT(S)	Peter Clark	pclark@ifrs.org	020 7246 6451
	Rachel Knubley	rknubley@ifrs.org	020 7246 6904

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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.

A1. This paper, intended as a draft of an appendix for the forthcoming discussion paper, provides examples illustrating an approach for distinguishing liabilities from equity. For ease of reference, the commentary on these examples is presented separately in agenda paper 5E.

Example A: Written put option, settlement net in cash

Fact pattern

A2. An entity issues a written put option on 1,000 of its own shares on 1 February 20X2. The issuer receives a premium of CU5,000 for the option. The option is exercisable only on 31 January 20X3, in exchange for paying a strike price of CU98 per share (CU98,000 in total). The option will be settled net in cash. In other words, if the holder exercises the option, it will receive the fair value of 1,000 shares on exercise date (31 January 20X3), less the total strike price of CU98,000.

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A3. Further data:

	1 February X2	31 December X2	31 January X3
Fair value per share	CU100	CU95	CU95
Fair value of option	CU5,000	CU4,000	CU3,000

A4. On 31 January 20X3, the holder exercises the option, receiving cash of CU3,000 (ie CU98,000 – CU95,000).

IAS 32 approach and proposed approach

A5. The same treatment would apply under IAS 32 and under the approach described in this discussion paper. The issuer would present the following in its statement of financial position, statement of comprehensive income and statement of changes in equity:

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	2,000
Derivative liability	-5,000	-4,000	0
Net assets	0	1,000	2,000
Share capital	0	0	0
Retained earnings	0	1,000	2,000
Total equity	0	1,000	2,000

Statement of comprehensive income

	31 Dec 20X2	31 Jan 20X3
Change in fair value of derivatives	1,000	1,000
Profit	1,000	1,000

Statement of changes in equity

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	0	0	0
Profit for X2	0	1,000	1,000
31 December 20X2	0	1,000	1,000
Profit for January X3	0	1,000	1,000
31 January 20X3	0	2,000	2,000

Example B: Written put option, settlement net in shares

Fact pattern

A6. The facts are as in example A, except that the option will be settled net in shares. In other words, if the holder exercises the option, the issuer will issue shares whose total fair value equals the amount of cash that would be paid in example A. Neither party pays cash when the option is exercised or expires.

A7. O 31 January 20X3, the holder exercises the option. The issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.[1]

IAS 32 approach

A8. Under IAS 32, the issuer accounts for the transactions as shown below. The accounting at 31 January 20X1 and 31 December 20X2 is the same as in example A. The accounting differs at 31 January 20X3 because the issuer must settle by issuing shares, not by paying cash.

[1] The example assumes fractional shares are possible.

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Derivative liability	-5,000	-4,000	0
Net assets	0	1,000	5,000
Share capital	0	0	3,000
Retained earnings	0	1,000	2,000
Total equity	0	1,000	5,000

Statement of comprehensive income

	31 Dec 20X2	31 Jan 20X3
Change in fair value of derivatives	1,000	1,000
Profit	1,000	1,000

Statement of changes in equity

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	0	0	0
Profit for X2	0	1,000	1,000
31 December 20X2	0	1,000	1,000
Profit for January X3	0	1,000	1,000
Shares issued	3,000	0	3,000
31 January 20X3	3,000	2,000	5,000

Proposed approach

A9. Applying the approach described in this [draft] discussion paper, the issuer would present the amounts shown below:

Statement of financial position

	1 Jan 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Net assets	5,000	5,000	5,000
Share capital	0	0	3,000
Retained earnings	0	1,000	2,000
Obligation to issue shares	5,000	4,000	0
Total equity	5,000	5,000	5,000

Statement of comprehensive income

	31 Dec 20X2	31 Jan 20X3
Income	0	0
Expense	0	0
Profit or loss	0	0

Statement of changes in equity	Share capital	Retained earnings	**Total existing shareholders**	**Obligation to issue shares**	**Total**
Opening 1 Feb 20X2	0	0	**0**	0	**0**
Profit or loss for X2	0	0	**0**	0	**0**
Change in fair value of option	0	1,000	**1,000**	-1,000	**0**
Change in net assets	**0**	**1,000**	**1,000**	-1,000	**0**
Written option issued	0	0	0	5,000	**5,000**
31 December 20X2	0	**1,000**	**1,000**	4,000	**5,000**
Profit or loss for Jan X3	0	0	**0**	0	**0**
Change in fair value of option	0	**1,000**	**1,000**	-1,000	**0**
Change in net assets	**0**	**1,000**	**1,000**	**-1,000**	**0**
New shares issued	3,000	0	3,000	-3,000	**0**
31 January X3	3,000	2,000	**5,000**	0	**0**

Example C: Written put option, settlement gross (cash for shares)

Fact pattern

A10. The facts are as in examples A and B, except that the option will be settled gross in shares. In other words, if the holder exercises the option, the issuer must pay the strike price (CU98,000) to the holder, and the holder must then deliver 1,000 shares. Additional data:

	1 February X2	31 December X2	31 January X3
Present value of total strike price	CU95,000	CU97,750	CU98,000

IAS 32 approach

A11. Applying the approach in IAS 32, the issuer would present the following:

Statement of financial position

	1 Jan 20X2	**31 Dec 20X2**	**31 Jan 20X3**
Cash	5,000	5,000	-93,000
Obligation under written put	-95,000	-97,750	0
Net assets	-90,000	-92,750	-93,000
Share capital	0	0	-95,000
Retained earnings	-90,000	-92,750	2,000
Total equity	-90,000	-92,750	-93,000

Statement of comprehensive income

	31 Dec 20X2	**31 Jan 20X3**
Income	0	0
Interest expense	-2,750	-250
Profit or loss	-2,750	-250

Statement of changes in equity	Share capital	Retained earnings	**Total existing shareholders**
Opening 1 Jan 20X2	0	0	**0**
Written option issued	0	-90,000	**-90,000**
Profit or loss for X2	0	-2,750	**-2,750**
31 December 20X2	0	**-92,750**	**-92,750**
Profit or loss for Jan X3	0	-250	**-250**
Repurchase of own shares	-95,000	95,000	**0**
31 January X3	-95,000	2,000	**-93,000**

A12. As explained in agenda paper 5E, IAS 32 does not specify where the entity would recognise the debit of CU90,000 on issuing the written option, nor what transfers, if any, it would make between categories of equity when the option is exercised or expires. This paper is not intended to imply a preference for any particular treatment in that regard.

Additional facts

A13. The following additional facts are supplied to apply the approach proposed in this [draft] discussion paper.

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Implied probability of exercise	60%	80%	100%
Implied present value of strike price	57,000	78,200	98,000
Implied value of shares on exercise	-52,000	-74,200	-95,000
Fair value of option	5,000	4,000	3,000

A14. The implied present value of the strike price is calculated as follows at 1 February 20X2. The total exercise price is CU98,000. The present value of that expected amount is CU95,000. The expected (ie probability-weighted) value of that amount is CU57,000 (ie CU95,000, multiplied by the implied probability of exercise). The implied probability of exercise (60% at 1 February 20X2) is given in the fact pattern. In real life, it would be determined in calculating the fair value of the option, or would be derived in a manner to be consistent with an observed fair value of the option and other observed market data.

A15. The implied expected value of the shares on exercise is the expected value of the shares that would be received on exercise, multiplied by the implied probability of exercise. In this example, it is the amount implied by the need to be consistent with the fair value of the option.

Proposed approach

A16. Applying the approach proposed in this [draft] discussion paper, the issuer would present the following:

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	-93,000
Obligation under written put	-57,000	-78,200	0
Net assets	-52,000	-73,200	-93,000
Share capital	0	0	-95,000
Retained earnings	0	1,000	2,000
Equity: existing shareholders	0	1,000	
Right to receive own shares	-52,000	-74,200	0
Total equity	-52,000	-73,200	-93,000

Statement of comprehensive income

	31 Dec 20X2	31 Dec 20X3
Income	0	0
Interest expense	0	0
Profit or loss	0	0

Statement of changes in equity

	Share capital	Retained earnings	**Total existing shareholders**	**Right to receive shares**	**Total**
Opening 1 February 20X2	0	0	**0**	0	**0**
Profit or loss for X2	0	0	**0**	0	**0**
Change in fair value of option	0	1,000	**1,000**	-22,200	**-21,200**
Change in net assets	**0**	**1,000**	**1.000**	-22,200	**-21,200**
Written option issued	0	0	**0**	-52,000	-52,000
31 December 20X2	0	**1,000**	**1,000**	-74,200	**-73,200**
Profit or loss for Jan X3	0	0	**0**	0	**0**
Change in fair value of option	0	**1,000**	**1,000**	-20,800	**-19,800**
Change in net assets	**0**	**1,000**	**1,000**	**-20,800**	**-19,800**
Repurchase of own shares	-95,000	0	95,000	95,000	**0**
31 January X3	-95,000	2,000	**-93,000**	0	**0**

Journal entries used to apply the proposed approach:

1 February 20X2		
Dr Right to receive own shares	52,000	
Dr Cash	5,000	
Cr Obligation under written put		57,000

To record issue of written put issued

31 December 20X2		
Dr Right to receive own shares	22,200	
Dr Retained earnings		1,000
Cr Obligation under written put		21,200

To remeasure the right to receive own shares and the obligation under the written put, and to record the wealth transfer of CU1,000 from option holders to existing shareholders

31 January 20X3		
Dr Right to receive own shares	20,800	
Dr Retained earnings		1,000
Cr Obligation under written put		19,800

To remeasure the right to receive own shares and the obligation under the written put, and to record the wealth transfer of CU1,000 from option holders to existing shareholders

31 January 20X3

Dr Obligation under written put	98,000	
Cr Cash		98,000

To record cash paid to settle obligation under written put

Dr Share capital	95,000	
Cr Right to receive own shares		95,000

To record receipt of 1,000 own shares from holders of written put options