STAFF PAPER

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IASB® meeting

Project	Financial Instruments with Characteristics of Equity (FICE)	
Paper topic	Obligations to redeem own equity instruments: background	
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Purpose of this paper

1. At the October 2019 IASB meeting (Agenda Paper 5), the IASB discussed the project plan for the FICE project, including the practice issues that it could address as part of the project. One of the topics discussed was accounting for financial instruments containing obligations to redeem own equity instruments. The objective of this paper and Agenda Paper 5A of this meeting is to begin the IASB's discussion on this topic.

2. This paper introduces the topic and provide background information. In Agenda Paper 5A of this meeting, the staff will analyse practice issues and explore what clarifications could be made (if any) to the underlying principles in IAS 32 *Financial Instruments: Presentation*.

3. At this meeting, the staff is seeking the IASB's views on the direction of the staff's future work, including initial views on whether IASB members think some or all of these practice issues are within or beyond the scope of the current FICE project.

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4. Based on the feedback provided at this meeting, the staff will develop a proposal for the clarified principles and bring back a further analysis at a future IASB meeting.

Introduction

5. Many companies in many jurisdictions issue contracts that contain an obligation to purchase its own equity instruments. Previous IFRS Interpretations Committee (Committee) and IASB consultations and discussions have confirmed that the amounts involved are material.

6. Issuing put options on non-controlling interests (NCI puts) is particularly common in many jurisdictions—NCI puts are granted to non-controlling interest holders to provide them with liquidity and the right to sell their shares to the majority shareholder in the future. NCI puts are either exercisable at a variable strike price or a fixed strike price at a specified future date (or period).

7. A parent in the consolidated group may write a put option on the shares of a subsidiary held by a non-controlling interest shareholder that obliges it to purchase those shares for cash or another financial asset. A put option may be also be written as part of, or separately from, a business combination in which the parent obtains control of the subsidiary.

8. 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. The staff note that the word ‘reclassified’ is used in a broad sense here and is different to the reclassifications between financial liabilities and equity instruments discussed by the IASB in March and June 2022.

9. There is evidence of accounting diversity in practice in the application of the requirements in paragraph 23 of IAS 32. In addition to the feedback on the 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 DP) confirming this diversity (see paragraphs 32-34 of this paper), a number of questions have been submitted to the Committee in the past that remain unresolved

(see paragraphs 20-31 of this paper). Those submissions resulted in several Committee and IASB discussions since 2006, all ultimately referring the issues to be considered comprehensively as part of the FICE project.

10. The objective of the FICE project is to address known practice issues by proposing clarifications to the underlying principles in IAS 32. Where there is not an implicit or explicit principle in IAS 32 for a particular requirement, the Board could fill this gap by developing a principle and accompanying rationale but the intention is not to develop new principles that will result in fundamental changes to the requirements.

11. The staff acknowledge that there will not be a single answer that would satisfy all stakeholder groups but there is certainly a need for clarification to reduce or eliminate accounting diversity which will improve the usefulness of information provided in the financial statements and ensure consistent application of the requirements in IAS 32.

12. In addition, the staff note that this paper addresses NCI puts which represent *contractual* obligations to repurchase own equity instruments. It does not cover the legal obligation to make mandatory tender offers (MTOs) to NCI shareholders until the offer is contractually made by the purchasing entity. MTOs were discussed at the IASB September 2021 meeting.

13. This paper is structured as follows:

    (a) Current requirements in IAS 32 (paragraphs 14-16);

    (b) Background

        (i) Brief history of the requirements for contracts containing an obligation to redeem own equity instruments 17-19);

        (ii) Summary of past IASB and Committee discussions (paragraphs 20-31); and

        (iii) Feedback on the proposals in the 2018 DP (paragraphs 32-34).

Current requirements in IAS 32

14. Paragraph 23 of IAS 32 discusses the accounting for a contract containing an obligation for an entity to purchase its own equity instruments for cash or another financial asset and requires:

    (a) a financial liability to be recognised initially at the present value of the redemption amount, reclassified from equity;

    (b) the financial liability to be subsequently measured in accordance with IFRS 9; and

    (c) the reclassification of the financial liability to equity if the contract expires without delivery.

15. In the case of NCI puts, the focus is at the consolidated level regardless of whether the put is written by the parent or any subsidiary in the consolidated group. In the consolidated financial statements, that put option is a contract to purchase the group's own equity instruments (equity instruments of a subsidiary are considered to be own equity instruments from the perspective of the consolidated financial statements) and thus gives rise to a financial liability for the present value of the option exercise price in accordance with paragraph 23 of IAS 32.

16. AG 29 of IAS 32 states:

> […] When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. […]

Background

Brief history of the requirements for contracts containing an obligation to redeem own equity instruments

17. In December 2003, the IASB revised IAS 32 as part of its project to improve IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*. The objective of the project was to reduce complexity by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations. The issue of how to measure obligations and potential obligations to purchase own equity instruments was thoroughly debated at that time, as illustrated by the dissenting opinion on that revision to the standard.

18. Paragraph BC11-BC12 of the Basis for Conclusions on IAS 32 explains the approach taken when an entity has an obligation to purchase its own shares for cash. The example given in paragraph BC10(a) of IAS 32 is of a forward contract to purchase own shares. Paragraph BC11 states:

    > An entity's obligation to purchase its own shares establishes a maturity date for the shares that are subject to the contract. Therefore, to the extent of the obligation, those shares cease to be equity instruments when the entity assumes the obligation. This treatment under IAS 32 is consistent with the treatment of shares that provide for mandatory redemption by the entity. […]

19. Applying the requirement in paragraph 23 of IAS 32 results in identical obligations to deliver cash in exchange for own equity instruments accounted for consistently regardless of whether the redemption clause is embedded in the equity instrument (eg puttable shares) or is a stand-alone derivative (eg NCI put). That consistency was the IASB's objective when it required physically-settled put options to be measured on a gross basis.

Summary of past IASB and Committee discussions

20. The IASB and the Committee discussed several issues related to obligations to redeem own equity instruments and NCI puts between 2006–2016 that remain

unresolved. Many of the questions are applicable to all derivatives on own equity—not only NCI puts.

21. In 2006, the Committee discussed a request to clarify the accounting related to NCI puts (or NCI forwards) to be settled for cash. As part of its finalised agenda decision in November 2006, the Committee agreed that there is likely to be divergence in practice in how an entity reclassifies the related equity but did not believe it could reach a consensus on this matter on a timely basis.

22. In May 2010, the Committee received a request regarding how a parent accounts for changes in the carrying amount of a financial liability for NCI puts to be settled for cash in the consolidated financial statements. The submission considered whether there was a potential conflict between IAS 27 *Consolidated and Separate Financial Statements* and IAS 39 (which were applicable at the time of the Committee's discussion). There was little diversity in practice concerning the initial recognition of a financial liability for the NCI put due to the requirement in paragraph 23 of IAS 32. There was agreement over the need to remeasure the financial liability at each reporting date; the issue leading to diversity in practice was whether that remeasurement should be recognised in profit or loss or in equity.

23. The Committee published a tentative agenda decision in September 2010 which explained that IAS 32 requires an entity to subsequently measure the financial liability applying IAS 39 and that additional accounting concerns related to NCI puts would best be addressed as part of the then on-going FICE project. The comment letters on the Committee's tentative agenda decision highlighted the significant diversity in practice in the accounting for NCI puts and expressed support for either the Committee, or the IASB, to provide additional guidance on a timely basis. Concerns were expressed about issuing a tentative agenda decision that could be read as an interpretation that the financial instruments guidance should be applied despite a perceived conflict in the standards. In November 2010, the Committee decided to add the issue to its agenda and offered to work with the FICE project team to explore possible solutions to the issues that the Committee had been discussing.

24. At the March 2011 Committee meeting, the Committee recommended that the IASB should consider making an amendment to the scope of IAS 32 that would

change the measurement basis of NCI puts to that used for other derivative contracts. The scope exclusion would apply only to the consolidated financial statements of the parent and only to NCI puts that are not embedded in another contract and that are gross physically settled. In September 2011 the IASB decided not to proceed with the proposed scope amendment that had been recommended by the Committee.

25. However, the IASB asked the Committee to consider addressing the diversity in accounting, not by changing the measurement basis of the NCI puts, but by clarifying the accounting for subsequent changes in those liabilities, including:

    (a) whether changes in the measurement of the NCI put should be recognised in profit or loss or in equity; and

    (b) whether the clarification described in subparagraph (a) above should be applied to only NCI puts or to both NCI puts and NCI forwards.

26. In response to the IASB's request, the Committee recommended that the IASB should address the diversity in accounting by amending IAS 27 and IFRS 10 *Consolidated Financial Statements* to clarify that all changes in the measurement of the NCI put must be recognised in profit or loss. The Committee noted that the NCI put is a financial liability and its remeasurement does not change the respective ownership interests of the controlling shareholder or the non-controlling interest shareholder. The Committee further noted that the clarification is consistent with the requirements for other derivatives written on an entity's own equity instruments.

27. The IASB agreed with the Committee's conclusion that changes in the measurement of the NCI put must be recognised in profit or loss but decided not to amend IFRS Accounting Standards. Instead, at the request of the IASB, the Committee published a draft Interpretation, *Put Options Written on Non-controlling Interests* in May 2012 which explained the following:

    (a) an entity remeasures the financial liability recognised for an NCI put applying IAS 39 (IFRS 9), which requires the entity to recognise changes in measurement in profit or loss; and

(b) the changes in measurement of that financial liability do not change the relative interests in the subsidiary held by the parent and the non-controlling-interest shareholder, and therefore are not equity transactions.

28. Many respondents to the draft Interpretation expressed the view that either the Committee or the IASB should address the accounting for NCI puts—or all derivatives written on an entity’s own equity—more comprehensively as many aspects of the accounting for those contracts have resulted in diversity in practice. Some of the respondents further believed the requirements to measure particular derivatives written on an entity’s own equity instruments on a gross basis at the present value of the redemption amount, do not result in useful information. Consequently, before finalising the draft Interpretation the Committee asked the IASB to reconsider the requirements in paragraph 23 of IAS 32 for put options and forward contracts written on an entity’s own equity including whether an entity accounts for NCI puts and NCI forwards differently from other derivatives written on an entity’s equity.

29. In March 2013, the IASB tentatively decided to re-consider the requirements in paragraph 23 of IAS 32, including whether all or particular put options and forward contracts written on an entity's own equity should be measured on a net basis at fair value.

30. The IASB began the FICE research project in April 2014 and the preliminary project plan mentioned accounting for NCI puts and reconsidering the requirements in paragraph 23 of IAS 32. When considering the scope of the FICE project, the IASB decided that it would consider derivatives that may or must result in buying back own equity as part of the FICE project, amongst other issues.

31. In May and November 2016, the Committee discussed a request about the accounting in the consolidated financial statements when the NCI put will or may be settled by the delivery of a variable number of the parent’s own equity instruments instead of cash or another financial asset ie a share-settled NCI put. The question was whether the parent accounts for the share-settled NCI put:

(a) as a financial liability at the present value of the option’s strike price on a gross basis; or

(b) as a derivative liability at fair value on a net basis.

The Committee observed that, in the past, it had discussed issues relating to NCI puts that are settled in cash and noted that on the basis of its previous discussion, the issue was too broad to address efficiently within the confines of existing IFRS Accounting Standards.

Feedback on the proposals in the 2018 DP

32. Although the IASB tentatively decided in September 2019 not to pursue the classification approach proposed in the 2018 DP, the staff considered the proposals for redemption obligation arrangements (eg own shares and a written put option on own shares) in the 2018 DP and whether any feedback could assist in further clarifying the underlying principles in IAS 32.

33. The IASB's preferred approach in the 2018 DP would require consistent accounting for redemption obligation arrangements and compound instruments (such as convertible bonds) because both have similar contractual rights and obligations that result in similar liability and equity outcomes. The 2018 DP proposed that an entity would:

    (a) consider the rights and obligations that arise from the derivative to extinguish the equity instrument (eg written put option) together with those that arise from the underlying equity instrument (eg own shares) as a package and apply the steps described in (b) to (e) below.

    (b) recognise a financial liability for the present value of the unavoidable redemption obligation—consistent with IAS 32.

    (c) derecognise equity instruments subject to potential/future redemption at fair value at the date the derivative is issued.

    (d) if the redemption obligation is an option contract, recognise a written call option as an equity component to represent the holder's option to waive their right to exercise the put option, ie the right to keep their shares.

    (e) recognise gains or losses, including those arising from subsequent measurement of the liability component, as income and expense. However, if the NCI is puttable at fair value, the separate presentation requirements in the 2018 DP might apply in which case the income or expenses on the

financial liability component would be presented in other comprehensive income (OCI).

34. The feedback analysis on the 2018 DP presented at the June 2019 IASB meeting, including 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.