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Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Comment letter feedback—compound instruments and redemption obligation arrangements		

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Objective

1. In this paper the staff summarise the detailed feedback received from comment letters and during outreach with stakeholders on Section 5 of the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP). Feedback from users of financial statements has been incorporated where appropriate and mentioned separately. Section 5 of the DP discusses compound instruments (contracts that include both a liability and an equity component, eg convertible bonds and puttable shares) and redemption obligation arrangements (arrangements that contain a non-derivative equity instrument and a standalone derivative to extinguish that equity instrument, eg own shares and a written put option on own shares). Both of these types of arrangements include derivatives on own equity—standalone or embedded—and involve alternative settlement outcomes one of which is settlement in own equity instruments. Section 3 of the DP discusses compound instruments with non-derivative components and feedback on these instruments is discussed in Agenda Papers 5A and 5B.

2. This paper is structured as follows:

(a) Background and questions in the DP (paragraphs 3-8);

(b) Key messages from the feedback received (paragraphs 9-12);

(c) Financial instruments with alternative settlement outcomes that are not controlled by the issuer entity (paragraphs 13-58);

  (i) Compound instruments (paragraphs 14-16);

  (ii) Unit of account (paragraphs 17-18);

  (iii) Redemption obligation arrangements (paragraphs 19-24);

  (iv) Gross vs net accounting for redemption obligation (paragraphs 25-32);

  (v) Derecognition of underlying equity instruments (paragraphs 33-37);

  (vi) Written call option (paragraph 38);

  (vii) Conditionality in settlement outcomes and measurement (paragraphs 39-44);

  (viii) Interaction with IFRS 10 *Consolidated Financial Statements* (paragraphs 45-51);

  (ix) Interaction with IFRS 3 *Business Combinations* (paragraphs 52-54);

  (x) Interaction with IAS 33 *Earnings per Share* (paragraph 55); and

  (xi) Other issues (paragraphs 56-58).

(d) Financial instruments with alternative settlement outcomes that are controlled by the issuer entity (paragraphs 59-76)

Background and Questions in the DP

3. The Board first considered the classification of financial instruments with alternative settlement outcomes in which *the entity does not control* the settlement outcomes (ie the settlement outcome is controlled by the holder or determined by an uncertain future event that is beyond the control of both the entity and the holder) with the aim to achieve consistency between the classification of

arrangements that have the same contractual rights and obligations but are structured differently. The Board also considered how its preferred approach would classify financial instruments with alternative settlement outcomes that *are controlled by the entity*.

4. Section 5 of the DP[1] contains the following proposals:

   (a) For compound instruments which include derivative components (eg convertible bonds), the requirement in IAS 32 *Financial Instruments: Presentation* is carried forward ie the issuer of a non-derivative financial instrument would evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component and classify such components separately. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:

      (i) firstly, classify an unavoidable contractual obligation that has the feature(s) of a non-derivative financial liability as such; and

      (ii) then, classify any remaining rights and obligations as an equity instrument, a financial asset or a financial liability, applying the derivative classification principle of the Board's preferred approach.

   (b) For redemption obligation arrangements (eg own shares and a written put option on own shares), an entity would:

      (i) 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 (ii) to (iv) below;

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

[1] See paragraphs 5.12, 5.30, 5.44, 5.45 and 5.48 of the DP.

(iii) derecognise equity instruments subject to potential/future redemption at fair value at the date the derivative is issued; and

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

(c) For financial instruments with alternative settlement outcomes in which the entity controls the settlement outcomes (eg reverse convertible bonds), in the absence of an unavoidable obligation that has the features of a financial liability, an entity would classify the entire instrument as an equity instrument. The Board considered whether, and if so, how to provide information about the alternative liability settlement outcome, including:

(i) separation of embedded derivatives from the equity host instrument; and

(ii) presentation and disclosure, such as attribution within equity.

5. The rationale for the proposed accounting described in paragraph 4(b) was that similar contractual rights and obligations should be classified consistently regardless of how they are structured. The Board used a written put option on own shares (together with own shares) and a convertible bond as an example to illustrate this similarity.

6. In addition to the proposals summarised in paragraph 4, some of which represent little or no change from the requirements in IAS 32, the following clarifications were proposed by the DP[2]:

(a) The order of identifying a liability and an equity component—that an entity would identify the obligation that has the feature(s) of a non-derivative financial liability first;

[2] See paragraphs 5.13 and 5.21 of the DP.

(b) The treatment of conditionality in settlement outcomes —that any conditionality would be included in the derivative ie the non-derivative liability component is treated as if it is unconditional; and

(c) The treatment of alternative settlement outcomes that are controlled by the holder (eg conversion option in a traditional convertible bond) and those that are contingent on an uncertain future event that are beyond the control of both the holder and the issuer—that they are treated the same for the issuer's classification purposes.

7. With respect to gains or losses, the Board proposed[3] that gains or losses, including those arising from subsequent measurement of the liability component, are recognised as income and expense, while changes in the equity components are recognised in the statement of changes in equity.

8. The feedback described in this paper includes the responses provided by stakeholders on the following questions in the DP (paragraph references have been replaced with those used in this paper).

> **Question 6**
>
> Do you agree with the Board's preliminary views set out in [summarised in this Agenda Paper paragraphs 4(a)–(b)]? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in [summarised in this Agenda Paper paragraphs 4(b)(ii)-(iv)] and as illustrated in in the DP.
>
> For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in [summarised in this Agenda Paper paragraph 4(c)], the Board considered possible ways to provide information about the alternative settlement outcomes as described in [summarised in this Agenda Paper 4(c)(i)-(ii)].
>
> (a) Do you think the Board should seek to address the issue? Why, or why not?

[3] See paragraph 5.41 of DP.

(b) If so what approach do you think would be most effective in providing the information, and why?

Key messages

9. Generally, respondents acknowledged diversity in the current accounting practice and welcomed the Board's efforts to address the accounting for compound instruments and in particular written put options on non-controlling interests (NCI puts) and the Board's attempts to minimise divergence in practice. A few respondents noted however that the preferred approach for compound instruments and redemption obligation arrangements seems to be overly complex i.e. more complex than the current requirements in IAS 32 which are relatively easy to understand and have in their view served their purpose effectively.

10. Most respondents to Question 6 of the DP focussed on the requirements proposed for redemption obligation arrangements and in particular, NCI puts, rather than discussing proposals for compound instruments in general.

11. Respondents expressed 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 proposed derecognition of own shares, particularly when they represent NCI, and the potential impacts on the consolidated financial statements regardless of whether they broadly agreed or disagreed with the Board's preliminary views. In this regard, many respondents highlighted or raised questions on the impact of the DP's proposals on other IFRS Standards such as IFRS 10 (see paragraphs 45-51), IFRS 3 (see paragraphs 52-54) and IAS 33 (see paragraph 55).

12. In their response to the questions related to financial instruments with alternative settlement outcomes controlled by the entity, many respondents agreed with some parts of the proposals in the DP while they disagreed with other parts. Most respondents to these questions agreed that the Board should address the issue and most of them were in favour of the Board addressing the issue through additional

disclosures. Some respondents suggested alternative approaches to classifying these instruments that would take into consideration the impact of economic compulsion and indirect obligations.

Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)

13. The first part of Question 6 of the DP deals with financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer). Nearly two-thirds of the respondents who sent comment letters have provided feedback to this part of the question.

Compound instruments (proposal summarised in paragraph 4(a) of this paper)

14. Most respondents that commented specifically on compound instruments supported the Board's preferred approach for compound instruments because it is consistent with the current requirements in IAS 32. In their view, the DP clarifies the treatment of compound instruments where some application issues arose in practice for example, more clarity on whether the liability component should be probability-weighted based on the likelihood of the liability settlement outcome occurring.

15. A question was raised on the rationale for the proposed order of classifying a financial instrument which includes both a liability component and an equity component, ie why an entity should first identify the non-derivative liability.

16. When asked about the adequacy of the information currently provided about compound instruments, a few users of financial statements mentioned that they would like to better understand the potential dilution of ordinary shares. In relation to separately classifying equity and liability components of a compound instrument, an equity analyst shared the view that to his knowledge more users of financial statements prefer a no-separation approach because of its simplicity but acknowledged that recognising an equity component may better reflect the economics. This respondent added that the fair value of a convertible instrument provides a useful indication of how the instrument is expected to settle for

example, if the instrument is trading close to the par value (redemption value), it indicates that cash settlement is likely.

Unit of account (proposal summarised in paragraph 4(b)(i) of this paper)

17. Many respondents agreed that the basis for the assessment should be the package of contractual rights and obligations. However, some respondents noted that no general principle was developed of when instruments should be linked or considered as a package and suggested the Board define what is meant by 'package of contractual rights and obligations' and how to determine when the combined unit of account should be applied. A respondent believes that a test should be applied to exclude circumstances where the extinguishment of the equity instrument is unlikely or has no commercial substance.

18. A few respondents observed that the DP's proposals for considering instruments as a package seem to have a broader application than the principle of 'linked instruments' illustrated in paragraph B6 of the Guidance on implementing IFRS 9. This is because the DP's proposals do not require the instruments in a package to have been entered into at the same time or in contemplation of each other. A respondent said that if the time that elapses between the two instruments' issuance is significant, then it is more likely they are two separate economic events and effectively combining the transactions could be inappropriate.

Redemption obligation arrangements (proposal summarised in paragraph 4(b)(ii)-(iv) of this paper)

19. There were mixed views from respondents on the proposed accounting of redemption obligation arrangements (eg own shares and a written put option on own shares). Respondents were largely equally split between agreeing and disagreeing with the proposals. However, most respondents noted similar concerns regardless of whether they expressed agreement or disagreement.

20. Those respondents that generally agreed with the proposals in the DP did so on the basis that they believe a written put option on own shares (when considered together with own shares) and a convertible bond have similar contractual rights and obligations and thus should be accounted for consistently. Another reason

given for their support is that the proposed accounting treatment is consistent with existing accounting requirements for compound financial instruments in IAS 32. These respondents also believe the DP provides much needed clarity for NCI puts and a clearer model for the accounting compared to paragraph 23 of IAS 32.

21. However despite broadly agreeing with the proposals, most of these respondents still expressed concerns about derecognising NCI and the potential impacts on the consolidated financial statements if NCI is derecognised (see paragraphs 33-37 and 50-51).

22. Most of the respondents that broadly disagreed with the DP's proposals in this area did so because they believe own shares and a written put option on own shares is fundamentally and economically different from a convertible bond. Some of these respondents agreed that two financial instruments (or combinations thereof) with similar settlement outcomes and similar economic substance should have similar accounting. For example, the combination of ordinary shares and a standalone written put option on the ordinary shares should be reflected in the financial statements in a similar manner to redeemable shares. However, in spite of this they believed that convertible bonds and written put options have significant differences and should not be conflated for classification purposes.

23. These respondents noted the following as the main differences between own shares together with a written put option on own shares and a convertible bond:

    (a) The impact on the financial resources of the entity are very different during the period the instruments are outstanding – with a convertible bond the payment of interest is a contractual obligation whereas the payment of dividends on the shares is discretionary;

    (b) In the case of a written put option on own shares, the shares still exist and if the shares contain voting rights, the holder of the shares retains such rights until the put option is exercised;

    (c) In the event of insolvency or liquidation before the option is exercised, the holder of a convertible bond will have a claim to cash over the outstanding balance while the investor in shares that are puttable will have a subordinated claim to the residual interest of the entity;

(d) Convertible bonds are issued to finance an entity whereas NCI puts are granted to minority interests to provide them with liquidity and the right to sell their shares to the majority shareholder; and

(e) The timing of when the liability arises is in their view different – in the case of convertible debt, there is a liability at the issuance of the convertible debt whereas the issuer of a written put option on own shares will only have the obligation to pay when the put option is exercised.

24. The respondents that disagreed with the proposals in the DP were mainly concerned with the accounting that would result if redemption obligation arrangements are seen as convertible bonds, in particular the grossing up of the NCI put liability—even though such a liability recognition is already required by IAS 32—(see paragraphs 25-32) and the derecognition of the underlying ordinary shares or NCI (see paragraphs 33-37). They also said the Board should clarify the implications and inconsistencies of the proposals in the DP to other IFRS standards such as IFRS 10 (see paragraphs 45-51), IFRS 3 (see paragraphs 52-54) and IAS 33 (see paragraphs 55).

Gross vs net accounting for redemption obligation (proposal summarised in paragraph 4(b)(ii) of this paper)

25. For the redemption obligation, the DP proposes recognising a gross financial liability for the present value of the redemption obligation—consistent with IAS 32. Less than a quarter of respondents to the first part of Question 6 gave specific feedback on the gross vs net accounting for the redemption obligation. Of these respondents, most raised concerns with gross accounting but there was no clear consensus in support of either approach.

26. A few respondents explicitly supported the proposal to recognise a gross liability (based on the obligation to potentially deliver economic resources) saying that it is consistent with a classification providing relevant information on liquidity and solvency and/or consistent with the current requirement of paragraph 23 of IAS 32. They noted that changing this requirement would have a significant impact on practice, which is contrary to the stated objective of the FICE project. A

respondent believes that the recognition of a gross liability for the redemption amount is the correct outcome but disagrees on the timing of its recognition, especially for NCI puts. This respondent believes that it is more appropriate for the NCI to continue to receive allocations of profit or loss and to be reclassified only at the end of each reporting period to reflect the implied acquisition of the NCI.

27. On the other hand, some respondents believed that all derivatives on own equity should be accounted for consistently ie derivatives to extinguish an equity instrument should not be treated differently from other derivatives on own equity and that net accounting would be a better reflection of the economics. They questioned the appropriateness of having some derivatives grossed-up in particular, when the obligation is conditional on the exercise of an option and said it is not consistent with the accounting for other options to recognise unconditional financial liabilities as if the options were already exercised. They therefore urged the Board to further consider the benefits of measuring all derivatives on own equity in a consistent manner, ie on a net basis like other derivatives or asked for further explanation of the rationale for treating them differently.

28. A few respondents specifically said that asset/equity and liability/equity exchanges should be treated consistently and that because these exchanges represent future receipts or delivery of equity they should only be accounted for as equity upon that receipt or delivery and not before. One of the respondents also noted that grossing up two legs of an executory contract and treating them as if they are non-executory is inconsistent with the IFRS requirement which prohibits the separation of the legs of a derivative into an asset (for the inflows) and a liability (for the outflows).

29. Another respondent proposed recognising a derivative equity instrument at the date of issuing the written put option equal to the premium received in cash and only recognising a financial liability and derecognising the issued shares upon exercise of the put option.

30. A few respondents disagreed with recognising a gross obligation with a debit in equity (including derecognition) at initial recognition when forward purchases or

written put options over own equity are exclusively net-share settled (or where the issuer has a choice of net-share settlement).[4] In these cases, they believe the entity is not obligated to pay the gross amount and recognising a gross obligation results in overstating liabilities (and understating equity) which will need to be fully or partially reversed when the instrument is actually net-share settled. They therefore questioned the usefulness of the information resulting from grossing up net-share settled written put options.

31. Similarly, another respondent said it is not clear from the DP whether the issuer of a contract to purchase its own equity instruments that has the option to settle the contract on either a gross or a net-cash basis should recognise a gross liability based on the full redemption price or measure the instrument at fair value through profit or loss.

32. A few respondents noted that some issues might also arise in the separate financial statements and more than one respondent questioned whether it made sense to recognise a liability component when accounting for NCI puts in the parent's separate financial statements. They believe that in addition to the effects on consolidated financial statements, the Board should also consider the consequences in the separate financial statements, particularly as some jurisdictions require IFRS to be applied in the separate financial statements.

Derecognition of underlying equity instruments (proposal summarised in paragraph 4(b)(iii) of this paper)

33. Many respondents to Question 6 welcomed the efforts made by the Board to deal with the issue of NCI puts, especially the accounting within equity. However, they raised a number of concerns with the proposed approach and said that it does not deal with specific conceptual issues that have been raised in the past or specific related application issues.

[4] While recognising a gross financial liability for the present value of the redemption obligation is consistent with IAS 32, the DP proposes this requirement would apply to net-share settled derivatives that contain an obligation to redeem own equity instruments in addition to those that are gross-physically settled.

34. Most respondents were concerned with derecognising the underlying equity instruments (whether they are own shares or NCI) when neither the voting rights nor rights to dividends are extinguished. A respondent said this may not be appropriate especially if it is neither clear nor highly likely that the equity would be extinguished. Respondents that disagreed with derecognising the underlying equity instruments provided the following comments:

    (a) the DP introduces a new concept of derecognition because it does not reflect the extinguishment of equity instruments but rather the change in the characteristics of equity instruments.

    (b) a further complication arises when written put options lapse unexercised as the entity will be required to recognise a sale of subsidiary's shares to NCI ie in effect reversing the purchase of NCI that did not actually occur. This treatment is unnecessarily complex and does not faithfully depict the current ownership interest of the NCI during the period the option remains outstanding.

    (c) the rationale for requiring derecognition of the NCI at current fair value should be better explained. It is possible for the current fair value of own shares or NCI to be above the book value and it is not clear whether the resulting negative equity or NCI balance would provide useful information.

35. Many respondents argued that these transactions should instead be analysed as transactions with owners acting in their capacity as owners (see paragraph 45) and accordingly a contra-equity account may be recognised instead of derecognising the NCI.

36. A few respondents argued that the analysis should be different for NCI puts at fair value (ie the strike price is the fair value of the shares at the exercise date) and NCI puts exercisable at a fixed or predetermined price. According to them, where the exercise price is predetermined, the NCI (ie the option holder) will have no further downside risk in the subsidiary and therefore it makes sense for it to be derecognised as the parent bears the full risk of the subsidiary's performance. Whereas, when the option is puttable at fair value, the NCI remains fully exposed to changes in the economic resources of the subsidiary ie continues to have

equity-type exposure and the risks and rewards of ownership of the underlying shares still reside with the NCI. Consequently, it might be argued that the initial debit entry should be recognised as a contra-equity account rather than derecognising NCI.

37. A respondent made a general comment that the Board should consider whether a different accounting model is warranted for the different types of arrangements containing an obligation to repurchase NCI shares for example, options, forwards or contingent consideration arrangements. Another respondent questioned whether a consistent treatment is necessary for NCI puts and other put options written by the entity on own shares.

Written call option (proposal summarised in paragraph 4(b)(iv) of this paper)

38. A few respondents gave feedback on the proposed recognition of a written call option that reflects the option of the holder to waive their right to exercise the put option. Those that did 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. A respondent questioned the usefulness of recognising the carrying amount of the conversion option within equity. Another respondent was concerned that reflecting the equity component of a written put option as a written call or conversion option in a convertible bond is complex for users of financial statements and preparers to understand and does not reflect the substance of the instruments.

Conditionality in settlement outcomes and measurement (proposals summarised in paragraphs 6(b) and 7 of this paper)

39. Not many respondents gave feedback specifically on the inclusion of conditionality in settlement outcomes. Of those that did, some mentioned that this is an area where the DP provides clarity. However, some respondents only supported excluding conditionality from the measurement of the non-derivative liability if the settlement outcomes are within the control of the holder. They believed that conditionality should be factored into the initial measurement of the non-derivative liability when the alternative settlement outcomes are contingent

on an uncertain future event that is beyond the control of both the entity and the holder.

40. The DP's approach in this scenario would mean that the liability would be measured at the full amount that the entity could be required to pay immediately. However, these respondents believed factoring the conditionality into the measurement of the non-derivative liability is conceptually stronger because it reflects the characteristics of the liability and how future cash flows of the entity could be affected and fits better with the measurement requirements in IFRS 9. Such measurement would also solve recurring practice issues with IAS 32, such as the amount of the liability component of a financial instrument being greater than the proceeds from the instrument and the need to recognise a full liability in cases when the contingency was remote for example, a change in tax law with specified effects. According to these respondents, the liability would be remeasured on an ongoing basis, with changes in the probability assessment being factored into the measurement and recognised in profit or loss.

41. However, in contrast an accountancy body specifically agreed that probability should not be factored into the measurement of a contingent settlement liability that is beyond the control of the issuer. They questioned the reliability of having to discount the contingent settlement obligation and said that requiring issuers to estimate the likelihood and timing they expect to be liquidated (or otherwise considered non-viable, if that is the trigger event) would not work. Rather they preferred to present the contingent settlement provision as a financial liability in full similar to the principle in paragraph 39 of IFRS 13 that applies to demand deposits. Further, in their view any distribution of cash flows that result from cash flows the entity could have avoided should be presented as a deduction from equity. This respondent also believes that if the entity could be required to pay an amount higher than the initial proceeds, then such difference should be treated as a derivative.

42. The DP proposes that gains or losses, including those arising from subsequent measurement of the liability component, are recognised as income and expense, while changes in the equity components are recognised in the statement of changes in equity. However, if the NCI is puttable at fair value, the separate

presentation requirements in the DP might apply in which case the income or expenses on the financial liability component would be presented in other comprehensive income (OCI). Some respondents highlighted that many NCI puts they have seen in practice have a price based on EBITDA multiples. These respondents acknowledged that such multiples are not fair value of the equity instruments but noted that they are designed to act as proxy. Some respondents did not agree with the different presentation of income and expenses depending on whether the strike price of the put option is the fair value of the underlying shares or is based on a fair value proxy for example, expressed in terms of an EBITDA multiple or a percentage of the fair value of the share. They highlighted that for financial instruments that are puttable at another variable based on the entity's performance, the current counterintuitive situation of a deterioration in profit or loss caused by an improvement in the entity's performance will persist.

43. A further question was raised on whether the release of interest unwind on the NCI put liability should be presented in profit or loss or in OCI if the NCI put liability is subject to the separate presentation requirements.

44. A few respondents questioned the accounting for discretionary interest payments on contingent convertible bonds when the entire amount was allocated to the financial liability component. They pointed out the apparent contradiction between paragraph 36 of IAS 32 (dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond) and AG37 of IAS 32 (discretionary dividends paid relate to the equity component and are recognised as a distribution of profit or loss). A respondent further questioned whether interest expense would be recorded on the liability if it is already measured at its redemption amount ie measured ignoring the effect of any conditionality in settlement outcomes because the issuer could be required to redeem or convert the instrument immediately regardless of the likelihood of redemption or conversion.

Interaction with IFRS 10

Transactions among shareholders

45. Many respondents suggested the Board consider IFRS 10 in the analysis of NCI puts when determining its approach, in particular whether the transaction with NCI is a transaction among shareholders which justifies recording changes in the NCI puts directly in equity as required by IFRS 10, for example. A respondent specifically questioned whether the issuance and expiry of NCI puts should be accounted for as changes in the proportion of equity held by NCI in accordance with paragraph B96 of IFRS 10 which requires an entity to recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

46. In addition, these respondents observed that for written put options on own equity with a fair value strike price, the approach in the DP would assign a nil value to the equity component. Consequently, the return on such put options would be entirely reflected in the changes in the liability component through OCI (subject to separate presentation requirements proposed in the DP).

47. These respondents noted that the DP is explicit that gains or losses, including those arising from subsequent measurement of the liability component, are recognised as income and expense. Some respondents questioned whether and why changes in the redemption amount are to be accounted for under IFRS 9 (through profit or loss) and not IFRS 10 (as transactions between equity holders).

48. Another respondent said transactions with NCI are not representative of the entity's performance and should not be reflected in profit or loss. They may impact the allocation of returns on that performance among shareholders and therefore may lead to changes in the allocation of equity.

49. A few respondents mentioned that the IFRS Interpretations Committee has acknowledged diversity in practice regarding whether changes in the subsequent measurement of an NCI put liability are recognised in profit or loss or equity and cited a perceived conflict between IFRS 10 Consolidated Financial Statements and IFRS 9 (IAS 27 and IAS 39 at the time of the Committee's discussion).

These respondents encouraged the Board to once again discuss and assess the effectiveness and challenges of recognising gains or losses arising from the subsequent measurement of the NCI put liability as changes in equity.

Consequences of derecognising NCI

50. Many respondents highlighted some application issues that could lead to uncertainty in the consolidated financial statements after the NCI have been derecognised, such as the profit allocation to NCI required by paragraph B94 of IFRS 10. These respondents asked the Board to clarify that a portion of the subsidiary's profit or loss and OCI would not be attributed to the NCI if the NCI has been derecognised. Some of these respondents also questioned the accounting for any cumulative results of the subsidiary that have not been attributed to, and the effects of subsequently recognising, the previously derecognised NCI in the event that the written put option is not exercised.

51. A respondent noted that it is not entirely clear whether it is still necessary to assess who has current access to the returns associated with the ownership interest of the underlying shares that are subject to the NCI put applying paragraph B90 of IFRS 10 because the DP requires derecognition of NCI as if the option was already exercised.

Interaction with IFRS 3

52. A few respondents said that because the NCI put is frequently issued concomitant with a business combination transaction, there is a possible conflict between the Board's proposed approach and paragraph 10 of IFRS 3. This paragraph requires the acquirer to recognise separately from goodwill, the identifiable assets acquired, the liabilities assumed and any NCI in the acquiree as of the acquisition date. These respondents questioned whether the written put option is part of the business combination transaction and the resulting implications for example, whether goodwill is computed on the basis that the NCI does not exist at acquisition or that it exists on day 1 but is derecognised on day 2.

53. Another area of potential conflict highlighted by respondents is that paragraph 19 of IFRS 3 allows the acquirer to measure at the acquisition date components of

NCI that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either fair value or the present ownership instrument's proportionate share in the recognised amounts of the acquiree's identifiable net assets. However, the DP proposes derecognition of the NCI at its fair value if it is subject to a put option. More than one respondent questioned if the NCI could then be negative in a scenario when the NCI was not recognised at fair value but based on the proportionate share of net assets under the measurement policy choice available in IFRS 3. Another respondent similarly said it is unclear whether, under the Board's preferred approach, the difference between the carrying amount of the NCI and the fair value is recognised directly in parent company equity or whether it creates a 'residual NCI' amount.

54. A respondent noted that if NCI is measured at full fair value in a business combination, this may not affect the overall goodwill amount if this is the same as the present value of the exercise price in the put liability. However, if NCI is presented as the proportionate share of the assets and liabilities, this distinction would affect the measurement of goodwill.

Interaction with IAS 33

55. A few respondents commented on the interaction of the redemption obligation requirements and IAS 33. It was noted that under the proposed approach, equity instruments that are still legally outstanding are derecognised and a clarification is needed whether they should be considered no longer outstanding for earnings per share purposes. These respondents also noted that derecognising NCI would also impact the earnings used in the EPS calculation because profit after NCI will increase ie assuming that a share of a subsidiary's earnings are not attributed to NCI that is subject to the written put option. More than one respondent mentioned that the impact on the diluted EPS calculation of derecognising NCI should also be considered because the earnings attributable to shareholders of the parent will effectively be subject to dilution if the NCI put is not exercised.

Other issues

56. This section highlights some other matters, mostly related to NCI puts that were raised by respondents in their responses to Question 6 of the DP and for which they asked the Board to consider or provide clarificatory guidance on.

57. Many respondents, including feedback gathered from outreach, requested clarification on how to determine whether an event is within the entity's control. A few respondents specifically requested guidance where decisions to redeem a financial instrument are made by voting shareholders as to when shareholders are acting as part of the entity and when they are acting outside of the entity. Similarly, a respondent suggested the Board clarify whether the following examples are outside the entity's control:

    (a) full repayment of an instrument in case of fraud in the company;

    (b) distributions that are required to be made to holders unless excess capital is reinvested in the business; or

    (c) repayment of an instrument in case of deadlock on key decisions.

58. In relation to NCI puts the following questions were raised:

    (a) whether discretionary dividends and distributions paid to NCI shareholders after the NCI is derecognised would be recognised in profit or loss as interest expense or recognised in equity.

    (b) whether dividends paid to NCI shareholders are debited against the value of the implicit written call option if the present value of any dividends expected to be paid prior to the exercise date is incorporated in the value of the implicit written call option. They also questioned the accounting treatment of dividends paid to NCI shareholders if any payment of dividends gives rise to an adjustment to the exercise price of the NCI put or if the NCI is puttable at fair value.

    (c) whether the analysis that applies to a written *call* option on NCI would apply in the same way to a written *put* option on NCI. The DP explains that ordinary shares in a subsidiary held by NCI or a written call option on such shares, in exchange for a fixed amount of cash in the subsidiary's functional currency, are equity for the group as the

'independent of available economic resources test' is applied by reference to the resources of the subsidiary rather than the group as a whole.

(d) whether the put option is considered to be affected by a variable that is independent of the entity's available economic resources, particularly if the parent writes a put option on a fixed number of the subsidiary's shares at fair value, whether it made a difference whether the parent shares the functional currency of the subsidiary or has a different functional currency and whether the applicability of the separate presentation requirements depends on whether the NCI puttable at fair value is written by the parent or the subsidiary.

(e) how a fixed strike price written put option on NCI and a purchased call option with matching terms should be accounted for especially where the NCI are still be entitled to dividends from the subsidiary prior to the exercise of the options and the parent controls the payment of the dividends.

Financial instruments with alternative settlement outcomes that are controlled by the entity (proposal summarised in paragraph 4(c) of this paper)

59. The second part of Question 6 of the DP deals with financial instruments with alternative settlement outcomes that are *controlled by the entity*[5] such as reverse convertible bonds or shares that are callable by the issuer entity. Over a third of the respondents who sent comment letters have provided feedback to this part of the question. Most of those who responded agreed that the Board should address the issue and most of them were in favour of enhanced disclosures about the alternative settlement outcomes rather than separating embedded derivatives from equity host instruments (see paragraphs 63-67). Out of those respondents that agreed the Board should address the issue, most agreed with the accounting

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[5] Financial instruments with alternative settlement outcomes discussed here contain at least one settlement outcome that has the features of an equity instrument and the issuer entity has the unconditional right to choose that equity settlement outcome.

outcome of the Board’s proposed approach ie such a financial instrument is classified as equity in its entirety (see paragraph 69). However some respondents did not agree with equity classification and suggested other approaches for the Board to consider (see paragraphs 70-75) in addressing the issue. In addition, a few respondents did not think the Board needed to address this issue (see paragraph 76).

Respondents that agreed the Board should address the issue

60. Most of the respondents that agreed the Board should address the issue also agreed with equity classification for these instruments (see paragraph 69).

61. Reasons given by respondents for the Board to address the issue include the increasing application of these instruments in the marketplace and the need to ensure consistent accounting for these instruments and for the Board to provide comprehensive guidance.

62. Other reasons to address the issue include the concerns raised that the proposed approach does not consider the intention of the issuer and that there are perceived inconsistencies with other IFRSs that appear to do so. A respondent mentioned that IFRS 2 *Share-based Payment* has requirements for share-based payment transactions in which the terms of the arrangement provide the entity with a choice of settlement. IFRS 2 states that an entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance, or if the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement. The respondent also highlighted certain provisions in IFRS *15 Revenue from Contracts with Customers* where the performance obligations identified in a contract with a customer may not be limited to the goods or services explicitly stated in the contract (ie contract may include implied promises) and where the economic incentives of the counterparty in a contract are required to be considered.

63. Most of the respondents that agreed the Board should address the issue, preferred providing information about the alternative settlement outcome through presentation and disclosure, and particularly through enhanced disclosure of the

characteristics and terms and conditions of such instruments. A few users of financial statements said they prefer disclosure that enables them to understand management's intentions or expectations so that they can understand the expected outcomes. In the context of instruments where the issuer has the option to settle in cash or in shares, they noted that the expected settlement will often be idiosyncratic to each issuer and classification outcomes reflecting such idiosyncrasy could reduce comparability.

64. More than one respondent acknowledged that separating embedded derivatives from equity host instruments could provide more information and best reflect the characteristics of the instruments. However, these same respondents along with most respondents were not in favour of separating embedded derivatives, citing the following reasons, amongst others:

    (a) creates complexity eg the premium for such an option would need to be determined;

    (b) such a requirement would be a fundamental change from current accounting practice;

    (c) the effort and costs for preparers to implement such requirement exceed any benefits derived from it;

    (d) an equity instrument represents a residual interest and the difficulty of determining what is not closely related to an equity host that represents residual interest; and

    (e) recognising an embedded derivative asset would result in the recognition of an asset related to a future equity transaction.

65. A respondent specifically mentioned the Board may consider exploring the merit of not separating the embedded derivative from the equity instrument. The respondent noted that arguably, an unconditional right to avoid a liability settlement outcome must be accompanied by an ability to waive the right to equity settlement outcome and choose the liability settlement outcome. They said that in terms of accounting, there is no separation between an equity instrument, such as ordinary shares, and the underlying right to satisfy, in whole or in part, the instrument at some point in time. Therefore, in the case of financial instruments

with alternative settlement outcomes controlled by the entity, they reasoned that the cash settlement option need not be separated and the financial instrument can be classified in its entirety as an equity instrument. Furthermore, they argued that the cash settlement option is part of the equity instrument, instead of an embedded derivative, because it has been considered in determining that the financial instrument as a whole is an equity instrument.

66. In contrast, some respondents supported the approach of separating embedded derivatives. A respondent did not see why separating the liability and equity components of a reverse convertible bond would give rise to more significant difficulties than those that arise in the case of a conventional convertible bond.

67. A respondent said there may be another way to separate the embedded derivative from the host instrument. They suggested the host instrument be identified based on the assumption there are no embedded derivatives i.e. no embedded reverse conversion option. The host instrument would therefore be a liability and the separated embedded derivative would have the features of a purchased put option on own shares as opposed to a purchased call option as suggested in the DP. This outcome is therefore in line with the respondents that disagree with equity classification for reverse convertible bonds.

68. Some respondents did not support either of the potential approaches mentioned in the DP (ie separation of embedded derivative or presentation and disclosure). These were generally those respondents that were not supportive of equity classification (see paragraphs 70-75) or acknowledged equity classification may be appropriate only if an entity can in all cases avoid a liability settlement outcome but still suggested other approaches.

Respondents that agreed with equity classification

69. Most respondents agreed with equity classification for these instruments and believe the proposals in the DP do not change the current requirements of IAS 32. A respondent agreed that equity classification is appropriate if the alternative settlement outcomes are practically and economically feasible and believes information about economic incentives should not impact the classification but can be incorporated into the measurement of the claim and/or its eventual settlement.

Respondents that disagreed with equity classification

70. Some respondents disagreed with equity classification for these instruments. A respondent did not agree for example, that a reverse convertible bond should be classified as equity because they believe it is a liability until it is converted—similar to a conventional convertible bond. This respondent was also concerned that if the option to elect for equity settlement is only exercisable at certain times for example, at maturity, then it would be reported as equity for the whole period for which the bond is outstanding which might be many years after the reporting date.

71. Another respondent does not believe classifying the contract in full as equity reflects the substance of the arrangement. This respondent believes the substance of the transaction is a liability for its cash outflows and negative equity for the purchased put option. This is because in their view, in all cases where the share price of the entity is higher than the cash alternative, it is reasonable to assume the entity will choose to pay cash and the share price movements are out of the control of the entity and therefore consistent with paragraph 25 of IAS 32, the instrument should be classified as a financial liability.

72. A few respondents were concerned that the proposed approach does not take into consideration the intention of the issuer and also could result in situations in which the accounting would not portray the economic substance of the instrument for example, if the intention of the issuer is to choose the liability settlement outcome and settle in cash. It was also highlighted that conversion features may sometimes specifically be included in instruments for structuring purposes to obtain equity classification.

73. In addition, more than one respondent discussed the perceived tension between the accounting provisions in paragraph 20 and paragraph 25 of IAS 32 and highlighted that there may be contradictory outcomes. Applying paragraph 20 of IAS 32 to instruments with alternative settlement outcomes that are controlled by the entity, for an instrument to be classified as equity, in their view the equity settlement outcome should be preferable to the cash alternative only in some scenarios that are genuine and not necessarily in all of them. However, applying paragraph 25 of IAS 32, for an instrument to be classified as equity, the issuer

should have the ability to avoid paying cash in all genuine scenarios. These respondents noted that a financial instrument will almost always be a financial liability where the entity does not control the contingent settlement options and will almost always be equity where the entity controls alternative settlement options.

74. These respondents therefore suggested other approaches for classifying instruments with alternative settlement outcomes controlled by the entity for example, approaches that consider economic compulsion or use paragraph 20(b) of IAS 32 which deals with indirect obligations as a starting point.

75. An accounting firm suggested an approach which aims to avoid structuring and gives a consistent accounting outcome – it would require liability classification where the issuer has settlement choices, unless all those settlement choices result in equity classification. Another respondent was also concerned that a reverse convertible bond in particular, could be structured through different contract terms with the same economic outcome but leading to a liability classification. This respondent suggested compound instrument accounting as used for conventional convertible bonds as an alternative approach.

Respondents that disagreed the Board should address the issue

76. A few respondents disagreed that the Board should address the issue because they were not aware of any practical issues or because the Board’s preferred approach is consistent with IAS 32, they did not believe further complexity should be introduced. They thought overall IAS 32 has worked well in practice and not caused significant concerns in this regard.