Project: **Financial instruments with characteristics of equity**

Topic: **Presentation of physically-settled forward purchase contracts and physically-settled written put options**

## Objective

1. At the December 2009 joint Board meeting we will ask the Boards whether physically settled forward purchase contracts and physically settled written put options should be reported on the statement of financial position as either:

   (a) Gross (as a liability for the future payment and an offsetting debit to equity); or

   (b) Net (in the same manner as other derivatives).

2. In June 2009 both Boards decided that instruments should be presented net with changes in income (consistent with other derivatives).

3. Appendix A provides examples and journal entries illustrating both presentations.

## Summary of the Two Approaches

### *Gross presentation*

4. Gross presentation would require the present value of the forward repurchase price or option exercise price to be reported as a liability with an offsetting debit to equity. That liability would be subsequently measured at amortised cost using the effective interest method. If the price is fixed, the contract appears as shares repurchased at inception financed by a fixed-rate loan for the term of the contract. In the case of a

varying price contract (for example, a forward to repurchase shares at fair value), the contract appears to be financed by debt indexed to the issuer's share price.

5. The offsetting debit to equity could be treated as either a reduction in shares outstanding or as a contra-equity account. The difference has significant implications for the calculation of diluted earnings per share (EPS).

6. Some think that treating the debit as a reduction in shares outstanding would be consistent with the treatment of the liability. The underlying shares would be treated as if the holder had returned them at the inception of the contract.

7. Others view the offsetting debit as a contra-equity. The debit in equity is a right of the entity to receive its own shares (shares receivable). Shares receivable would be classified as contra-equity instead of an asset because the shares will not be assets when the entity holds them. Even though net equity decreases, the number of shares outstanding would remain unchanged.

8. Forward purchase contracts and written put options are currently reported gross under IAS 32, *Financial Instruments: Presentation*.[1] Topic 480, Distinguishing Liabilities from Equity (originally issued as FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity)* requires gross presentation for physically settled forward purchase contracts but not for written put options.

***Net presentation***

9. Net presentation would require physically settled forward repurchase contracts and physically settled written put options to be accounted for as a derivative under Topic 815, Derivatives and Hedging (originally issued as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities)* or IAS 39/IFRS 9.

[1] The IAS 32 gross presentation requirements are argued as much on the basis of consistency of accounting treatment with other situations as anything else. A liability is recognised for obligations that are conditional on events or choices that are beyond the entity's control (unless it has specified features) and measured at the full amount of the conditional obligation.

They would be remeasured at fair value with changes in earnings unless they are liabilities under IAS 39 and the shares to be received have no quoted market prices.

## Staff Analysis

### *Gross presentation*

10. Proponents of gross presentation have provided the following reasoning for their view:

    (a) The entity cannot avoid settlement for *the entire redemption amount* in cash, or another financial asset, unless the counterparty decides not to exercise its redemption right. The gross presentation fittingly recognises a liability for this amount. Also, gross presentation addresses concerns that the entity's transfer of cash reduces net assets for the entire amount of the cash outflow unlike other derivatives that involve receipt of assets.

    (b) It reduces structuring opportunities. For example, an entity may issue shares for cash and simultaneously issue a physically settled forward purchase contract for the same shares. The end result is expected to be very similar to the issuance of debt.

11. Some supporters of gross presentation have stated that the fair value changes reflect a shift in the value between different classes of equity holders and not the performance of the entity. Gross presentation is closer to their preferred approach, which would be to report those contracts net, classify them in equity, and remeasure them at fair value with changes in another equity account. Those supporters acknowledge that their preferred approach is inconsistent with earlier decisions and have not asked for a comprehensive reconsideration. For completeness, Appendix A provides an example of this approach labelled "equity presentation" but the staff does not plan to discuss it further.

***Net presentation***

12. Proponents of net presentation have provided the following reasoning for their view:

   (a) The entity has a liability for the entire redemption amount only on receipt of the shares. Gross presentation requires those derivatives to be treated as if part of the exchange had already occurred.

   (b) Gross presentation may reduce structuring opportunities. However, the following are also of concern:

      (i) Introducing specific requirements to minimise structuring will increase complexity. In this case, it results in inconsistency with the treatment of other derivatives and would negate the previous decision to separate instruments redeemable at the option of the holder or on the occurrence of events outside the control of the issuer. The effect of presenting a put option gross would have the same effect on total liabilities as classifying the entire redeemable instrument as a liability.

      (ii) A linkage requirement would be a more effective way to deal with structuring. Arrangements such as physically settled derivatives and the related shares could be combined and accounted for as a single instrument. Linkage requirements will be discussed Agenda Paper 5F/Memo 78.

   (c) Reporting the effects of the issuer's share price in net income is an issue that affects other contracts and that should be addressed through income statement presentation and/or by requiring additional disclosures.

   (d) Some are concerned with the period over which interest should be accreted when the exercise date of a put is not fixed. Any estimate of when the put is to be exercised is likely not to coincide with when the put is actually exercised. Exercising the put at a date earlier than expected would create extinguishment gains and losses that are difficult to explain. Exercising the put at a date later than expected would result in a period with no interest accretion, which is also difficult to explain.

## Staff Recommendation

13. Forward contracts to repurchase an issuer's own shares and written put options should be reported net and measured at fair value through net income, primarily based on the reasoning discussed in paragraph 12 of this memo. Additionally, we think that many entities are indifferent to physical or net-share settling and those entities would have the ability to choose the settlement alternative that provides the accounting treatment they prefer.

| **Questions** | |
|---|---|
| Q1. | Should physically settled forward purchase contracts and physically settled written put options be presented:<br><br>(a) Gross and measured at the present value of the redemption amount; or<br><br>(b) Net (consistent with other derivatives)? |
| Q2. | If the Boards choose gross presentation, should the related debit be treated as (a) a reduction outstanding shares or (b) contra-equity for the purposes of calculating diluted EPS? (See paragraphs 5–7.) |
| Q3. | If the Boards choose gross presentation, how should instruments redeemable at the option of the holder or on contingent events outside the control of the issuer (referred to as puttables in IAS 32) be treated:<br><br>(a) Separated into a derivative (to be presented net) and an equity component;<br><br>(b) Separated into a derivative (to be presented gross in the same manner as if it were freestanding) and another equity component; or<br><br>(c) As a financial liability in its entirety?<br><br>(See paragraph 12(b)(i)) |

## Appendix A: Examples contrasting the gross versus net presentation approach

### *Example 1: Forward to buy shares ('gross physical settlement')*

A1. This example illustrates the journal entries for forward purchase contracts on an entity's own shares. The contract will be settled by delivering cash in exchange for shares. To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (ie the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

*Assumptions:*

| | |
|---|---|
| Contract date | 1 February 20X2 |
| Maturity date | 31 January 20X3 |
| Year-end reporting date | 31 December 20X2 |
| | |
| Market price per share on 1 February 20X2 | CU100 |
| Market price per share on 31 December 20X2 | CU110 |
| Market price per share on 31 January 20X3 | CU106 |
| | |
| Fixed forward price to be paid on 31 January 20X3 | CU104 |
| Present value of forward price on 1 February 20X2 | CU100 |
| Number of shares under forward contract | 1,000 |
| Fair value of forward on 1 February 20X2 | CU0 |
| Fair value of forward on 31 December 20X2 | CU6,300 |
| Fair value of forward on 31 January 20X3 | CU2,000 |
| | |
| Issued capital and reserves on 1 February 20X2 | CU300,000 |
| Other assets on 1 February 20X2 | CU300,000 |
| Total liabilities on 1 February 20X2 | CU0 |
| Profit/loss for year ending 31 December 20X2 (before derivative activity) | CU50,000 |
| Profit/loss for the month ending 31 January 20X3 (before derivative activity) | CU10,000 |

A2. On 1 February 20X2, Entity A enters into a contract with Entity B to receive the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 in exchange for a payment of CU104,000 in cash (ie CU104 per share) on 31 January 20X3. Settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. The price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B (CU104 × 1,000) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

| **Gross presentation approach** | **Net presentation approach** | **Equity presentation** |
|---|---|---|
| **1 February 20X2** | **1 February 20X2** | **1 February 20X2** |
| Dr Equity CU100,000 | | |
| Cr Liability CU100,000 | | |
| *To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IAS 39, paragraph AG64).* | *No entry is required because the fair value of the derivative is zero and no cash is paid or received* | *No entry is required because the fair value of the derivative is zero and no cash is paid or received* |

| **Gross presentation approach** | **Net presentation approach** | **Equity presentation** |
|---|---|---|
| **31 December 20X2** | **31 December 20X2** | **31 December 20X2** |
| Dr Interest expense CU3,660 | Dr Forward asset CU6,300 | Dr Equity - forward CU6,300 |
| Cr Liability CU3,660 | Cr Gain CU6,300 | Cr Other equity CU6,300 |
| *To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.* | *To record the increase in the fair value of the forward contract* | *To record the increase in the fair value of the forward contract* |

A3. The financial statements as of 31 December 20X2 year end. The following financial statements have been simplified to highlight the differences between the different methods.

| **Income Statement 31 December, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Profit/loss for year | 50,000 | 50,000 | 50,000 |
| Interest expense on forward contract | (3,660) | - | - |
| Gain on forward contract | - | 6,300 | - |
| Net Profit/Loss | 46,340 | 56,300 | 50,000 |

| **Statement of Changes in Equity 31 December, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** | |
|---|---|---|---|---|
| | Issued capital and reserves | Issued capital and reserves | Issued capital and reserves | Forward contract |
| Beginning balance | 300,000 | 300,000 | 300,000 | - |
| Net profit/loss for year | 46,340 | 56,300 | 50,000 | - |
| Transfer from forward contract | - | - | 6,300 | (6,300) |
| Buy-back of ordinary shares | (100,000) | - | - | - |
| Ending balance | 246,340 | 356,300 | 356,300 | (6,300) |

$$\underbrace{356{,}300 \quad (6{,}300)}_{\text{Total Equity CU350,000}}$$

| **Balance Sheet 31 December, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Assets | | | |
| Forward asset | - | 6,300 | - |
| Other assets | 350,000 | 350,000 | 350,000 |
| Total Assets | 350,000 | 356,300 | 350,000 |
| Total Liabilities | 103,660 | - | - |
| Equity | | | |
| Issued capital and reserves | 246,340 | 356,300 | 356,300 |
| Forward contract | - | - | (6,300) |
| Total Liabilities & Equity | 350,000 | 356,300 | 350,000 |

| **Gross presentation approach** | **Net presentation approach** | **Equity presentation** |
|---|---|---|
| **31 January 20X3** | **31 January 20X3** | **31 January 20X3** |
| Dr Interest expense CU340 | Dr Loss CU4,300 | Dr Other equity CU4,300 |
| Cr Liability CU340 | Cr Forward asset CU4,300 | Cr Equity - forward CU4,300 |
| *To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.* | *To record the decrease in the fair value of the forward contract (ie CU4,300 = CU6,300 – CU2,000).* | *To record the decrease in the fair value of the forward contract (ie CU4,300 = CU6,300 – CU2,000).* |

A4. Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

| **Gross presentation approach** | **Net presentation approach** | **Equity presentation** |
|---|---|---|
| **31 January 20X3** | **31 January 20X3** | **31 January 20X3** |
| Dr Liability CU104,000 | Dr Equity CU106,000 | Dr Other equity CU106,000 |
| Cr Cash CU104,000 | Cr Forward asset CU2,000 | Cr Equity - forward CU2,000 |
| | Cr Cash CU104,000 | Cr Cash CU104,000 |
| *To record the settlement of the obligation to redeem Entity A's own shares for cash.* | *To record the settlement of the forward contract.* | *To record the settlement of the forward contract.* |

A5. The financial statements as of 31 January 20X3 after settlement. The following financial statements have been simplified to highlight the differences between the different methods.

| **Income Statement 31 January, 20X3** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Profit/loss for year | 10,000 | 10,000 | 10,000 |
| Interest expense on forward contract | (340) | - | - |
| Loss on forward contract | - | (4,300) | - |
| Net Profit/Loss | 9,660 | 5,700 | 10,000 |

| **Statement of Changes in Equity 31 January, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** | |
|---|---|---|---|---|
| | Issued capital and reserves | Issued capital and reserves | Issued capital and reserves | Forward contract |
| Beginning balance | 246,340 | 356,300 | 356,300 | (6,300) |
| Net profit/loss for year | 9,660 | 5,700 | 10,000 | - |
| Transfer to forward contract | - | - | (4,300) | 4,300 |
| Buy-back of ordinary shares | - | (106,000) | (106,000) | 2,000 |
| Ending balance | 256,000 | 256,000 | 256,000 | - |

Total Equity
CU256,000

| **Balance Sheet 31 January, 20X3** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Assets | | | |
| Forward asset | - | - | - |
| Other assets | 256,000 | 256,000 | 256,000 |
| Total Assets | 256,000 | 256,000 | 256,000 |
| Total Liabilities | - | - | - |
| Equity | | | |
| Issued capital and reserves | 256,000 | 256,000 | 256,000 |
| Forward contract | - | - | - |
| Total Liabilities & Equity | 256,000 | 256,000 | 256,000 |

***Example 2: Written put option on shares ('gross physical settlement')***

A6. This example illustrates the journal entries for a written put option on the entity's own shares that will be settled by delivering cash in exchange for shares.

*Assumptions:*

| | |
|---|---|
| Contract date | 1 February 20X2 |
| Exercise date | 31 January 20X3 |
| | (European terms, ie it can be exercised only at maturity) |
| Exercise right holder | Counterparty (Entity B) |
| | |
| Market price per share on 1 February 20X2 | CU100 |
| Market price per share on 31 December 20X2 | CU95 |
| Market price per share on 31 January 20X3 | CU95 |
| | |
| Fixed exercise price to be paid on 31 January 20X3 | CU98 |
| Present value of exercise price on 1 February 20X2 | CU95 |
| Number of shares under option contract | 1,000 |
| Fair value of option on 1 February 20X2 | CU5,000 |
| Fair value of option on 31 December 20X2 | CU4,000 |
| Fair value of option on 31 January 20X3 | CU3,000 |
| | |
| Issued capital and reserves on 1 February 20X2 | CU300,000 |
| Other assets on 1 February 20X2 | CU300,000 |
| Total liabilities on 1 February 20X2 | CU0 |
| Profit/loss for year ending 31 December 20X2 (before derivative activity) | CU50,000 |
| Profit/loss for the month ending 31 January 20X3 (before derivative activity) | CU10,000 |

| Gross presentation approach | Net presentation approach | Equity presentation |
|---|---|---|
| **1 February 20X2**<br>Dr Cash CU5,000<br>Cr Equity CU5,000<br>*To recognise the option premium received of CU5,000 in equity.*<br>Dr Equity CU95,000<br>Cr Liability CU95,000<br>*To recognise the present value of the obligation to deliver CU98,000 in one year, ie CU95,000, as a liability.* | **1 February 20X2**<br>Dr Cash CU5,000<br>Cr Put option liability CU5,000<br>*To recognise the option premium received of CU5,000.* | **1 February 20X2**<br>Dr Cash CU5,000<br>Cr Equity - option CU5,000<br>*To recognise the option premium received of CU5,000.* |

| Gross presentation approach | Net presentation approach | Equity presentation |
|---|---|---|
| **31 December 20X2**<br>Dr Interest expense CU2,750<br>Cr Liability CU2,750<br>*To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.* | **31 December 20X2**<br>Dr Put option liability CU1,000<br>Cr Gain CU1,000<br>*To record the decrease in the fair value of the put option.* | **31 December 20X2**<br>Dr Equity - option CU1,000<br>Cr Other equity CU1,000<br>*To record the decrease in the fair value of the put option.* |

A7. The financial statements as of 31 December 20X2 year end. The following financial statements have been simplified to highlight the differences between the different methods.

| **Income Statement 31 December, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Profit/loss for year | 50,000 | 50,000 | 50,000 |
| Interest expense | (2,750) | - | - |
| Gain on put option | - | 1,000 | - |
| Net Profit/Loss | 47,250 | 51,000 | 50,000 |

| **Statement of Changes in Equity 31 December, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** | |
|---|---|---|---|---|
| | Issued capital and reserves | Issued capital and reserves | Issued capital and reserves | Put option |
| Beginning balance | 300,000 | 300,000 | 300,000 | - |
| Net profit/loss for year | 47,250 | 51,000 | 50,000 | - |
| Put option (transfer) | - | - | 1,000 | 4,000 |
| Buy-back of ordinary shares | (95,000) | - | - | - |
| Ending Balance | 257,250 | 351,000 | 351,000 | 4,000 |

Total Equity
CU355,000

| **Balance Sheet 31 December, 20X2** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Other assets | 355,000 | 355,000 | 355,000 |
| Total assets | 355,000 | 355,000 | 355,000 |
| Total liabilities | 97,750 | 4,000 | - |
| Equity | | | |
| Issued capital and reserves | 257,250 | 351,000 | 351,000 |
| Put option | - | - | 4,000 |
| Total liabilities & equity | 355,000 | 355,000 | 355,000 |

A8. On the same day, Entity B exercises the put option and the contract is settled gross. Entity A has an obligation to deliver CU98,000 in cash to Entity B in exchange for CU95,000 worth of shares (CU95 × 1,000).

| Gross presentation approach | Net presentation approach | Equity presentation |
|---|---|---|
| **31 January 20X3** | **31 January 20X3** | **31 January 20X3** |
| Dr Interest expense CU250 | Dr Put option liability CU1,000 | Dr Equity - option CU1,000 |
| Cr Liability CU250 | Cr Gain CU1,000 | Cr Other Equity CU1,000 |
| *To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.* | *To record the decrease in the fair value of the put option.* | *To record the decrease in the fair value of the put option.* |

| Gross presentation approach | Net presentation approach | Equity presentation |
|---|---|---|
| **31 January 20X3** | **31 January 20X3** | **31 January 20X3** |
| Dr Liability CU98,000 | Dr Equity CU95,000 | Dr Other Equity CU95,000 |
| Cr Cash CU98,000 | Dr Put option liability CU3,000 | Dr Equity - option CU3,000 |
| | Cr Cash CU98,000 | Cr Cash CU98,000 |
| *To record the settlement of the option contract.* | *To record the settlement of the option contract.* | *To record the settlement of the option contract.* |

A9. The financial statements as of 31 January 20X3 after settlement. The following financial statements have been simplified to highlight the differences between the different methods.

| **Income Statement 31 January, 20X3** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Profit/loss for year | 10,000 | 10,000 | 10,000 |
| Interest expense | (250) | - | - |
| Gain on put option | - | 1,000 | - |
| Net Profit/Loss | 9,750 | 11,000 | 10,000 |

| **Statement of Changes in Equity 31 January, 20X3** | **Gross Presentation** | **Net Presentation** | **Equity presentation** | |
|---|---|---|---|---|
| | Issued capital and reserves | Issued capital and reserves | Issued capital and reserves | Put option |
| Beginning balance | 257,250 | 351,000 | 351,000 | 4,000 |
| Net profit/loss for year | 9,750 | 11,000 | 10,000 | - |
| Transfer from put option | - | - | 1,000 | (1,000) |
| Put option sale | - | - | - | - |
| Buy-back of ordinary shares | - | (95,000) | (95,000) | (3,000) |
| Ending Balance | 267,000 | 267,000 | 267,000 | - |

$\underbrace{\hphantom{267,000 \quad -}}_{\text{Total Equity CU267,000}}$

| **Balance Sheet 31 January, 20X3** | **Gross Presentation** | **Net Presentation** | **Equity presentation** |
|---|---|---|---|
| Other assets | 267,000 | 267,000 | 267,000 |
| Total assets | 267,000 | 267,000 | 267,000 |
| Total liabilities | - | - | - |
| Equity | | | |
| Issued capital and reserves | 267,000 | 267,000 | 267,000 |
| Put option | - | - | - |
| Total liabilities & equity | 267,000 | 267,000 | 267,000 |