IASB/FASB Meeting February 2010

IASB agenda reference	**15B**
FASB memo reference	**87**

Project	**Financial instruments with characteristics of equity**
Topic	**Puttable shares and gross up of freestanding written put options**

Introduction

1. This paper discusses puttable shares and freestanding put options. (For convenience, in the discussion of this paper and for this paper only, put options include forward repurchase contracts that are triggered by events that are not certain to occur.) In particular, this paper discusses the interaction of the following three possible decisions:

   (a) Gross-up of freestanding written put options

   (b) Separation of puttable shares

   (c) Classification of freestanding and bifurcated written put options as equity if they require the entity to repurchase a specified number of shares for a specified price.

2. Point (c) relates to whether the specified-for-specified provision (for classification as equity of derivatives that require an entity to issue its own shares) should be extended to derivatives that require the entity to repurchase its own shares. The decision in this project so far only goes in one direction—issuances of shares but not repurchases. IAS 32 currently applies its fixed-for-fixed provision in both directions—issuances and repurchases.

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3. The boards have said in past meetings that derivatives should be treated the same way whether they are freestanding or embedded. Therefore, we have assumed that the same classification will be applied to both a freestanding written put option and the put option embedded in a puttable instrument. Because the most troubling issues arise with the puttable instrument, that issue is discussed first in this paper.

Puttable Shares

4. There are two questions related to the classification of puttable shares that are not classified as equity in their entirety:

   (a) Should they be separated?

   (b) If separated, should the bifurcated option be classified as equity or as a liability?

   (c) And if they are separated, should the embedded put option be presented gross (which is one possible way of treating freestanding written put options)?

5. Previously, the boards decided that puttable shares (other than those that are classified as equity in their entirety) should be separated into a share and a written put option. If the board retains that decision and answers yes to the question about grossing up the separated option, the combination would produce results very similar if not identical to classifying the puttable shares as liabilities in their entirety.

6. If the boards decide that puttable shares should be separated, the liability component would represent a written put option. If the boards decide the liability component should be presented gross, the effect would be very much like classifying the entire puttable instrument as a liability. There would be both a debit and a credit in equity, but the two should be equal since the put and the shares were issued on the same day (as part of the same instrument).

7. If the boards decided to separate but not to gross up the separated written put option, they must decide whether the specified-for-specified provision would apply. If the specified-for-specified provision applies, there would be little point in separating a puttable instrument with a specified put price (as specified is defined in Agenda Paper 15/FASB Memo 85). Both the option and the share would end up in equity with the end result being very similar to classifying the share as equity in its entirety.

8. The complexities raised by interactions of the three issues are so significant that we had significant difficulties in figuring out how to explain them in this paper. This analysis leads us to question why the boards would want to introduce this level of complexity by separating the instrument when the end result will either be to classify the instrument as a liability it its entirety or, for a put with a specified price, as equity in its entirety.

Possible Solutions to Classification of Puttable Shares

9. We have identified two possible solutions to this issue.

   (a) **Do not require separation**—Under this alternative, a puttable instrument would be classified as a liability in its entirety. As a result, some entities may have no equity.[1] In some jurisdictions, limited partnership interests do not meet the criteria for equity classification under the boards' previous decision. Those limited partnership interests are puttable; however, the limited partner does not participate in the management of the partnership. Because the holder only has a financial interest in the partnership and does not participate in the activities of the entity, it does not qualify for equity classification.

   (b) **Require separation but do not gross up the separated put option**—Under this alternative, puttable instruments that do not meet the criteria for

[1]Paragraph 23 of the IASB Discussion Paper on financial instruments with characteristics of equity notes that one of the criticisms of IAS 32 is that the standard results in some entities with no equity instruments.

equity classification would at least have some equity (the equity component).

Up to this point, our analysis has focused on a puttable share; however, an entity could issue a physically settled written put option and a share at the same time, and the overall effect would be similar to issuing a puttable share. If the board chooses to gross up a freestanding put, the debit to equity would equal the credit in equity for the freestanding share. In that case, the overall effect would be one liability. Absent any linkage requirements, different accounting for freestanding and embedded instruments would lead to structuring opportunities.

In a previous meeting, the boards decided to present a mandatorily redeemable share as a liability. An entity could issue a physically settled forward contract and a share at the same time and the overall effect would be similar to issuing a mandatorily redeemable share. The boards also have previously decided to present physically settled forward contracts gross. Similar to the analysis in the preceding paragraph, the debit to equity would equal the credit in equity for the freestanding share. The overall effect would be one liability, however, that result would be consistent with classifying a mandatorily redeemable share as a liability. No linkage requirements would be necessary in that case.

Freestanding Written Put Options

10. The questions about freestanding written put options on an entity's own shares include:

    (a) Should freestanding written put options be treated in the same way as the put options embedded in puttable shares?

    (b) Should freestanding written put options be grossed up; that is, should the entity present a liability for the payment of the put price and an offsetting

debit in equity (to shares receivable or to an account similar to treasury shares)?

(c) Should the specified-for-specified requirement (which currently would apply only to derivatives that require issuances of shares and not to those that require repurchases of shares) be applied?

11. The most logical way to answer the three questions is to consider them in order.

12. If the boards decide to treat freestanding written put options in the same way as the put options embedded in puttable shares, they should consider the issues related to puttable shares first (because they are more complicated and potentially more confusing) and simply apply that decision to freestanding written put options. The other two questions answer themselves.

13. If the boards do not feel that it is necessary to treat freestanding written put options in the same way as embedded put options, then they should consider whether grossing up freestanding put options faithfully represents the entity's economic exposure. The boards previously decided that a forward contract that requires a certain repurchase of shares should be grossed up. That results in treating the forward and a mandatorily redeemable share similarly.

14. Written put options are superficially similar to forward repurchase contracts. However, unless the written put is more than slightly in the money when issued or there are other factors at work (such as linkages with contracts issued at the same time to the same party), the probability that the repurchase will occur is substantially less than 100 percent. That creates different economics and different reporting issues, such as how to explain and account for a gross liability that disappears without being settled (if the option expires unexercised).

15. If the boards answer no to the first two questions, the question about specified-for-specified arises. None of the approaches the boards have considered so far would have resulted in applying that requirement in both directions. One reason why some want to classify contracts to issue shares as equity is that the holder is on the way to becoming an owner and has some of the same risks and rewards as owners.

It contrast, the holder of a written put option is on the way to becoming a non-owner and has risks that are similar in magnitude but opposite in sign to the holder of a written call option or similar instrument.

Question for the Boards

1. Do you agree with the staff recommendation?
2. If not, which of the alternatives in paragraph 9 do you support, and how would you answer the questions in paragraph 10?

Staff Recommendation

16. The staff recommends that puttable shares (other than those that are equity in their entirety because of the special provision related to death, retirement, and so forth) be separated into a share and a written put option, and that the written put option be reported net as a liability even if the exchange is specified-for-specified. The staff further recommends that all freestanding written put options be reported net as liabilities. Any other alternatives raise complicated and confusing issues or result in inconsistent treatment of freestanding and embedded put options.

17. If the board wants to add special provisions to prevent abuses such as issuing shares and an in-the-money put option at the same time to the same party, we recommend a targeted statement that the arrangements of that type should be linked and treated as a single debt instrument. That would be much simpler.