



Memorandum

To:	Members of the FRSB and AASB	Date:	5 March 2010
From:	Sarah Bate	Agenda Item:	B3A.1
Subject:	Financial Instruments with the Characteristics of Equity	File:	--

Action

B3A.1 Note memo from Sarah Bate

B3A.2 Note IASB paper September 2009 – *Classification Approach*

B3A.3 Note IASB paper January 2010 (approach 4.2)

Purpose

1. The purpose of this memo is to update the FRSB and AASB on the progress of the IASB and FASB to simplify and improve the accounting for financial instruments. This is one of three long-term projects on the IASB's agenda to address issues related to financial instruments. IAS 32 *Financial Instruments: Presentation* provides the relevant guidance for distinguishing between asset and liability instruments (non-equity instruments) and equity instruments.
2. The specific aims of this project are to develop a better distinction between equity and non-equity instruments, and to converge IFRS and US GAAP in this area. The project is part of the Memorandum of Understanding between the IASB and the FASB. The project is still very much a work in progress; no final decisions have been taken by either the IASB or the FASB.
3. An Exposure Draft is expected in Q2 2010 and the resulting standard in H1 2011

Background

4. In general, there are two broad classes of criticisms that arise from the distinction set out in IAS 32:
 - (a) a lack of clarification as to how the principles in IAS 32 should be applied; and
 - (b) whether application of those principles results in an appropriate distinction between equity instruments and non-equity instruments.
5. In February 2008 the IASB published a discussion paper on *Financial Instruments with Characteristics of Equity*, which included an invitation to comment and the FASB's November 2007 *Preliminary Views: Financial Instruments with Characteristics of Equity*.

6. The responses were discussed in October 2008 and the following views being the perpetual and basic ownership approaches developed to facilitate an appropriate starting point for discussions between the two Boards:
 - *perpetual approach*: an instrument is classified as equity if it lacks a settlement requirement and entitles the holder to a share of the entity's net assets in liquidation.
 - *basic ownership approach*: an instrument is classified as equity if it is the most subordinated claim and entitles the holder to a share of the entity's net assets.
7. This memo updates the FRSB and AASB as to the progress on this project. Staff has selected the September 2009 joint meeting of the IASB and FASB as an appropriate starting point for the update as that was when the approaches to IAS 32 currently under discussion were formulated.

Terminology

8. The language used in IASB and FASB staff papers, which are the source of information for this memorandum, needs to be carefully considered. This is particularly so when distinguishing between "share-based payments" (equity settled) and "share-settled contracts" such as forwards. Staff also note that the papers do not address the issuance of instruments directly into the market.

Detail

The following paragraphs detail how the IASB and FASB reached the decisions taken to date. The decisions are summarised in paragraph 44 of the memorandum.

September 2009 IASB Meeting

9. Should FRSB and AASB members wish to develop a deeper understanding of the background to Approach 4, staff have appended the IASB Staff *Classification Approach* document at agenda item B3A.2.
10. The objective of the classification approach is to classify as equity those instruments that the entity relies on as the foundation of its capital structure. This could be described as identifying the owners of an entity. The approach is referred to as "Approach 4", as the previous FASB paper *Financial Instruments with Characteristics of Equity* describes three classification approaches, and this is the fourth approach to be developed in this project.
11. The IASB considered the impact of the decisions made on Classification of Rights Issues on this project. The staff pointed out that the approved amendments to IAS 32 are inconsistent with the proposed classification approach. The IASB decided to develop a new principle, (which is Approach 4.1 as described in the October 2009 meeting review below) in the classification approach that would allow including some share-settled instruments to be classified as equity. The IASB Staff pledged to provide additional analysis for October 2009 Board meeting.
12. The IASB then discussed the details of the classification approach as presented by the staff (without reflecting the, as yet underdetermined new principle). The IASB Staff presented a summary of the approach with examples reflecting the principles. The IASB agreed with the basic idea behind those principles, which reflected and further articulated tentative decisions already taken by the Board.

13. The IASB Staff noted that accounting for share-based payments and subsidiaries' instruments in consolidation would have to be addressed for the next meeting. The IASB Staff also noted that the highlighted issue of classification of preferred shares that are mandatorily convertible to equity instruments may be solved by the new principle and would be addressed in that context. Detailed examples reflecting the changes would also be provided for the next meeting.

October 2009 Joint IASB-FASB Meeting

14. In response to the request of the IASB at the September 2009 meeting the IASB Staff developed a new proposal called Approach 4.1 for distinguishing between liability and equity instruments.
15. The Staff asked the Boards whether they were interested in pursuing this approach. Under Approach 4, shares that are issued pursuant to the settling of the contract (that is, all share-settled instruments) would be classified as liabilities regardless of their terms. Under the new Approach 4.1, share-settled instruments would be subject to a separate classification principle, under which the shares that an entity is not using as currency would be classified as equity. In particular, an instrument required to be settled by issuing equity instruments would be equity unless:
- (c) either party has a cash settlement option,
 - (d) it requires net settlement in shares or either party has a net settlement option, or
 - (e) the contract exposes either party to risks of changes in value other than those resulting from share price changes, time value of money, counterparty performance risk, and possibly foreign currency.
16. This classification principle would result in equity classification of certain share-settled instruments like preferred shares convertible into common shares, forwards to sell shares, physically settled written call options, and stock options. These instruments would have been classified as liabilities under Approach 4.
17. Puttable or mandatorily redeemable instruments would be classified as equity if they are redeemable upon death or retirement, or upon the holder ceasing to participate in the activities of an entity. All other puttable or mandatorily redeemable instruments would be separated or classified as liabilities in their entirety.
18. Concerns were raised about the arbitrage and structuring opportunities with Approach 4.1, including unstated cash settlement features. For example, Approach 4.1 would allow an entity to avoid liability classification by writing a gross physically settled written call option (which would be classified as equity) and not having sufficient authorised and unissued shares available to satisfy the contract, in which case the entity would pay the holder cash instead of shares. The economics of the transaction would be the same as if the issuer had written the derivative to be cash settled; the derivative to be cash settled however would be classified as a liability.
19. Some members from both Boards raised concerns that under Approach 4.1 the information about the effects of dilution by particular instruments to shareholders would not be reflected in the financial statements. It was suggested that shareholders should be informed about the dilutive effect of certain instruments through appropriate presentation in the financial statements.

20. The Staff also explained that in relation to developing a definition of a liability in the conceptual framework that is consistent with Approach 4.1, the Staff intended to keep the definition of a liability similar to what is in the current framework (that is, a liability requires a transfer of cash or assets) and to provide exceptions to the definition for share-settled instruments classified as a liability and for cash-settled instruments classified as equity.
21. Most members agreed to pursue Approach 4.1 and to consider ways to resolve arbitrage issues inherent in Approach 4.1.

December 2009 IASB Meeting

Scope exemption for share-based payments

22. The Boards considered granting a scope exemption for share based payments from the requirements of the Financial Instruments with Characteristics of Equity project.
23. The Boards considered this issue in the context of the Approach 4.1 and Approach 4 (as discussed on the October joint meeting). Both Boards preferred to scope out share-based payments from the scope of the project under Approach 4.1. However, some Board members were concerned that a full exemption from the project was not economically justified, especially in the post-vesting period. More specifically, some Board members expressed their preference for a more limited exemption under the Approach 4 (for instance, covering only stock options in the pre-vesting period). Other Board members were concerned that scoping-in share-based payments in the project would re-open the debates that preceded deliberations of share based payments standards on which no consensus existed.
24. The Boards approved a scope exemption for share based payments from the project under both Approach 4 and Approach 4.1.

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

25. The Boards revisited their tentative decision (made in June 2009) that these instruments should be presented net with changes in income (consistent with other derivatives).
26. It was noted that the tentative decision would lead to reporting of many changes of own share price in profit or loss. Consequently, both Boards failed to confirm their original tentative decision.

Classifying share-settled instruments as equity

27. The Boards discussed the decision from the October Joint meeting to pursue Approach 4.1, which would classify some instruments settled by delivering shares as equity. This approach was supported by most of the IASB members. However, most of the FASB members preferred Approach 4 as a starting point for any potential exemptions to a general principle.
28. The Boards debated each of the approaches on classification of convertible debt and fixed-for-fixed condition as well as potential for reduction of scope of the project to amend IAS 32, and agreed to refocus their discussion on the original issue. In October 2009 the Approach 4.1 was perceived as a minor modification of the Approach 4 that

subsequently proved to be more substantive. The Boards asked the Staff to come back to Approach 4 and consider a less substantive modification than Approach 4.1 and present its analysis to the Board at a future meeting.

January 2010 Joint IASB-FASB Meeting

29. In order to give the FRSB and AASB an understanding of the background to Approach 4.2, staff have appended the IASB Staff *Classification of Instruments an entity will settle by issuing its own shares* document at agenda item B3A.3.

Classification of instruments an entity will settle by issuing its own shares

30. The Boards continued their discussion from the December joint IASB-FASB meeting on the classification approach for instruments that an entity is required to settle (and has the ability to settle) by issuing its own shares.
31. The Boards discussed another variant of Approach 4, being Approach 4.2, which would require classification as equity for more instruments than Approach 4.0 and fewer instruments than Approach 4.1 (as defined above). This Approach was developed as a compromise that aimed to alleviate IASB and FASB differences. The particular instruments that would be classified as equity under Approach 4.2 (and not Approach 4.0) would include rights issues and 'regular-way' forward contracts to issue shares that are outstanding for a relatively short time, stock-purchase warrants issued solely for the purpose of raising additional capital as well as mandatorily convertible preferred shares (convertible to ordinary shares). The requirements of Approach 4.2 would result in classifying convertible instruments as liabilities in their entirety.
32. Some IASB members were troubled that these exceptions to the classification criteria have no conceptual basis. The Staff replied that they were exceptions to accommodate the concerns by both of the Boards. The IASB members were particularly concerned that some of these exceptions might lead to otherwise identical stand-alone instruments being treated differently based on the instruments to they are attached.
33. It was stated that first the answer to a more fundamental question whether writing an option on own shares should be classified as equity or as a derivative liability should be addressed. The answer to this question should be the basis for the development of a classification approach.
34. In an indicative vote, the IASB supported classification of forwards/options to issue fixed amounts of shares for cash as equity (15 votes), whereas the FASB was opposed (two votes against three).
35. It was suggested that the basis for the classification should be whether there is a 'determinable obligation' of the entity and should be not dependent on the short-term/long-term horizon.
36. The FASB Chairman pointed out that the issue took the Boards back to the 'dilution' versus 'solvency' perspective which the Boards had already discussed many times. He underlined that this was the tension point between the FASB and the IASB as the IASB was in the 'solvency view' whereas the FASB was in the 'dilution view'. As the IASB was unanimous in this view and the FASB was split, the FASB Chairman expressed his support for the

classification approach 4.2 on the conditions that overall classification principles were tightened and additional disclosures that show dilution effects were provided. The FASB chairman acknowledged that the IASB was 'not particularly unhappy with IAS 32' but that US GAAP needed a change. Therefore, he expressed his willingness to work for a converged compromise.

37. Various IASB members argued for the 'solvency' view. In particular these members were concerned by the impact of the classification of these instruments as liabilities on the performance statement and the potential negative impact on the usefulness of the information provided. The IASB chairman and FASB chairman tried to find a common ground that the majority of both Boards would be able to support. They agreed that the dilution issue could be addressed by a set of comprehensive and consistent disclosures that would capture wealth transfers and address the issue of using operating cash flows to re-purchase the shares (based on issued call options).
38. A FASB member was concerned by the effect of the proposed classification approach on convertible debt and possible arbitrage. That member proposed a classification approach based on the improvement of IAS 32 (that is, bifurcation) and not based on a completely new classification approach. Several IASB members agreed. Nonetheless, other IASB members disagreed as they believed that IAS 32 had its own problems that needed to be addressed. They agreed that the result of the classification might be very similar but urged the Boards to develop a new approach.
39. Consequently, both Boards asked the Staff to develop a modified classification approach ('Approach 5') based on improved and modified IAS 32 requirements, particularly for cash-settled instruments and better articulation of the fixed-for-fixed rule (the Boards briefly discussed the 'specified-for-specified' rule, a modification of the fixed-for-fixed rule designed to make it more granular). The Boards agreed that the staff should include in its analysis the classification of these instruments in the consolidated financial statements as well as the treatment of convertible instruments. At the same time the staff should prepare an analysis of disclosure requirements that would address the dilution aspects of the issue (including wealth transfer and its disclosure in the Statement of Changes in Equity) and granularity of these disclosures.
40. The Boards will discuss the new classification approach at the regular February meeting. The remaining issues that were not discussed during the January meeting will be addressed at a separate special meeting in February.

2nd February 2010 joint IASB-FASB Meeting

41. FRSB Staff note that discussion regarding Financial Instruments with the Characteristics of Equity did not occur at the 2nd of February meeting due to time restrictions.

18th February 2010 joint IASB-FASB Meeting

42. IASB and FASB staff have further considered the paper entitled "Initial Discussion of the Modified IAS 32 Approach" (IASB 3 and FASB 84) that was to have been presented at the 2nd February joint meeting and decided

that it did not represent the best way to go forward with this project. They have requested that these papers be discarded.

Broad Classification Questions

43. The IASB and FASB considered particular financial instruments and their desired classification in order to be able to determine a principle underpinning the model being developed. Firstly, the Boards reaffirmed all their decisions already made during the project. These decisions are detail below for the convenience of the FRSB and the AASB.

Previous Decisions

44. The key decisions made by the boards in previous meetings are more in the nature of rules rather than principles and are as follows:

- (a) Instruments currently accounted for under IFRS 2 *Share-based Payment*, and Topic 718 of the *FASB Accounting Standards Codification* (originally issued as Statement 123 (R) *Share-Based Payment*), are not within the scope of this project.
- (b) Perpetual instruments (instruments not required to be redeemed unless the entity decides to or is forced to liquidate its assets and settle claims against the entity) issued by entities without specified limits to their lives will be classified as equity in their entirety. (That includes both ordinary and preferred shares.)
- (c) The following mandatorily redeemable and puttable instruments (which would have been equity under any of the approaches in the 4 series) will be classified as equity in their entirety:
 - i. Instruments with terms that require, or permit the holder or issuer to require, redemption to allow an existing group of shareholders, partners, or other participants to maintain control of the entity when one of them chooses to withdraw.
 - ii. Instruments that the holder must own in order to engage in transactions with the entity or otherwise participate in the activities of the entity and whose terms require, or permit the holder or issuer to require, redemption when the holder ceases to engage in transactions or otherwise participate.
- (d) All other mandatorily redeemable instruments (instruments that an entity is required to redeem on a certain date or on the occurrence of an event that is certain to occur) will be classified as liabilities.
- (e) Contracts that require or may require an entity to issue a specified number of its own perpetual equity instruments in exchange for a specified price (for example, options, forwards, rights issues, and purchase warrants) will be classified as equity. (For this purpose, the specified number must be either fixed or vary only so that the counterparty will receive a specified percentage of total shares that were outstanding on the issuance date for a specified price.) The specified price must be fixed in the reporting entity's currency unless the domestic currency of the shareholder that holds the derivative (or functional currency if the shareholder is a reporting entity or a unit of a reporting entity) is different from the currency in which the issuing entity issues

- equity instruments to domestic shareholders. In that case, the price may be specified in the currency of the shareholder instead of in the currency of the issuer.
- (f) Instruments that require an entity to issue a specified number of its own perpetual equity instruments for no further compensation will be classified as equity (for example, prepaid forward contracts to issue shares).
 - (g) The entity's ability to issue its own perpetual equity instruments to settle share-settled instruments classified as equity will be assessed at the date that each instrument is issued and at each reporting date thereafter. If, at any time, the entity does not have enough shares to settle a share-settled instrument classified as equity, that instrument will be reclassified as a liability and left there for the remainder of its life.
 - (h) Preferred shares required to be converted into a specified number of common shares on a specified date or on the occurrence of an event that is certain to occur will be classified as equity.
 - (i) Contracts that require an entity to repurchase its own shares on a specified date or on the occurrence of an event that is certain to occur will be separated into a liability representing the amount to be paid (measured according to standards for similar freestanding instruments) and an offsetting debit to equity (grossed up).
45. The IASB and FASB then considered five issues addressing:
- (a) Perpetual instruments issued by limited-life entities;
 - (b) Contracts that require specified-for-specified issuances of equity instruments;
 - (c) Contracts that require the entity to issue a specified number of equity instruments in exchange for no future compensation;
 - (d) Convertible preferred shares; and
 - (e) Classification of subsidiary instruments in consolidated financial statements.
46. The Boards agreed that nominally perpetual instruments issued by limited-life entities should be classified as equity in the separate financial statements of the issuer.
47. The Boards further agreed that, consistent with the previous decisions, contracts that require issuance of specified number of puttable and mandatory redeemable equity instruments for a specified price (which are classified as equity in accordance with previous decisions) and contracts covering derivatives classified as equity would be classified as equity. On the other hand, contracts over puttable instruments that would be bifurcated when issued would be classified as a liability.
48. Contracts that require an entity to issue a specified number of equity instruments in exchange for no future compensation (prepaid instruments) would be classified consistently with contracts that require specified-for-specified issuance of equity instruments (see previous paragraph).
49. The Boards also agreed that mandatorily convertible preferred shares convertible into specified number of perpetual equity instruments or specified number of puttable or mandatory redeemable equity instruments would be classified as equity.

50. Finally, both Boards agreed that the classification of an instrument in a subsidiary's financial statements should be carried forward in the consolidated financial statements unless the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.

Puttable shares and gross-up of freestanding written put options

51. The IASB and FASB staff put forward a paper discussing puttable shares and freestanding put options. In particular, the paper discussed the interaction of the following three possible decisions:

- (a) Gross-up of freestanding written put options;
- (b) Separation of puttable shares; and
- (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.

52. 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.

53. The IASB and FASB have stated in past meetings that derivatives should be treated the same way whether they are freestanding or embedded. Therefore, the IASB and FASB staff assumed that the same classification will be applied to both a freestanding written put option and the put option embedded in a puttable instrument.

54. There are three 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) If separated, should the embedded put option be presented gross (which is one possible way of treating freestanding written put options)?

55. The Boards decided that puttable shares should be separated into a share and a written put option, and that the written put option should be reported net as a liability even if the exchange is specified-for-specified. The Boards further decided that all freestanding written put options should be reported net as liabilities.

56. A member of the IASB preferred grossing up of the separated put option as he believed that the agreed solution should facilitate structuring of the debt as equity. However, most Board members disagreed as they believed that any alternative that contains grossing up could be counterintuitive and extremely complex to implement.

57. The Boards agreed to add special provisions to prevent abuses (such as an example that issuing shares and an in-the-money put option at the same time to the same party should be linked and treated as a single debt instrument).

Convertible debt

58. The IASB and FASB considered bifurcation of convertible debt. The IASB preferred bifurcation of convertible debt as Board members believed that such treatment is more consistent with the overall IASB model. Moreover, the IASB members believed that the existing requirement for bifurcation of convertible debt is well understood, used in practice, and perceived as decision-useful. One IASB member noted, even if convertible debt were classified as liability in its entirety under this project, it would be bifurcated under the proposed guidance for classification and measurement of financial liabilities, which would then require a new set of conditions for bifurcation and result in additional complexity.
59. On this basis the IASB decided to retain the conditions for bifurcation of convertible debt. Views of FASB members were divided, with some members preferring measurement of convertible debt at fair value through net income in its entirety, and others preferring bifurcation. The FASB narrowly decided to proceed with bifurcation.
60. The Boards also considered the methodology for bifurcation. Some Board members preferred a simplified bifurcation method by which the debt component would be allocated on the basis of a 'plain vanilla' instrument with the same maturity date, and the interest rate would be the rate of nonconvertible bond of comparable credit quality from the same issuer (with the remainder allocated to the equity component). Other Board members preferred to retain the IAS 32 bifurcation method, in which any interdependency is allocated to the liability component. Most Board members preferred the simplified method, subject to additional analysis by the staff that would consider potential consequences of such an approach.

11th March 2010 joint IASB-FASB Meeting

61. FRSB and AASB Staff to give a verbal update of discussions and decisions at the 11th March joint IASB and FASB Meeting.

Question for the FRSB

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| <p>62. <i>Does the FRSB and AASB wish to comment on the approach the IASB and FASB are taking towards Financial Instruments with the Characteristics of Equity?</i></p> |
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Next steps

63. Staff will continue to provide the Boards with selected IASB/FASB agenda papers and relevant summaries for consideration as the IASB and FASB progress towards an updated IAS 32.

Attachments

B3A.2 Note IASB paper September 2009 – *Classification Approach*

B3A.3 Note IASB paper January 2010 (approach 4.2)