



Project	Financial instruments with characteristics of equity
Topic	Classification Approach

Introduction and Purpose

1. This paper discusses the same approach discussed at the May 2009 IASB meeting and the May 6, 2009, FASB meeting but describes it differently. The previous description apparently led some board members to believe that the approach is not principles-based. That description has deliberately been changed in an attempt to demonstrate that there are clear underlying principles. Some of the descriptions are unfamiliar (for example, the use of the terms *redemption* to describe distributions to equity holders and *settlement* to describe payments on liabilities), but the approach has not changed.
2. The objective of the approach described in this paper is to classify as equity those instruments that the entity relies on as the foundation of its capital structure. In other words, the objective of the approach could be described as identifying the owners of an entity. The approach is referred to in this paper as *Approach 4*. (The FASB Preliminary Views, *Financial Instruments with Characteristics of Equity*, describes three classification approaches; therefore, this approach is the fourth to be developed in this project).
3. The decision rules presented in the May 2009 paper would still work for the approach described in this paper, but the new description may make them unnecessary.
4. Appendices to this paper include the following:

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

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- (a) Appendix 1 is a list of instruments, which have been considered problematic in the past, that compares the accounting under current standards with the accounting under Approach 4.
- (b) Appendix 2 is a discussion of possible definitions of claims, liabilities, and equity to be considered in the conceptual framework project if Approach 4 is adopted by the boards.

Approach 4

Claim Status

- 5. All claims against an entity must eventually be satisfied (although some will not be satisfied until the entity winds up its affairs and distributes all of its assets). We are using the term *claim status* to mean the order in which the claims are satisfied. Equity interests as a group are the claims against an entity with the lowest claim status. There may be more than one class of equity instruments and those classes may have different rights and obligations and one may have a lower claim status than another. However, an equity instrument is never senior to a liability.
- 6. The discussion of lowest claim status necessarily starts with perpetual instruments. A perpetual instrument is one whose holder has no right to force the entity to distribute assets unless the entity decides to cease its activities and distribute all of its assets. A perpetual instrument always has a very low claim status. If the holder of an instrument cannot require the entity to make a payment, other payments automatically come first. Therefore, except in unusual and deliberately contrived circumstances, a perpetual instrument is equity. (One such contrived circumstance would involve an entity with a specified life in which no payments are made until dissolution. Instruments with a lower claim status issued by such an entity may be liabilities.)
- 7. Holders of equity instruments may receive distributions only if the issuer's ability to make payments required by other instruments has been considered first. An entity

cannot make distributions on equity instruments if doing so would create or significantly increase a risk that the entity cannot make other required payments.

Redemption

8. All liabilities have settlement features either on a specified or determinable date or if specified conditions or events occur. All equity instruments have redemption features (but, for perpetual instruments, only if the issuer chooses to distribute all of its assets).
9. Instruments that do not require redemption unless the entity chooses to wind up its affairs are the lowest claim status instruments issued by that entity and are equity. For the lowest claim status instruments that require payments before distribution of all of the entity's assets, the distinction between settlements of liabilities and redemption of equity instruments is critical.
10. Under Approach 4, the *currency* (cash or shares) used for settlement does not matter. The distinction between settlement and redemption is based on why the instrument is settled or redeemed.
11. *Redemptions* of equity instruments occur for the following reasons:
 - (a) The entity issuing the instrument chooses or is required by an event such as bankruptcy to distribute all its assets
 - (b) The issuer chooses to pay a dividend (partial redemption) or repurchase shares
 - (c) The terms of the instrument require, or permit the holder or issuer to require, retirement of that instrument to allow an existing group of shareholders, partners, or other participants to maintain control of the entity when one of them chooses to withdraw.
 - (d) The terms of the instrument require, or permit the holder or issuer to require, retirement of that instrument when the holder has ceased to

engage in transactions with the entity or otherwise participate in the activities of the entity.

12. In contrast, *settlements* of liabilities have both of the following characteristics:
- (a) The payment date is fixed or determined by events or conditions other than those that determine redemption dates
 - (b) The issuer may be able to influence the timing of the event that triggers settlement but cannot prevent the event or condition from occurring.

Derivative Instruments and Equity-Liability Combinations

Derivative Instruments

13. Derivative instruments represent claims against an entity or rights of the entity. Holders or writers of derivative instruments based on an entity's equity instruments may suffer because of losses or benefit because of profits. However, those claims are not equity under Approach 4 because they fail one or both of the criteria for equity instruments.
14. First, the claim against the writer of a derivative instrument is seldom, if ever, among the lowest status claims against that entity. If the derivative instrument calls for the writer to issue its own equity instruments, the issuance of those instruments would not endanger the claims of the entity's creditors. Those creditors probably would be indifferent to derivative instruments settled with equity instruments. If the derivative instrument requires delivery of assets, it is possible that the claim could be among the lowest status claims against the entity. However, that is not common practice as we understand it. As we understand the market, derivative instruments would usually have a relatively high standing and may even require collateral if the issuer's credit rating is not above a specified level.
15. Second, even if the claim is a very low status claim, the delivery of assets or issuance of equity instruments under a written derivative instrument is required on a fixed date or on the occurrence of an event that the writer has no ability to prevent. Therefore,

that delivery or issuance is a settlement of a liability instead of redemption of an equity instrument.

16. Treating equity derivatives such as call options, put options, purchase warrants, and forward purchase or sale contracts as derivative instruments means that they will be subject to the same requirements as derivatives that are unrelated to the writer's or holder's own stock. That is, they will be reported net and measured at fair value through profit and loss.
17. Share-based-payment transactions with employees are a very special case. They raise scope issues that will be discussed in a separate paper to be presented later.

Instruments with Settlement Obligations and Redemption Obligations (Equity-Liability Hybrid Instruments)

18. Some instruments have both liability features and equity features (equity-liability hybrid instruments). There are two types of equity-liability hybrid instruments.
19. One type of equity-liability hybrid instrument has both a settlement *and* a redemption (both occur). A perpetual share with a required dividend is an example of a hybrid instrument with two separate outcomes.¹ The issuer must pay cash on a specified date or if specified events occur (liability feature) but the perpetual instrument remains outstanding until and unless the entity distributes all its assets (equity feature). In other words, the instrument has equity features and, at particular times, it also requires the issuer to transfer cash (settlement).
20. The other type of equity-liability hybrid instrument has a settlement *or* a redemption, only one of which will occur:
 - (a) An otherwise perpetual instrument that gives the holder the option to require the issuer to settle the instrument (an embedded written put option)

¹Another common example is an ordinary share with a registration rights penalty. A registration right penalty is a promise to remit consideration to an investor if an instrument held by the investor is (a) not registered for public trading by a specified date or (b) not listed on a stock exchange by a specific date.

- (b) An otherwise perpetual instrument that is required to be settled upon a specified event or condition that is not certain to occur (an embedded forward purchase contract that does not apply unless triggered by an event or condition).

21. Approach 4 would deal simply and directly with both types of equity-liability hybrid instruments by separating them into equity components and liability components. The equity component would be measured at an allocation of the original transaction price and the liability component would be accounted for based on its nature. If the liability component is a derivative, it would be accounted for like any other embedded derivative that has been separated from its host. If the liability component requires a fixed payment or stream of payments, it would be accounted for like other instruments with fixed payments.

Convertible Debt Instruments

22. Many different types of instruments have been described as convertible debt instruments, and some have many different and complicated features. Under Approach 4, the only thing that matters is that all convertible debt instruments of which we are aware require settlement either in cash or by issuing equity instruments. Therefore, convertible debt instruments would be classified as liabilities. Some or all convertible debt instruments may be required by other authoritative literature to be measured at fair value or separated into a host contract and an embedded derivative and accounted for accordingly.

Mandatorily Redeemable Instruments

23. Instruments that are equity in legal form but that require the issuer to make a payment on a fixed date or on the occurrence of an event that is certain to occur are called *mandatorily redeemable* in the United States and *puttable* in other places. Despite the label, those instruments would not be classified as equity under Approach 4. The

payment would be considered a settlement of a liability as discussed in paragraph 12 of this paper.

Questions for the board

Questions

1. Is Approach 4 understandable?
2. Is it what you expected based on previous board discussions? If not, what aspects differ from your expectations?
3. Would you expect to support Approach 4 if the following issues can be resolved to your satisfaction?
 - a) Accounting for share-based payments
 - b) Accounting of subsidiaries' instruments in consolidation
 - c) Classification of preferred shares that are mandatorily convertible to equity instruments.
4. If not, are there other specific issues that concern you, or do you oppose the basic features of the approach?

Appendix 1

	Instrument	Approach 4	Current IFRS	Current U.S. GAAP²
1	Common share	Equity	Equity	Equity
2	Perpetual preferred share	Equity	Equity	Equity
3	Share issued by a limited life entity	Equity	Liability or Equity³	Equity
4	General partnership interest Classification assumes that (a) the general partner takes an active role in the management of the partnership, (b) the instrument must be redeemed if the general partner retires from the partnership, and (c) the partnership does not liquidate upon the partner's redemption	Equity	Liability or Equity³	Equity

²Current U.S. generally accepted accounting principles (GAAP) include the requirements of *FASB Accounting Standards Codification*TM Topic 480 (originally issued as FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*) before the deferral under FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No., 150*. Instruments denoted by a * indicate those that might have been subject to an indefinite deferral for certain nonpublic entities.

³ IAS 32, *Financial Instruments: Presentation*, classifies instruments that are required to be redeemed and that are redeemable at the option of the holder as financial liabilities unless they have particular features and meet particular conditions.

	Instrument	Approach 4	Current IFRS	Current U.S. GAAP²
5	<p>Limited partnership interest</p> <p>Classification assumes that the (a) limited partner does not participate in the management of the partnership, but, rather, only has a financial interest in the partnership, (b) instrument is redeemable at the option of the partner, and (c) partnership does not liquidate upon the partner's redemption</p>	Liability and Equity	Liability or Equity³	Equity
6	<p>Limited liability partnership instrument</p> <p>Classification assumes that the (a) limited liability partner takes an active role in the management of the partnership, (b) instrument must be redeemed if the partner retires from the partnership, and (c) partnership does not liquidate upon the partner's redemption</p>	Equity	Liability or Equity³	Liability*

	Instrument	Approach 4	Current IFRS	Current U.S. GAAP²
7	Ownership instrument that is redeemable at the option of the holder (other than upon retirement or death)	Liability and Equity	Liability or Equity³	Equity (Temporary equity for public companies)
8	Ownership instrument that is required to be redeemed if an uncertain event occurs	Liability and Equity	Liability or Equity³	Liability*
9	Ordinary share with a required dividend	Liability and Equity	Liability and Equity	Equity
10	Ordinary share with a substantive registration rights penalty ⁴	Liability and Equity	Liability and Equity	Liability and Equity
11	Preferred share convertible into variable number of ordinary shares at the option of the holder	Liability and Equity	Liability	Equity
12	Preferred share that is required to be converted into a variable number of ordinary shares on a specific date or event that is certain to occur (other than death or retirement)	Liability	Liability	Equity
13	Instrument issued by a cooperative that gives the holder the right to request redemption, but the cooperative can refuse that request	Equity	Equity	Equity

⁴A promise to remit consideration to an investor if an instrument held by that investor is (a) not registered for public trading by a specified date or (b) not listed on a stock exchange by a specified date.

	Instrument	Approach 4	Current IFRS	Current U.S. GAAP²
14	Instrument issued by a cooperative that must be redeemed upon the holder's death, retirement, or decreased participation	Equity	Liability or Equity³	Liability*
15	Instrument that <i>converts</i> mandatorily on a specific date or event that is certain to occur (other than death or retirement) into a variable number of share instruments with a fixed monetary amount (for example, share-settled debt)	Liability	Liability	Liability
16	Written call option, warrant, share-settled stock appreciation right (SAR), and employee stock option settled with shares ⁵	Liability	Equity⁶	Equity
17	Net-cash-settled written call option and cash SAR	Liability	Liability	Liability
18	Physically, net-cash- or net-share-settled forward purchase contract at a fixed price	Liability or Asset	Liability or Asset	Liability or Asset
19	Prepaid forward purchase contract for a fixed number of shares	Asset	Contra-equity⁷	Generally, Contra-equity

⁵ The implications of applying the principles developed in this project to instruments within the scope of Topic 718 (originally issued as FASB Statement No. 123 (revised 2004), *Share-Based Payment*) and IFRS 2, *Share-based Payment*, will be discussed at a later date.

⁶ Classification as equity assumes that the instrument will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of its own equity instruments.

	Instrument	Approach 4	Current IFRS	Current U.S. GAAP²
20	Physically, net-cash- or net-share-settled written put option	Liability	Liability	Liability
21	Prepaid written put option for a fixed number of shares	Asset	Contra-equity⁷	Generally, contra-equity
22	Convertible debt for fixed number of shares	Liability	Equity and Liability	Liability⁸
23	Share redeemable at the option of the issuer (callable share)	Equity	Equity	Equity
24	Preferred share convertible into a fixed number of ordinary shares at the option of the holder	Liability and Equity	Equity⁹	Equity
25	Preferred share puttable, callable, and convertible	Liability and Equity	Liability	Equity (Temporary equity for public companies)
26	Note receivable settled with cash or a variable number of shares ¹⁰	Asset	Asset	Asset (if cash settled) Contra-equity (if share settled)

⁷ Classification as contra-equity assumes that the issuer has prepaid a fixed amount of cash and that the instrument will be settled by the issuer receiving a fixed number of its own equity instruments.

⁸ Classification assumes the instrument is not within the scope of Subtopic 470-20 (originally issued as FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*).

⁹ Classification as equity assumes that the preferred share includes no other contractual obligations.

¹⁰The example assumes the counterparty can choose the form of settlement. That fact is relevant to current U.S. GAAP classification only.

	Instrument	Approach 4	Current IFRS	Current U.S. GAAP²
27	Debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash)	Liability	Liability	Liability (with a separated embedded derivative)

Appendix 2

Possible Definitions of Claims, Liabilities, and Equity under Approach 4

Definition of claims

- A1. Claims against an entity are existing rights of other parties (entities or individuals) to compel the entity to take actions it would not take without compensation (or additional compensation) if the claim did not exist. Those compelled actions are referred to as performance in this Appendix.

Discussion of the definition of claims

- A2. Claims are created by contract, statute, regulation, common law, legal codes, judicial actions, and other authoritative bodies or actions. Claims do not exist unless there is an outside party to enforce them. An entity cannot be obligated to itself.
- A3. Some, but not all, claimants (parties with the right to compel an entity to take actions) may have a right to receive something or otherwise benefit directly from the compelled entity's performance. For example, creditors have the right to receive cash from the debtor and taxing authorities have the right to receive cash from taxpayers with unpaid taxes.
- A4. In contrast, some statutes, such as environmental remediation requirements, give a claimant—a government or agency—the right to compel an entity to take a particular action without giving any particular entity the right to receive anything from the compelled entity.
- A5. Performance includes, but is not limited to, delivering cash or other assets, exchanging assets on unfavorable terms, providing services, and issuing financial instruments.

- A6. Performance does not include avoiding actions. Covenants not to compete do not create claims. Covenants associated with debt agreements do not create claims (but of course the debt itself is a claim). Laws prohibiting certain actions do not create claims, but violating the law may create a claim by the statutory authority for a fine or remedial actions.
- A7. Different claimants have different rights to demand performance by the entity as follows:
- (a) Immediately or any time the claimant chooses (possibly within a specified range of dates)
 - (b) In the future, at fixed times or times determined by events or circumstances
 - (c) Only if specified events occur or conditions exist
 - (d) Only if the entity winds up its affairs or otherwise chooses to distribute some or all of its assets.

Definitions of liabilities and equity

- A8. Claims are classified as either liabilities or equity.
- A9. Liabilities are existing claims that will require settlement. Settlement includes payments with the following characteristics:
- (a) The payment date is fixed or determined by events or conditions other than those that determine redemption dates
 - (b) If the payment is determined by events or conditions, the issuer may be able to influence the timing of the event or condition that triggers settlement but cannot prevent the event or condition from occurring.
- A10. Equity includes existing claims that will require redemption and net assets not subject to claims by other parties (if any). Redemptions are payments that occur for one of the following reasons:

- (a) The entity issuing the instrument chooses or is required by an event such as bankruptcy to distribute all its assets
- (b) The issuer chooses to pay a dividend (partial redemption) or to repurchase shares
- (c) The terms of the instrument require or permit the holder or issuer to require retirement of that instrument to allow an existing group of shareholders, partners, or other participants to maintain control of the entity when one of them chooses to withdraw, especially in organizations with a relatively small number of equity holders who actively participate in making decisions about the entity's activities.

A11. The terms of the instrument require or permit the holder or issuer to require retirement of that instrument when the holder has ceased to engage in transactions with the entity or otherwise participate in the activities of the entity.